

**CMA Market Investigation into Veterinary Services for Household Pets
IVC Response to CMA Profitability Working Paper**

IVC welcomes many of the CMA's proposals and its acknowledgement of the challenges facing its profitability analysis, as well as the need to address those challenges.

However, as set out in this response, there are fundamental challenges that require significant work to overcome and properly address. If, despite its best efforts, the CMA is unable to develop a robust analysis, then the CMA cannot reliably place any weight on this analysis in its assessment of the market.

1. Overview

1.1 The CMA has confirmed in its *'Approach to profitability and financial analysis'* Working Paper ("Working Paper") that it intends to conduct an economic profitability analysis using a return on capital employed ("ROCE") versus WACC methodology, including calculating absolute economic profits.

1.2 In Section 2 below IVC outlines in table format its key comments on the Working Paper. IVC expands on, and provides supporting evidence on those comments, in Sections 3-9.

1.3 In this Overview Section, IVC sets out the following overarching concerns:

- (i) If the CMA is to provide any meaningful estimates of profitability, it needs rapidly to adopt a revised methodology in order to address the significant data and methodological challenges particular to the vets sector. See sub-section (A) below.
- (ii) It is not appropriate for the CMA to assess the profitability of LCG's veterinary businesses in aggregate. See sub-section (B) below.
- (iii) The CMA needs to set out in more detail its proposed approach to WACC – well ahead of the next Working Paper, such that input from IVC and others can be meaningfully reflected in that Working Paper. See sub-section (C) below.
- (iv) Given the challenges it is facing, if the CMA is to be successful in developing a robust profitability assessment, it needs to engage intensively with parties on methodology – starting with a round table discussion.

(A) If the CMA is to provide any meaningful estimates of profitability, it needs rapidly to adopt a revised methodology in order to address the significant data and methodological challenges particular to the vet sector.

- 1.4 **A ROCE analysis in the vets sector will face significant data and methodological challenges.**¹ These challenges are in part due to the history of the vets sector and the nature of the small independent businesses acquired by the LCGs. Specifically:
- (i) **Net book value (“NBV”) is a very poor approximation for the replacement cost of IVC’s tangible fixed assets.** This is driven by at least two significant shortcomings: (1) the fixed asset register is incomplete, [CONFIDENTIAL] of in-use assets found at clinics during a pilot verification exercise were not recorded on the asset register (which will in part be reflected in accounting goodwill upon acquisition of practices); and (2) a significant number of fixed assets (of those that are even on the fixed asset register) have a NBV substantially lower than replacement cost, including a number of live assets that have a NBV of zero. Adjusting for both of these issues at a sample of IVC’s clinics almost trebles NBV relative to the NBV recorded on the asset register. Relying on accounting data will therefore provide meaningless results. (Section 4).
 - (ii) **Intangible assets are substantial in the vets sector, but are not fully reflected in the balance sheet.** The importance of intangible assets to the operation of a successful vet practice (e.g. customer relationships, vet practice reputation / brand, know-how / intellectual capital) which are built up over years prior to acquisition is a key reason behind the LCG acquisition-based growth strategy. IVC has invested to acquire these intangible assets, which are included within the substantial amount of goodwill within the balance sheet. The alternative organic growth model would require substantial investment to build these intangible assets from scratch. (Section 5).
- 1.5 **The CMA’s Working Paper recognises these challenges**, and the CMA plans to “*make adjustments to financial information... where it is likely to make a material difference to our assessment,*”² and “*will consider the most appropriate approach.*”³
- 1.6 **These challenges and data limitations are fundamental** and are particularly acute given the vet sector is service-based and therefore relatively (tangible) asset-light. Even small measurement errors in the data can materially skew ROCE estimates. **If the CMA is to continue with a ROCE approach, it is imperative that the CMA’s methodology for asset revaluation robustly addresses these challenges.** This is essential if the CMA’s analysis is to provide economically meaningful and reliable ROCE estimates.
- 1.7 **Addressing these challenges requires the CMA to adopt a revised methodology – one that goes beyond adjustments to accounting data and effectively ‘starts from scratch.’** The solutions to these challenges are not straightforward (even within the context of the past economic profitability analyses the CMA has conducted in other MIRs), nor is the information to address them readily available “off the shelf.” The CMA’s usual approach to ROCE analysis is to start with accounting data and make adjustments. However, IVC’s (and likely other LCGs’) accounting data provides a wholly inadequate

¹ See IVC’s Economic Profitability Analysis submission.

² CMA Working Paper, para. 4.29

³ CMA Working Paper, para. 4.47

starting point for an economic profitability analysis, which can only lead to the CMA deriving inaccurate and implausible ROCE estimates.

- 1.8 **IVC has previously submitted evidence to the CMA demonstrating the scale of these challenges and how material they are to the CMA’s assessment.** IVC’s analysis shows that correcting for these challenges using ‘proof of concept’ approaches has a clear and material impact, **increasing the MEAV of IVC’s fixed assets by 4 times the value recorded on the balance sheet.** This brings IVC’s ROCE down from an implausible starting point to a level that would be expected in a competitive market.
- 1.9 **IVC has considered how to address these challenges in a robust but practical way, including appropriate alternative valuation approaches.** IVC has already shared with the CMA a proposed methodology on ‘proof of concept’ approaches including: (1) rebuild cost estimates for tangible fixed assets; (2) clinic start-up losses; and (3) marketing / customer acquisition cost approach for intangible assets. The CMA has the opportunity to build on this work; develop a full and detailed methodology; and extend the analysis across the market, in order to develop a robust ROCE methodology and analysis.

If the CMA is unable to develop a robust analysis, then the CMA cannot reliably place any weight on this analysis in its assessment of the market.

(B) It is not appropriate to assess the profitability of LCG’s veterinary businesses in aggregate (Section 3)

- 1.10 **The CMA’s Working Paper outlines that it is considering assessing the profitability of each LCG in aggregate.** The CMA proposes “*to assess the profitability of the veterinary services operations of each LCG*” and not “*assess separately the economic profitability of the different types of veterinary services*”.⁴
- 1.11 **IVC strongly disagrees with the CMA’s approach to assess all activities in aggregate.** In IVC’s view, it is critical to distinguish between the *clinical* veterinary services of each LCG (FOP, referral centres, animal hospitals, OOH) and the *non-clinical* veterinary services of each LCG (pet crematoria, online pharmacies, external diagnostics laboratories). The CMA should assess profitability focusing on the core clinical veterinary services of each LCG, and exclude non-clinical veterinary services. This is because:
- (i) Non-clinical veterinary services are fundamentally different businesses compared to clinical veterinary services – with different assets, cost structures and supply and demand characteristics.
 - (ii) LCGs have a range of different business models and offer a different mix of non-clinical veterinary services. An aggregate group profitability analysis will limit comparability across LCGs, and between LCGs and mid-tier firms and independent veterinary practices who only offer clinical veterinary services.

⁴ CMA Working Paper, para. 4.38

- (iii) An aggregate group profitability analysis will not be informative in helping the CMA's diagnosis of where potential competition issues lie...

(C) The CMA needs to set out in more detail its proposed approach to WACC – well ahead of the next Working Paper such that input from IVC and others can be meaningfully reflected in that Working Paper. (Section 6).

- 1.12 At a high level, the CMA's approach to WACC seems reasonable but there are a number of technical choices which must be made when estimating each WACC parameter (e.g. financial gearing, comparable beta sample, debt indices). The CMA has not yet provided any detail on these.
- 1.13 These elements could have a significant impact on the WACC calculation and will be challenging to estimate for the vets sector.
- 1.14 It follows that it would not be sufficient for the CMA to set out its proposed approach to WACC "*around the same time as the profitability WP.*" Doing so would not allow parties to comment in a way that can be meaningfully reflected in the CMA's profitability Working Paper.
- 1.15 In some previous market investigations, for example Private Healthcare, the CMA did publish a planned methodology for the cost of capital well in advance of its overall profitability analysis working paper. Furthermore, given the CMA does not plan to publish the Profitability Working Papers until after January, the available time for the CMA to gather further views on these topics is limited.
- 1.16 IVC requests the CMA provides a detailed proposed approach on WACC well ahead of the next Working Paper.

(D) Given the challenges it is facing, if the CMA is to be successful in developing a robust profitability analysis it needs to engage intensively with parties on methodology – starting with a round table discussion.

- 1.17 The CMA is required to conduct the analysis in a relatively short period of time.
- 1.18 If the CMA is to develop a robust economic profitability analysis in this timeframe, the publication of the CMA's Working Paper needs to be the start of an intensive period of ongoing engagement and collaboration between the CMA and the LCGs. In IVC's view **an important next step is for the CMA to host a roundtable with LCGs now** as it starts to develop its methodology in more detail, and IVC repeats its request to the CMA to engage with this suggestion.

2. Summary of key comments on the Working Paper

2.1 Table 2.1 below summarises IVC’s key comments on the CMA’s Working Paper, which IVC expands on, and provides supporting evidence on, in the remainder of this paper.

Table 2.1: Summary of IVC comments

CMA’s proposed approach	IVC comments
Section 3: Approach to profitability analysis for the LCGs	
<p>Assessing in-scope activities: Aggregate vs segmented profitability analysis</p> <p>The CMA proposes “<i>to assess the profitability of the veterinary services operations of each LCG</i>” and not “<i>assess separately the economic profitability of the different types of veterinary services.</i>” (WP, para. 4.38)</p>	<p>IVC strongly disagrees with the CMA’s proposal to assess the profitability of <i>all</i> of the veterinary services for each LCG together in aggregate.</p> <p>IVC considers it reasonable to assess profitability of LCG’s <i>clinical</i> veterinary services in aggregate at the group level (i.e. combining FOP, referral centres and OOH sites).</p> <p>But <i>non-clinical</i> veterinary services need to be excluded from this (e.g. pet crematoria, online pharmacy etc.). (Paras. 3.3 to 3.10)</p>
<p>ROCE vs WACC</p> <p>The CMA proposes to undertake a ROCE vs WACC methodology.</p> <p>The CMA recognises that a ROCE analysis:</p> <ul style="list-style-type: none"> • Can be susceptible to a number of distortions (WP, para 4.8) • Requires adjustments to accounting figures (WP, para. 4.17) • Requires a number of assumptions to be made (WP, para 4.11) • Can be sensitive to the assumptions made, especially around asset valuations (WP, para 4.11) 	<p>The CMA has rightly acknowledged the limitations and sensitivity of a ROCE analysis.</p> <p>These issues are particularly acute for the vets sector. The CMA will face significant data and methodological challenges in conducting a ROCE in the vets sector, not least because accounting data in the vets sector is a wholly inadequate starting point.</p> <p>The CMA has previously acknowledged that “<i>Asset valuation is typically one of the most significant problems faced in estimating ROCE...difficulties may occur in sectors with low levels of physical assets and high intangibles,</i>”⁵ as is the case for vets.</p>

⁵ Competition Commission, 2011, Local Bus Services Market Investigation, Final Report Appendices 9.1 to 10.4, para. 10.34

<p>The CMA plans to revalue assets to ensure estimates reflect the true value to the business / replacement cost. (WP, paras. 4.47, 4.61)</p> <p>The CMA states that it will also be “<i>mindful of the sensitivity of [its] analysis and results to key assumptions and undertake sensitivity analysis where appropriate.</i>” (WP, para. 4.98)</p>	<p>IVC therefore supports the CMA’s proposal to revalue assets appropriately, and conduct sufficient sensitivity analysis.</p> <p>If the CMA is to adopt a ROCE approach, it is imperative that the CMA’s methodology for asset revaluation robustly addresses the data challenges and limitations – in particular (i) NBV is a very poor approximation for the replacement cost of tangible fixed assets; and (ii) intangible assets are substantial in the vets sector, but are not fully reflected in the balance sheet.</p> <p>IVC would expect the CMA to conduct sensitivity analysis of key assumptions at a minimum, but this may not be sufficient for the CMA to produce a reliable analysis, given the fundamental challenges of conducting a ROCE analysis in the vet sector. The CMA must ensure the inherent uncertainty that exists in relation to ROCE estimates given these challenges are appropriately reflected in any conclusion drawn from the analysis.</p> <p>If the CMA is unable to develop a robust approach to asset valuation, then the CMA cannot reliably place any weight on this analysis in its assessment of the market. (Paras. 3.11 to 3.17)</p>
<p>Additional analysis for diagnosis of profitability levels in the LCGs</p> <p>The CMA does not propose to undertake price and/or margin benchmarking against other professional service sectors in the UK or other veterinary businesses in other countries given comparability challenges. (WP, para. 4.107)</p>	<p>IVC agrees with the CMA that benchmarking will face comparability challenges.</p> <p>However, this means the CMA may have limited additional quantitative analysis to stress test the ROCE results.</p> <p>IVC is therefore concerned that the scope of the CMA’s additional analysis will be insufficient to provide the CMA with the reassurance required that its ROCE results are reasonable. Accordingly it is imperative the CMA seeks to address the fundamental challenges facing the analysis. (Paras. 3.18 to 3.22)</p>
<p>Time period under consideration</p>	<p>IVC supports this on the basis that it is an improvement to the current time period.</p>

<p>The CMA proposes to “gather information for a further two years, covering a five year historical period in total.” (WP, para. 3.9)</p>	<p>However, five years is still a relatively short period of time for the purposes of an economic profitability analysis. (Paras. 3.23 to 3.24)</p>
<p>Section 4: Approach to asset valuation: tangible fixed assets</p>	
<p>Tangible fixed assets</p> <p>The CMA recognises that the accounting values of assets may not reflect replacement cost, and the CMA acknowledges the LCGs’ views that NBV is not a good approximation for modern equivalent asset value (MEAV). (WP paras. 4.19, 4.47)</p>	<p>IVC welcomes the CMA’s recognition of these challenges, and is keen to emphasise how poor NBV is as an approximation for MEAV. It is an entirely inadequate starting point for the CMA’s analysis. (Paras. 4.3 to 4.23)</p>
<p>Approach to asset valuation: Tangible fixed assets</p> <p>The CMA is considering the most appropriate approach for revaluing tangible fixed assets, and the CMA has asked for views on alternative methods of valuation including: insurance, rebuild estimates and second-hand market. (WP, para. 3.9)</p>	<p>Absent a better alternative, IVC considers CMA asset valuation must include a rebuild approach. Conducted thoroughly and using a robust methodology, this is the best approach for estimating MEAV of tangible fixed assets of vet operators. This approach considers what it would cost if an operator had to fit-out and equip a veterinary clinic from scratch. It relies on actual costs; avoids unnecessary complexity; and addresses the issue of missing assets. (Paras. 4.31 to 4.41)</p> <p>The second-hand market is not a viable approach: there is no liquid and comprehensive second-hand market for veterinary services equipment. (Para. 4.26)</p> <p>Insurance is not a viable approach: For the reasons set out at paras. 4.27 to 4.30 IVC’s insurance coverage is an inadequate proxy for the MEAV of its fixtures and fittings, and equipment.</p>
<p>Tangible fixed assets: Leased properties</p> <p>The CMA proposes to capitalise leases to avoid the distortive effect on ROCE, given that all LCGs lease a portion or all of their property assets. (WP, para. 4.45)</p>	<p>IVC fully supports this approach and welcomes the CMA’s recognition that this can distort ROCE. (Paras. 4.44 to 4.49)</p>
<p>Section 5: Approach to asset valuation: intangible assets</p>	
<p>Importance of intangibles</p> <p>The CMA notes that “the LCGs include very high amounts for intangible assets on their</p>	<p>The CMA rightly recognises the high value of intangible assets. The importance of intangible assets to the operation of a successful vet practice (e.g. customer</p>

<p><i>balance sheets, including goodwill, software, and brand and reputation assets such as customer relationships, know-how and trade names</i>". (WP, para. 4.49)</p> <p>The CMA recognises that <i>"the LCGs may have avoided incurring higher customer acquisition costs under the organic model (for example marketing costs and one or more years of losses during the start-up phase."</i> (WP, para. 4.58)</p> <p>The CMA recognises that <i>"an element of goodwill may represent the value of intangible assets not capitalised on a business's balance sheet."</i> (WP, para. 4.38)</p>	<p>relationships, vet practice reputation / brand, intellectual capital) is a key reason behind the LCG acquisition-based growth strategy.</p> <p>IVC has invested to acquire these intangible assets, and the CMA rightly recognises that goodwill on the balance sheet will in part reflect the value of intangible assets acquired (as well as the significant underestimation of fixed tangible assets). (Paras. 5.3 to 5.5)</p>
<p>Brand/reputation assets</p> <p>The CMA considers that brand / reputation assets (including customer relationships, trade names and know-how) <i>"meets two of the CMA's three criteria for recognition of intangible assets."</i> (WP, para. 4.59)</p> <p>However, the CMA considers it <i>"unlikely"</i> that brand / reputation assets meet its third criteria, i.e. that it is an asset separable from the general running of the business. (WP, para. 4.59)</p> <p>The CMA highlights examples of customer lists / relationships being acquired in the vets sector as a standalone asset separately from other business assets. (WP, footnote 59)</p>	<p>IVC agrees that brand and reputation assets clearly meet the first two criteria.</p> <p>However, IVC strongly disagrees that brand / reputation assets do not meet the CMA's third criteria, i.e. a separable asset.</p> <p>The CMA has highlighted examples of customer lists being acquired separately within the vets sector. The ability to buy and sell a standalone asset must surely be the clearest possible evidence that the asset is separable.</p> <p>The CMA recognised this in the Energy Market Investigation. In concluding that customer lists are separable it stated, <i>"they form assets that are separable from any arising from the general running of the business... demonstrated by the fact that customer relationships can be sold by one firm to another."</i>⁶</p> <p>The test of the CMA's third criterion is not that every transaction must be designed in such a way, but only that the asset is separable such that a transaction could be. Accordingly, exclusion of brand / reputation is not reasonable. (Paras. 5.7 to 5.10)</p>

⁶ CMA, 2016, Energy Market Investigation Final Report, Appendix 9.10: Analysis of retail supply profitability – ROCE, para. 6

<p>Approach to asset valuation: brand/reputation intangible assets</p> <p>The CMA recognises that <i>“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, using a cost based approach.”</i> (WP, para. 4.6)</p> <p>The CMA confirms that <i>“there are two approaches which we are currently considering, in order to estimate the replacement cost of a firms’ brand and/or reputation assets: marketing costs, as a proxy for the value of a firm’s customer relationships, and start-up losses, as a proxy for the investment required to build the necessary intangible assets in the start-up period.”</i> (WP, para 4.61)</p>	<p>IVC strongly supports this. IVC agrees with both of these approaches in principle (assuming sufficient data is available to the CMA and it is able to develop a robust methodology), and both offer a cost-based method for valuing brand and reputation assets.</p> <p>Both of these approaches are likely to conceptually underestimate the true value of intangible assets (i.e. do not reflect know-how; unpaid hours invested by “owner-vets” and other staff in the start-up phase; marketing costs only capture customer relationships). However, IVC considers them to be the most suitable approach, absent any better alternative. (Paras. 5.11 to 5.15)</p>
<p>Section 6: Approach to calculating WACC</p>	
<p>The CMA proposes to calculate a market-based WACC for a notional stand-alone provider of veterinary services. (WP, para. 4.65)</p> <p>The CMA proposes to estimate beta using the two listed LCGs – CVS and Pets at Home. (WP, para. 4.69)</p>	<p>IVC requests the CMA provides a detailed proposed approach on WACC well ahead of the next Working Paper, such that the CMA is able meaningfully to reflect comments from IVC and others in that Working Paper. The current Working Paper provides no detail on the important technical choices it will make. (Para. 6.4). The CMA’s suggestion of only providing its proposed approach on WACC around the same time as the profitability working paper would undermine the procedure followed by the CMA with respect to its analysis on profitability.</p> <p>IVC disagrees with the CMA’s proposal to estimate beta using Pets at Home. Pets at Home is predominantly a retailer and, as such, is wholly unrepresentative of a stand-alone veterinary provider. (Paras. 6.5 to 6.6(ii))</p>
<p>Section 7: Assessment of potential inefficiencies</p>	

<p>The CMA proposes to “<i>assess potential inefficiencies through an analysis of costs, as well as a review of internal documents.</i>” (WP, para. 4.77)</p> <p>The CMA also recognises that there could be legitimate reasons for cost variation not related to inefficiency. (WP, para. 4.75)</p>	<p>IVC strongly disagrees with the CMA’s proposal.</p> <p>Any attempt by the CMA to assess inefficiencies will be highly speculative, given the complexities of the sector and company knowledge required to make a well-informed assessment.</p> <p>More generally, any competitive market will involve firms with a temporary efficiency advantage over rivals, and these firms should expect to be able to earn a return in relation to this competitive advantage. (Para. 7.2)</p> <p>IVC would note that one of the benefits of corporatisation within the vets sector is to increase efficiency. (Paras. 7.3 to 7.4)</p>
<p>Section 8: Approach to profitability analysis for the independent vet businesses</p>	
<p>The CMA proposes to “<i>analyse profit margins of smaller vet businesses</i>” and not calculate ROCE given data challenges. (WP, para. 4.89)</p>	<p>IVC notes that the same data challenges are also relevant to LCGs, and there is no conceptual reason why the CMA could not estimate a ROCE for smaller vet businesses using the same revaluation approaches it will adopt for the LCGs. (Para. 8.3(i))</p> <p>The CMA will need to make appropriate adjustments to ensure the profit margins of smaller vet business are comparable to the LCGs (e.g. reflecting different accounting approaches). (Para. 8.3(iv))</p> <p>The CMA will also need to appropriately account for the fact that many “owner-vets” pay themselves a below market rate salary and receive their remuneration via dividends and/or capital on sale. This will understate costs in the P&L. (Para. 8.4)</p>

2.2 The remainder of this paper outlines IVC's detailed response to the CMA's Working Paper. The response is structured as follows:

- (i) Section 3 covers the approach to profitability analysis for the LCGs, setting out considerations regarding the overall approach to profitability analysis for the LCGs, covering:
 - (a) aggregate vs segmented analysis;
 - (b) overall comments on ROCE vs WACC;
 - (c) additional sensitivity analysis; and
 - (d) time period.
- (ii) Section 4 covers asset valuation for tangible fixed assets;
- (iii) Section 5 covers asset valuation for intangible assets;
- (iv) Section 6 addresses the approach to calculating WACC;
- (v) Section 7 addresses inefficiencies;
- (vi) Section 8 covers the approach to profitability analysis for the independents; and
- (vii) Section 9 concludes.

3. Approach to profitability analysis for the LCGs

3.1 This section addresses i) aggregate vs segmented profitability analysis, ii) ROCE vs WACC, iii) additional analysis for diagnosis of profitability levels in the LCGs, and iv) the time period under consideration.

3.2 The key takeaways from this section are:

- (i) IVC strongly disagrees with the CMA's proposal to assess the profitability of *all* of the veterinary services for each LCG together in aggregate at the group level:
 - (a) IVC considers it is reasonable to assess profitability of LCG's *clinical* veterinary services in aggregate (i.e. combining FOP, referral centres and OOH sites for each group).
 - (b) But *non-clinical* veterinary services must be excluded from this.
- (ii) The CMA has acknowledged the limitations and sensitivity of ROCE analysis. If the CMA is unable to develop an economically robust approach to asset valuation, then the CMA cannot reliably place any weight on this analysis in its assessment of the market.
 - (a) The limitations of ROCE analysis are particularly important for the vets sector and the CMA will face significant data and methodological challenges in conducting a ROCE in the vets sector, not least because accounting data in the vets sector is a wholly inadequate starting point.
 - (b) It is therefore essential that the CMA follows through with its proposal to revalue assets appropriately. The CMA's typical approach of making adjustments to accounting data will not be sufficient.
- (iii) The CMA is correct that benchmarking to other countries or sectors will involve comparability limitations.
- (iv) IVC supports extending the time period to cover 5 years.

Assessing in-scope activities: Aggregate vs segmented profitability analysis

3.3 The CMA proposes "*to assess the profitability of the veterinary services operations of each LCG*" and not "*assess separately the economic profitability of the different types of veterinary services.*"⁷ The CMA's primary reason appears to be one of simplicity based on the way LCGs currently segment their businesses.⁸ This is not a reasonable justification for aggregating all veterinary services.

⁷ CMA Working Paper, para. 4.38

⁸ CMA Working Paper, paras. 4.38 and 4.39

- 3.4 **IVC strongly disagrees with the CMA’s proposal to assess the profitability of all of the veterinary services for each LCG together in aggregate.**
- (i) **IVC considers it reasonable to assess profitability of LCG’s *clinical* veterinary services in aggregate** (i.e. combining FOP, referral centres and OOH sites).
 - (ii) **However, *non-clinical* veterinary services must be excluded from this.**
- 3.5 It is necessary to distinguish between *clinical* veterinary services (FOP, referral centres, animal hospitals, OOH) and *non-clinical* veterinary services (pet crematoria, online pharmacies, external diagnostics laboratories). IVC recognises it may not be practicable to conduct individual profitability analyses for all these services individually (given the data availability and time constraints the CMA faces), but the appropriate solution to this is not an aggregate analysis that mixes together services of very different kinds, but rather an analysis that focuses as much as is practicable on the core *clinical* veterinary services.
- 3.6 **IVC considers it is reasonable and appropriate to assess the profitability of *clinical* veterinary services in aggregate for each LCG.** There are additional reasons to do so beyond those outlined by the CMA.⁹ Specifically, clinical services (whether that be FOP, referrals or OOH) all require substantially the same clinical property and equipment. In other words, they have a number of shared assets. It is therefore reasonable to consider these in aggregate from a ROCE perspective, given both the practical difficulties in separating out different clinical services and that doing so is economically appropriate.¹⁰
- 3.7 **However, the CMA must exclude non-clinical veterinary services¹¹ from its economic profitability analysis of clinical veterinary services.** This is because:
- (i) **These are fundamentally different businesses to clinical veterinary services:** these have different assets, cost structures and supply and demand characteristics. For example, online pharmacy is a retail business, where the main physical asset is the warehouse and there are very few intangible assets. Clinical services in contrast, require specialist premises and equipment and rely heavily on intangible assets. IVC’s crematoria business predominantly serves B2B customers, whilst clinical services are customer facing.
 - (ii) **It limits comparability both across LCGs and between LCGs and mid-tier firms and independent vets.** The LCGs are active in different ways across non-clinical veterinary services. For example, amongst the LCGs, only CVS, IVC and

⁹ IVC agrees with the CMA’s view that “*there is no clear delineation between FOP services and referral services, and that OOH services are not generally structurally separate from the regular operations of a site*” (CMA Working Paper, para 4.37).

¹⁰ Whilst IVC runs Vets Now as a separate legal entity to UK Vets, Vets Now operates out of host clinics (i.e. clinics which provide FOP services in the daytime and lease the premises to Vets Now out of hours). The majority of assets used by Vets Now are owned by host clinics (including both IVC and non-IVC host clinics). Accordingly, UK Vets and Vets Now are legally separate but the assets (and therefore capital employed) are largely shared. As the CMA notes in the Working Paper, the other LCGs typically do not separate their first opinion and OOH services, hence their assets are shared (CMA Working Paper, Table 1)

¹¹ Pet crematoria, online pharmacy, external diagnostics laboratories.

VetPartners provide crematoria and online pharmacy services in addition to clinical services. CVS, VetPartners, Linnaeus and Medivet provide diagnostics but IVC and Pets at Home do not.¹² Most mid-tier firms and independent vets are not active in non-clinical veterinary services. An aggregate profitability analyses, including veterinary and non-veterinary services, will limit comparability across LCGs, and between LCGs, mid-tier firms and independent veterinary practices. To ensure comparability, profitability should be assessed based on activities which are most common across the sector.

- (iii) **It will make interpretation of the results of the economic profitability analysis very challenging** and is unlikely to meaningfully assist the CMA in its diagnosis of the market. If the CMA considers profitability in aggregate, having one overall figure will not tell the CMA anything about where competition is or is not working. For example, high or low overall profitability could be driven by one particular product market, but this will not be evident from assessing in aggregate. It is unclear how the CMA could use such figures to inform its investigation and infer anything about consumer outcomes.

3.8 **Additionally, the CMA's main reasons¹³ for assessing the profitability of all in-scope veterinary services in aggregate do not hold for non-clinic veterinary services.** It is more straightforward to split out non-clinical veterinary services. This is both from an economic perspective (because the assets are distinct and standalone) and from an accounting perspective (reflecting how many of the LCGs currently report on their businesses).

- (i) IVC reports separately on its pet crematoria business (separate P&L, balance sheet). IVC's online pharmacy has a separate P&L, and whilst there are some shared central costs and IVC does not have a separate balance sheet for its online pharmacy, it would be possible to make sensible and pragmatic assumptions (that are not overly complex) in the next phase of the work to address this.¹⁴ IVC is not active in small animal external diagnostic laboratories.
- (ii) CVS reports separately on its Laboratories Division, Crematoria Division, Online Retail and UK Veterinary Practice Division.¹⁵

¹² See Table 1 of the CMA's Working paper.

¹³ Namely (1) how the LCGs currently segment their businesses; (2) the suggestion that it is not possible to separate out the in-scope activity; and (3) the considerable complexity involved.

¹⁴ IVC notes that the CMA's instructions to it via a data call were to respond to its Financial Information Request based on how it currently reports on its business initially, in line with its current reporting, and there would be a further chance to allocate costs / assets separately later. Specifically, see recording of data call on 2nd August 2024 at 03.26 where Sean Ellerton states that the template is "*Just looking to go with the grain of your business and we're just looking to find out what do you have, what is relatively easily obtainable in, you know, a matter of weeks rather than a matter of months.*"

¹⁵ CMA Working Paper, para. 4.37(a)

- (iii) Vet Partners appears to have provided the financial information as requested by the CMA using a number of assumptions.¹⁶
 - (iv) The only non-clinical services provided by Linnaeus and Medivet are Diagnostic Laboratory services. The CMA did not include any feedback from Linnaeus or Medivet in the Working Paper on the ability to separate out the financial information of Diagnostic Laboratory services from the rest of their businesses. However, IVC would anticipate this would be possible using sensible assumptions and should not be a significant constraint.
 - (v) Pets at Home is only active in clinical veterinary services.¹⁷
- 3.9 Accordingly, with sensible assumptions it is practical to separate out non-clinical services from clinical services to a sufficient degree of confidence, and it is important to do so given the risks associated with not doing so (as set out above).
- 3.10 In contrast, attempting to distinguish and separate out activities within clinical services is highly complex, and economically inappropriate.

ROCE vs WACC

- 3.11 The CMA is proposing to assess profitability by using ROCE benchmarked against the weighted average cost of capital (WACC), as well as presenting this in the form of absolute economic profits (which also relies on the WACC estimate).
- 3.12 **The CMA will face significant data and methodological challenges in conducting a ROCE in the vets sector**, as described in the Overview and Summary above and in further detail in the sections below.
- 3.13 **The CMA has acknowledged that ROCE can be susceptible to a number of distortions.** For example, due to i) leasing a material proportion of assets, ii) intangibles which are expensed rather than capitalised, and iii) the accounting depreciation method. The CMA also acknowledges that the difference between ROCE and WACC may not provide a clear view of any excess profits in monetary terms.
- 3.14 **IVC agrees with the CMA that ROCE can be easily distorted** – in particular, significantly overstated – by the factors mentioned in the paragraph above, resulting in misleading conclusions in relation to economic profitability. **The CMA also rightly recognises that “economic profitability analysis can be sensitive” to the assumptions used** and that it will be “*mindful of the sensitivity of [its] analysis and results to key assumptions and undertake sensitivity analysis where appropriate.*”¹⁸
- 3.15 These challenges are particularly significant in the vets sector given the significant data and methodological challenges. ROCE is also extremely sensitive to assumptions in

¹⁶ CMA Working Paper, para 4.36(b)

¹⁷ CMA Working Paper, Table 1

¹⁸ CMA Working Paper, paras. 4.98, 4.98

(tangible) asset-light sectors (i.e. service sectors). Much of the asset base in the vets sector is built on intangible assets, resulting in a relatively low value for capital employed on the balance sheet. Where the capital base recorded on the balance sheet is relatively small (including because of significant measurement error and underestimation in the value of tangible fixed assets), minor changes to assumptions around capital employed have a disproportionate impact on ROCE.¹⁹ **The CMA has acknowledged this previously, stating “Asset valuation is typically one of the most significant problems faced in estimating ROCE...difficulties may occur in sectors with low levels of physical assets and high intangibles.”**²⁰

- 3.16 **IVC agrees with the CMA that the results of its analysis will be sensitive to assumptions. As a minimum, the CMA must conduct appropriate sensitivity analysis on the key assumptions used.**
- 3.17 **However, IVC is concerned that sensitivity analysis is insufficient if the CMA is unable to develop a robust methodology that addresses the fundamental challenges facing the analysis. The CMA should be cautious about drawing strong conclusions given the level of uncertainty which will be associated with any estimates.**

Additional analysis for diagnosis of profitability levels in the LCGs

- 3.18 To address the sensitivity and potential distortions of an economic profitability analysis, the CMA intends to undertake additional supplementary analysis to test the results of its economic profitability analysis.²¹ This includes reviewing internal documents including acquisition documents, and potentially margin benchmarking.
- 3.19 The CMA's current view is that benchmarking prices or profits to veterinary services in other countries or to other professional services in the UK is unlikely to yield robust conclusions. As such, it is not proposing to explore this any further.
- 3.20 IVC agrees with the CMA that any price or profit benchmarking to other countries or sectors will face limitations in terms of comparability.
- 3.21 However, without any benchmarking, the CMA's main form of supplementary analysis to test its economic profitability results will be predominantly *qualitative* in nature (i.e. internal documents). Analysis of internal documents also suffers from material limitations. For example, internal documents are often misleading as they reflect the incentives of the author (e.g. to support an acquisition) rather than the view of the corporate entity as a whole.

¹⁹ As set out by the CMA in para. 4.5 of the Working Paper, ROCE is calculated as EBIT divided by capital employed. A small capital base means the denominator is smaller and thus changing assumptions on capital employed will have more significant impact on the ROCE percentage.

²⁰ Competition Commission, 2011, Local Bus Services Market Investigation, Final Report Appendices 9.1 to 10.4, para. 10.34

²¹ CMA Working Paper, para. 4.100

- 3.22 As described, the CMA's proposal for additional analysis is not sufficient to reassure the CMA that its ROCE results are reasonable. Accordingly it is imperative that the CMA i) fully addresses the fundamental challenges facing ROCE; and ii) considers further, quantitative, options for its additional analysis.

Time period under consideration

- 3.23 The CMA has confirmed that it intends to assess profitability over a five-year historical period, extending its data collection by a further two years.²² Extending the analysis to a five-year period is an improvement on the current three-year period. However, IVC would note that a five-year period is still a relatively short period of time in order to address the challenges associated with market fluctuations and the economic cycle. This is particularly the case given the time period considered by the CMA is heavily affected by a number of "once in a lifetime" events, such as Brexit, the Covid-19 pandemic and the high inflationary period leading to the largest reduction in living standards in the UK since World War II.
- 3.24 In practice, collecting this data will be burdensome for IVC, particularly given the change in accounting standards during this period.²³ However, as noted above, IVC is keen to collaborate with the CMA as much as possible to ensure robust analysis can be undertaken.

²² CMA Working Paper, para.3.9

²³ IVC moved from UK GAAP to IFRS from FY22 onwards.

4. Approach to asset valuation: Tangible fixed assets

4.1 This section covers i) fixtures and fittings, and equipment, ii) leased properties and iii) freehold properties.

4.2 The key takeaways from this section are:

- (i) The CMA is right to recognise that NBV is not a good approximation for MEAV, and in IVC's view it cannot be the starting point for the CMA's analysis.
- (ii) This is driven by two significant shortcomings: (1) an incomplete fixed asset register and (2) a significant number of assets with an NBV substantially lower than replacement cost, in part as accounting life is shorter than useful economic life.
- (iii) These shortcomings are significant and cannot be addressed with adjustments to the accounting data, i.e. a revaluation of NBV.
- (iv) A rebuild approach, conducted thoroughly, is the best methodology for revaluing tangible fixed assets: it relies on actual costs; avoids unnecessary complexity; and addresses the issue of missing assets. It can also be used to value the fixed assets of independents. IVC has outlined a 'proof of concept' here, but the CMA needs to build on this and develop a full methodology.
- (v) The second-hand market and insurance valuations are not viable approaches for revaluing assets in the vet sector.
- (vi) IVC supports the CMA's proposed approach to capitalise leases, given the distortive effect on ROCE of not doing so.
- (vii) IVC agrees that, as with all asset classes, freehold properties should be revalued to reflect the MEAV in order for the ROCE estimates to be economically meaningful.

Tangible fixed assets: Fixtures and fittings, and equipment

4.3 The CMA has identified the main tangible fixed assets required for the provision of veterinary services as buildings, fixtures and fittings, and medical equipment.²⁴

4.4 The CMA has recognised that the accounting values of these assets may not reflect the value to business / replacement cost.²⁵ It has further set out the LCGs' views (including IVC's) that NBV is not a good approximation for modern equivalent asset value (MEAV),²⁶

²⁴ CMA Working Paper, para 4.42

²⁵ CMA Working Paper para 4.19

²⁶ CMA Working Paper, para 4.43

and is seeking further information on the most appropriate approach to determining MEAV.²⁷

- 4.5 **The CMA is right to recognise that NBV is not a good approximation for MEAV**, in particular as:
- (i) The fixed asset register is incomplete. There are fundamental problems with data recording such that this cannot be used as a starting point for any analysis.
 - (ii) Accounting life is shorter than useful economic life for a material proportion of IVC's tangible fixed assets. The implication is that a significant number of assets (of those that are even on the asset register) have a NBV substantially lower than replacement cost, including a number of live fixed assets that have a NBV of zero.
- 4.6 Significant inflation in recent years also means the original purchase cost is unlikely to reflect current market prices.
- 4.7 Below (paras. 4.8 to 4.23) IVC outlines the evidence that demonstrates these challenges. This predominantly focuses on UK Vets (i.e. FOPs, referral centres), given this represents the majority of IVC's business. However, some of the same challenges also apply to crematoria and OOH.²⁸ All figures therefore relate to UK Vets unless stated otherwise.

Incomplete fixed asset register

- 4.8 IVC's UK Vets fixed asset register is incomplete as a result of: i) IVC's acquisition of hundreds of small businesses; and ii) [CONFIDENTIAL]
- (i) Firstly, **acquired asset registers are often incomplete** and whilst IVC conducts operational due diligence, valuations are done on the basis of EBITDA rather than capital employed. Therefore, [CONFIDENTIAL], with considerable tangible fixed asset value captured within goodwill. Upon acquisition, their balance sheets are incorporated into IVC's asset register, with IVC inheriting an incomplete asset register as a result.²⁹
 - (ii) Secondly, historically, [CONFIDENTIAL] but the result is that many in-use fixed assets are still missing from the asset register and balance sheet.

Evidence from pilot fixed asset verification exercise

- 4.9 As the CMA is aware,³⁰ IVC has undertaken a pilot fixed asset verification exercise of four UK veterinary sites as part of its wider Finance transformation programme. The results

²⁷ CMA Working Paper, para 4.47

²⁸ IVC's response to RF17 explains the different drivers of limitations across the asset register for UK Vets, Vets Now and CPC.

²⁹ See para. 1.6 of IVC's response to RF17 for further details.

³⁰ IVC provided details of this in its response to RF17 and in Frontier Economics' Economic Profitability Analysis submission ("EPA") submission.

from this asset verification exercise showed that [CONFIDENTIAL] of in-use assets found in the four clinics were not recorded in the asset register.³¹

4.10 IVC has now extended the pilot scheme to an additional six UK clinics (including the CMA site visit clinic), taking it to ten clinics in total. The combined results for the ten clinics corroborate the initial findings:

- (i) approximately [CONFIDENTIAL] of the “in-use” assets present in the clinics were not recorded in the fixed asset register. In total over [CONFIDENTIAL] assets were in use across the 10 clinics, of which fewer than [CONFIDENTIAL] were recorded on the asset register.³²
- (ii) The total value of in-use fixed tangible assets present is over [CONFIDENTIAL] greater than what is recorded on its asset register across the 10 pilot clinics.

Evidence from analysis of the fixed asset register

4.11 Additional analysis of the fixed asset register, included in IVC’s previous submissions, showed an implausibly low asset value per clinic at [CONFIDENTIAL] on average.³³ There is also substantial variation in the number of fixed assets recorded at clinics, with variations showing little correlation with the clinic’s revenue. Notably, **approximately [CONFIDENTIAL] clinics have five or fewer live fixed assets which is implausible.**³⁴ A clinic could not feasibly run with so few fixed assets.

4.12 The CMA has also seen evidence of the asset register inaccuracies at its site visit. When visiting Rosemary Lodge (Bath Vet Group), the CMA saw a CT and MRI scanner. The CMA was made aware that both of these assets have a NBV of zero, but are high value items, which cost around £250k and £600k to replace, respectively.

Accounting life is shorter than useful economic life

4.13 IVC’s Depreciation and Amortisation Policy depreciates owned equipment assets over a maximum lifetime of five years, and computer assets over three years. This is significantly shorter than the typical useful economic life of these assets. IVC has a consistent Depreciation and Amortisation policy across segments, hence this issue applies to all of IVC’s UK veterinary service businesses.

³¹ These sites were selected on the basis that they provided a range of size and type of clinics (covering 3 small animal sites and 1 mixed site) to represent IVC’s portfolio.

³² Note that there were further unidentified assets, where assets were recorded on the asset register but not present in the clinic. The majority of these assets have a NBV of zero.

³³ As noted in RF17, this number was calculated based on the total NBV listed in IVC’s asset register, divided by the number clinics. Only in-scope clinics were used for the NBV and total number of clinics (i.e. those related to UK Vets, excluding farm, equine, Pet Drugs Online, central office, Isle of Man clinics). Please note that this calculation relies on the NBV based on IVC’s asset register; reconciliations are required to match this to the balance sheet. IVC estimates it typically costs over £600,000 in capital to run a vet practice.

³⁴ See IVC’s EPA submission, slide 16.

- 4.14 Table 4.1 below is taken from IVC’s Economic Profitability Analysis (EPA) submission and shows several equipment types, such as CT scanners, MRI scanners, kennels / cages, have useful economic lifetimes that are substantially longer than their accounting life – and often over ten years.

Table 4.1: Useful economic lifetimes compared with accounting life by equipment type

Item	Accounting life	Useful economic life
CT & MRI scanners	5	10-12
Kennels / cages	5	10-15
Anaesthetic machines	5	5-7

Evidence from pilot fixed asset verification exercise

- 4.15 Additional analysis presented in IVC’s EPA submission showed that in the four UK Vets clinics visited as part of the pilot fixed asset verification exercise, [CONFIDENTIAL] of “in-use” assets found were more than 5 years old, with [CONFIDENTIAL] at least 10 years old.
- 4.16 Additional analysis undertaken since IVC’s EPA submission **confirms accounting life substantially understates actual useful economic life**. At the 10 clinics now visited as part of the pilot fixed asset verification exercise:
- (i) Overall, approximately [CONFIDENTIAL] of the “in-use” equipment assets found were at least 5 and 10 years old respectively. The mean and median age of these assets was around 6 years (which by definition means approximately half will be more than 6 years old).
 - (ii) Furthermore, assuming clinics are in a ‘steady state’,³⁵ assets will be around halfway through their useful life on average. Therefore, a mean asset age of 6 years is indicative of an actual economic life closer to 12 years (as opposed to the 5 years assumed for accounting purposes).
 - (iii) [CONFIDENTIAL] of computer assets were at least 3 years old, with a mean asset age of around 2-3 years, indicative of a useful economic life closer to 5 years (as opposed to the 3 years assumed for accounting purposes).

Evidence from analysis of the fixed asset register

³⁵ Given all assets (or clinics) are observed at a given point in time, some assets will be brand new, some will be close to the end of their life and others will be somewhere in between. Without any evidence to indicate that there is a particularly new or depreciated portfolio, a simplifying assumption is that assets are half way through their useful economic life on average.

- 4.17 Analysis of the fixed asset register, which covers all of IVC's clinics, also corroborates that assets are used well beyond their accounting lives.³⁶ Analysis of the fixed asset register shows approximately [CONFIDENTIAL] of IVC's recorded assets have a NBV of near zero.³⁷ Over 60 clinics have an overall NBV of [CONFIDENTIAL] or less, which would be unfeasible, and 26 have a NBV of zero or below.

Materiality

- 4.18 IVC has completed further analysis to quantify the impact on NBV of accounting fixed asset lives being shorter than actual useful economic life. A revised NBV has been calculated for the assets found in the 10 fixed asset verification pilot clinics. To be more in line with the actual lifetimes of the assets found, equipment assets have had their asset life extended to 10 years, whilst computer equipment asset lives have remained (conservatively) at 3 years. This was assessed by taking each asset's starting value at the time of purchase, and calculating what its NBV would be in 2024 assuming a straight line depreciation, using the extended asset life. This resulted in more than a 100% increase in NBV.
- 4.19 Taken together with the uplift in NBV resulting from the newly found assets previously unrecorded on the asset register for the 10 clinics, this gives an MEAV which is **almost 3 times as large as the NBV shown in the asset register**. In other words, **taking account of both the incompleteness of the asset register and that accounting life is shorter than useful economic life results in the asset value almost trebling**.
- 4.20 This calculation of NBV is also likely to underestimate MEAV, because it takes as its starting point the value of the assets when they were purchased, as opposed to their modern equivalent value today.
- 4.21 This exercise, in addition to the analysis IVC has previously submitted to the CMA, demonstrates the materiality of these issues.
- 4.22 These issues persist across other IVC businesses which are in-scope of the CMA's investigation. Accordingly, the CMA would need to give consideration to them, if it were to assess all veterinary services in aggregate. IVC provided further information on the asset lives of its cremators used in its CPC business in response to RF17. Cremators are depreciated on an accounting basis using IVC's policy of a 5-year equipment lifetime. However, cremators typically have a lifetime of around 20 years. This means that more than half of CPC's cremators have a NBV of zero. Further, calculating the depreciated replacement cost of CPC's cremators which do have a NBV above zero, shows a significant gap between NBV and MEAV. For example, CPC's two 8-chamber cremators have a NBV of around [CONFIDENTIAL] respectively, whereas the MEAV is approximately £234,000 and £240,000.³⁸

³⁶ See slide 17 of IVC's EPA submission which shows the number of clinics where all assets have a NBV of <£0.

³⁷ This is estimated by looking at the total number of clinic assets in IVC's asset register with a NBV of < £1 as a proportion of the total number of clinic assets.

³⁸ MEAV is based on the new cost of cremators, sourced directly from suppliers, depreciated by the number of years equal to the existing assets' ages. See IVC's response to RF17.

- 4.23 **This evidence shows that not adequately addressing these shortcomings in the CMA's analysis would materially impact the CMA's assessment.**

Alternative approaches to asset valuation

- 4.24 The CMA acknowledges that NBV is not a good approximation for MEAV and seeks views on alternative approaches to assessing MEAV.³⁹ The CMA should note that the issue of missing assets is critical and so material that a simple revaluation exercise which utilises the asset register will not provide a credible value for MEAV.
- 4.25 IVC has given considerable thought to alternative approaches for evaluating MEAV.⁴⁰ For completeness, these arguments are also summarised here. Additionally, as with the asset verification exercise, since the EPA submission, IVC has further developed some of its analysis on alternative approaches to asset valuation, which is also included here.

Second-hand market

- 4.26 **The second-hand market it is not a viable approach for revaluing tangible assets in the veterinary sector.** This is because:
- (i) It would not account for missing assets in IVC's asset register.
 - (ii) There is no liquid and comprehensive second-hand market for veterinary services equipment.⁴¹

Insurance valuations

- 4.27 **An insurance valuation approach is not an appropriate approach for revaluing tangible assets in the veterinary sector.** Whilst conceptually insurance valuations may provide insights into replacement values, in practice they are not useful in the case of the veterinary sector as in IVC's case, its insurance coverage is an inadequate proxy for the MEAV of its fixtures and fittings, and equipment.
- 4.28 IVC's insurance valuations have similar limitations to the asset register. IVC typically inherits a clinic's previous insurance valuation, which is based on the previous owner's assessment of the value of assets in the business.⁴² Where an asset register was not kept up to date by the prior owner, it will not accurately estimate the total value of assets which should be insured. [CONFIDENTIAL].⁴³

³⁹ CMA Working Paper, para 4.47

⁴⁰ As set out in its proactive EPA submission and its response to RF17.

⁴¹ This is the case for both clinical activities and crematoria, and as per IVC's previous submissions to the CMA and also highlighted by VetPartners in the CMA's Working Paper.

⁴² As set out in IVC's response to RF17.

⁴³ Whilst there may be some updates to the insurance valuations from time-to-time, limited verification is done at acquisition.

- 4.29 IVC's insurance coverage is sufficient for business needs, i.e. insurance covers the low-cost claims IVC typically makes, but clinics are [CONFIDENTIAL].⁴⁴
- 4.30 This means that the level of insurance and quality of the data is not sufficient to provide a reasonable estimate of the replacement cost. For example, over 200 clinics are insured for [CONFIDENTIAL] or less, of which 16 clinics are insured for [CONFIDENTIAL]. In practice, IVC estimates it usually requires over £600,000 in capital to run a typical vet practice.

Rebuild estimate

- 4.31 **IVC's view is that the best alternative methodology for establishing MEAV for clinical services is a rebuild estimate.** This approach considers what it would cost if an operator had to fit-out and equip a veterinary clinic from scratch.⁴⁵
- 4.32 This approach assesses the typical fit-out and equipment cost per square foot of clinic floorspace based on actual examples of clinic refurbishments, re-locations and extensions. This can be multiplied by the total square footage of the clinic to provide an estimate of the total cost. This can then be scaled up across all of the clinics within an operator's clinic estate.
- 4.33 This approach is robust and pragmatic and avoids unnecessary complexity:
- (i) It is based on data on the actual cost of internal construction, fixtures, fittings and clinical equipment, i.e. it considers the costs involved with setting up a clinic.
 - (ii) It addresses the challenge of the incomplete fixed asset register / missing fixed assets.
 - (iii) It could be practically applied across the LCGs – and even mid-tier firms and independents alike.
- 4.34 IVC has developed 'proof of concept' estimates for this approach and has previously shared these with the CMA. It drew upon the outturn costs from five recent IVC refurbishments or relocations of FOP sites and public information on two CVS sites. This provided a median and mean cost per square foot of £241 and £270 respectively – giving a mid-point of £255. The range from these seven sites was £230 to £371 per square foot.⁴⁶
- 4.35 Since the EPA submission, IVC has obtained data on three further FOP sites. These additional data points lead to a very similar average cost, with the mean cost per square

⁴⁴ [CONFIDENTIAL] But it does mean that insurance values are not an appropriate approximation of replacement cost for the purposes of the CMA's analysis.

⁴⁵ Note that if the CMA were to assess profitability for all in-scope veterinary services – i.e. without excluding non-clinical services – it would also need to consider how to appropriately value the tangible fixed assets of these business segments.

⁴⁶ A similar exercise was done for farm and equine clinics.

foot for these refurbishments now £264, and the median of £242. This provides a mid-point of £253.

- 4.36 Note that since each of these “rebuilt” was completed inflation will have significantly increased relevant costs, so £253 is likely to be an underestimate.
- 4.37 Scaled up across IVC’s portfolio of veterinary clinics, this suggests a total rebuild cost of [CONFIDENTIAL]. Assuming IVC’s veterinary clinic portfolio is in ‘steady state’, i.e. the average clinic or tangible fixed asset is halfway through its useful economic life, **implies a MEAV estimate of IVC’s internal construction, fixtures, fittings and clinical equipment for its UK Vets business (FOP and referrals) of [CONFIDENTIAL]. This is over 4x the net book value of those asset classes recorded on IVC’s balance sheet.**
- 4.38 **This clearly demonstrates the substantial limitation of using NBV as a proxy for MEAV, and the importance of appropriately revaluing LCGs tangible fixed assets. It is critical to the CMA’s assessment, and it is imperative that the CMA corrects for this in its methodology and analysis if it is to estimate economically meaningful ROCE figures.**
- 4.39 **In addition, IVC has engaged an external surveyor to undertake an independent, expert cost estimate** following the EPA submission. IVC provided the surveyor with a floorplan for an average sized IVC clinic along with a specification and instructed the surveyor to estimate the build cost covering fit-out and equipment. Based on IVC’s standard building specifications and the current prices for labour and materials, this provided an external estimate of £318 per square foot.⁴⁷ This further supports IVC’s current rebuild calculations, and indicates that costs are slightly higher than they were a year ago (when many of IVC’s examples were rebuilt).
- 4.40 **To further demonstrate materiality, IVC has considered the impact of this re-valuation on ROCE estimates.** Using the rebuild approach⁴⁸ (which only covers some fixed asset categories, e.g. motor vehicles and some ROU assets are not captured) reduces the estimated ROCE by substantially more than half. Moreover, this ‘proof of concept’ approach likely underestimates the impact on ROCE, since: i) no uplift in asset value has been applied to other asset categories which are not captured in the rebuild valuation; and ii) this relies on conservative assumptions regarding depreciation.⁴⁹
- 4.41 This demonstrates that NBV cannot be used as a starting point for ROCE analysis in this sector, as well as the significant uncertainty involved with any ROCE estimation here. However, if the CMA chooses to do ROCE analysis, it should note that the rebuild figures

⁴⁷ This was based on 1,500sqft IVC template floorplan, with the cost covering a standard IVC specification, excluding contingency budget and costs for shell abnormalities.

⁴⁸ This is based on the updated £253 per square foot figure.

⁴⁹ In adjusting the value of IVC’s assets, one should adjust the value of depreciation in a way which is internally consistent. We have calculated depreciation on the conservative basis that all assets have a 15 year life span for the purposes of calculating the EBIT depreciation charge. Assuming a shorter depreciation window would have resulted in a higher annual depreciation figure, with the consequence that EBIT and ROCE would have been lower.

provided above are still a proof of concept, and the CMA would need to build on this further to get to a more developed methodology.

Suggested CMA next steps

- 4.42 We invite the CMA to develop the rebuild approach by developing the methodology further and applying this across LCGs by taking the following steps:
- (i) Request information from other LCGs and independent clinics on rebuild costs, i.e. the outturn costs of new sites, refurbishments, relocations or extensions to stress-test and corroborate IVC’s estimates of the cost per square foot. IVC can provide specifics of how it approached this in order to ensure comparability;
 - (ii) Instruct a third-party surveyor to provide an independent estimate of the rebuild costs of a veterinary clinic. The CMA could work with IVC, other LCGs and independent clinics to inform the appropriate specification; and
 - (iii) Request information from LCGs on the size of its veterinary clinics (to be able to scale up the cost per square foot estimates).

Summary of fixtures, fittings and equipment

4.43 As noted, IVC has previously provided the CMA with significant information on the replacement cost and alternative valuation methods for tangible fixed assets, but given paragraph 4.47 (a)-(d) of the CMA’s profitability Working Paper sets out specific questions, responses are also summarised directly in line with these questions in the table below.

Table 4.2: Summary of IVC response to CMA consultation questions on fixtures and fittings, and equipment

Working Paper paragraph number	CMA consultation question	Summary of IVC response
4.47a)	The extent to which insurance values, and rebuild estimates, are an appropriate method of valuation.	<p>Insurance data is not an appropriate method of valuation based on IVC’s insurance policies (and likely other LCGs too).</p> <p>The rebuild estimate (if appropriately conducted) is the most appropriate way to estimate MEAV, as it overcomes the issues of both valuing assets which are recorded and also accounting for assets which are not recorded. This indicates a 4-</p>

		fold increase in the depreciated value of fixed assets.
4.47b)	Other appropriate methods of valuation we should consider.	As noted, IVC considers the rebuild estimate to be the most appropriate alternative method of valuation.
4.47c)	The extent to which there is a second-hand market for veterinary services equipment.	Using second-hand values does not address the challenge of assets missing from the register. There is no liquid and comprehensive second-hand market that can be used to value veterinary service assets.
4.47d)	The extent to which an adjustment for any missing assets will make a material difference to our assessment, and if so, any approach for identifying and valuing those assets.	The impact of missing assets is highly material. Of the 10 clinics considered in IVC's asset verification exercise, [CONFIDENTIAL] of the in-use assets found at clinics were not recorded on the asset register. In addition, adjusting for a more realistic economic useful life of the assets concerned almost trebled the NBV.

Tangible fixed assets: Leased properties

- 4.44 The CMA proposes to capitalise leases to avoid the distortive effect on ROCE, given that all LCGs lease a portion or all of their property assets.⁵⁰
- 4.45 IVC agrees with the CMA's suggested approach as, among other things, it makes a necessary adjustment for firms which are currently recording on a UK GAAP basis. The accounting treatment of leased assets can have a material impact on ROCE estimates so it is essential that the CMA takes this into consideration. As set out in IVC's EPA submission, two firms which are equivalent in every way, apart from how they record their leased assets (i.e. as expense or capitalised items), will have very different ROCE figures. IVC has previously provided the CMA with an illustrative example to demonstrate this. This demonstrates that all else equal, a firm which records its leases as a P&L expense would have a ROCE of around 60%, whereas a firm which records its leases as a capitalised expense would have a ROCE of around 30%. Therefore, without an adjustment, the treatment of leases will materially distort the CMA's profitability findings.
- 4.46 It is also essential that profitability across the industry is compared on a like-for-like basis. Treating leases consistently is therefore necessary to enable the CMA to look at industry-

⁵⁰ CMA Working Paper, para 4.45

wide profitability. IVC therefore welcomes the CMA's proposal that it will adjust accordingly such that leased properties are included in the capital base.

4.47 It should be noted that IVC moved from using UK GAAP to IFRS from FY22. IFRS requires all leases to be capitalised, where the term is more than 12 months and the underlying asset is not low value, hence this is now less of an issue for IVC. However it is important that: i) all parties are considered on a comparable basis, ii) the move from UK GAAP to IFRS is appropriately adjusted for, and iii) ROCE is not distorted due to accounting principles.

4.48 Separately, as outlined in IVC's previous submissions to the CMA, there are [CONFIDENTIAL]

4.49 The result of this is that the NBV for IVC's right-of-use (ROU) assets is understated.⁵¹

Tangible fixed assets: Freehold properties

4.50 The CMA recognises that the carrying value of freehold properties is unlikely to reflect MEAV, and is considering the most valid approach to revalue freehold properties.⁵²

4.51 IVC owns just one freehold property, so is unable to comment on the materiality of the extent to which the carrying value is unlikely to reflect MEAV.

4.52 However, in principle IVC agrees that, as with all asset classes, freehold properties should be revalued to reflect the MEAV in order for the ROCE estimates to be economically meaningful.

⁵¹ [CONFIDENTIAL] Charges to the P&L are the depreciation of the proxy short-term lease extension, rather than the rent payments themselves.

⁵² CMA Working Paper, para. 4.46

5. Approach to asset valuation: Intangible assets

5.1 The key takeaways from this section are as follows:

- (i) Intangible assets within the veterinary sector are substantial.
- (ii) IVC has invested to acquire these intangible assets, which will be included within the substantial amount of goodwill within the balance sheet. The CMA rightly recognises that in principle “*when purchasing a business, an element of the goodwill may represent the value of intangible assets that are not capitalised.*”⁵³
- (iii) IVC agrees with the CMA that brand and reputation assets (including customer relationships, trade names and know how) clearly meet the first two CMA criteria for recognition.
- (iv) However, IVC strongly disagrees that brand and reputation does not create an asset that is separable from assets arising in the general running of the business.
 - (a) The CMA has itself identified examples of customer lists being sold on a standalone basis – which is clear evidence that it is a separable asset.
 - (b) The CMA recognised this in the Energy Market Investigation. It concluded that customer lists are separable in stating “*...they form assets that are separable from any arising from the general running of the business... demonstrated by the fact that customer relationships can be sold by one firm to another.*”⁵⁴
 - (c) There are many examples within the veterinary sector which demonstrate that brand and reputation are separable assets.
- (v) IVC strongly supports the use of marketing costs and start-up losses as cost-based approaches for valuing brand / reputation assets.
- (vi) IVC agrees with the CMA that IT systems and software assets clearly meet the first two CMA criteria for recognition. However, IT systems and software are also separable assets as these can be licensed to specific clinics.

5.2 The CMA plans to consider whether certain intangible assets should be included in capital employed, and whether intangible assets meet its three criteria for recognition of intangible assets outlined in the Guidelines.⁵⁵ This section first addresses brand and reputation assets, followed by IT systems, software and development costs.

⁵³ CMA Working Paper, para. 4.38

⁵⁴ CMA, 2016, Energy Market Investigation Final Report, Appendix 9.10: Analysis of retail supply profitability – ROCE, para. 6

⁵⁵ CMA Working Paper, paras. 4.49, 4.50

Brand and reputation assets

- 5.3 **Intangible assets within the veterinary sector are substantial.**⁵⁶ The importance of intangible assets to the operation of a successful vet practice (e.g. customer relationships, vet practice reputation / brand, intellectual capital) is a key reason behind the LCG acquisition-based growth strategy.
- 5.4 **IVC has invested to acquire these intangible assets, which will be included within the substantial amount of goodwill within the balance sheet.** The CMA rightly recognises that in principle “...when purchasing a business, an element of the goodwill may represent the value of intangible assets that are not capitalised.”⁵⁷
- 5.5 **The alternative is to set-up a veterinary practice from scratch and incur costs to build these intangible assets organically over time.** IVC is pleased to see that the CMA has recognised this in its Working Paper.⁵⁸
- 5.6 **The CMA has acknowledged that expenditure on brand and reputation assets (whether organic or inorganic) “meets two of the three of the CMA’s criteria,”**⁵⁹ namely that: (1) they require costs that are incurred primarily to obtain earnings in the future; and (2) the costs are additional to those necessarily incurred at the time in running the business.⁶⁰ **IVC welcomes this, and agrees that brand and reputation assets clearly meet these two criteria.**
- 5.7 **However, IVC considers that brand and reputation assets also demonstrably meet the CMA’s third criterion. IVC strongly disagrees with the CMA that it is “unlikely that trade names/reputation assets”** would meet its third criteria, namely that it creates an asset that would be separable from assets arising in the general running of the business.⁶¹
- 5.8 The test of the CMA’s third criteria is not that every transaction must be designed in such a way, but only that the asset is separable such that a transaction could be. The CMA recognised this in the Energy Market Investigation. In concluding that customer lists are separable it stated, “*they form assets that are separable from any arising from the general*

⁵⁶ CMA Working Paper, para. 4.51

⁵⁷ CMA Working Paper, para. 4.55

⁵⁸ CMA Working Paper, para. 4.59 which states “We recognise that the reputation of a veterinary business... may be developed over time... Some of the LCGs may have avoided incurring higher acquisition costs under the organic growth model (for example marketing costs and or more years of losses during the start-up phase of a veterinary practice), by growing customer volumes by acquisition.”

⁵⁹ The CMA has defined brand and reputation assets as comprising customer lists, trade names and know-how (CMA Working Paper, para. 4.57).

⁶⁰ CMA Working Paper, para. 4.59

⁶¹ CMA Working Paper, para. 4.59

*running of the business... demonstrated by the fact that customer relationships can be sold by one firm to another.*⁶²

- 5.9 Customer lists are capable of being sold or transferred separately from the veterinary practice they are associated with. The CMA has highlighted two examples where a LCG has purchased customer relationships.⁶³ The ability to buy and sell a standalone asset must surely be the clearest possible evidence that the asset is separable. In addition to the two examples cited by the CMA, IVC has in the past also purchased the customer list in a UK transaction and has purchased customer lists from over 100 Dutch clinics. In each case, only the customer data was transferred, not the tangible assets, staff, or rental contracts.
- 5.10 There are many examples within the veterinary sector which support the view that brand and reputation assets more broadly (beyond customer lists) are separable assets. For example:
- (i) The Vets4Pets model is comparable to a franchise model, whereby Vets4Pets contributes the brand name, and the practice owner is responsible for the ordinary running of the practice. In essence, Vets4Pets, as a well-known veterinary brand, allows independent operators to open new locations under its name, creating an asset that is separate from the business's regular veterinary services.
 - (ii) The Medivet model has been to acquire the assets of independent veterinary practices and re-brand the sites as Medivet – demonstrating the brand asset is clearly separable from assets arising from the general running of the business.
 - (iii) It is common for independent vet practices with a strong local reputation to expand and open new sites under the same branding, leveraging its brand / reputation as a separable asset.

Approach to valuing intangible brand and reputation assets

- 5.11 Intangible assets within the veterinary sector are substantial, and IVC has previously provided analysis to the CMA that indicates the value of IVC's intangible assets is in the region of [CONFIDENTIAL].⁶⁴ Therefore appropriately valuing intangible assets will have a substantial bearing on the CMA's assessment.
- 5.12 **The CMA has confirmed that “there are two approaches which we are currently considering, in order to estimate the replacement cost of firms’ brands and/or reputations: *marketing costs* as a proxy for the value of a firm’s customer relationships,**

⁶² CMA, 2016, Energy Market Investigation Final Report, Appendix 9.10: Analysis of retail supply profitability – ROCE, para. 6

⁶³ Working Paper, footnote 59

⁶⁴ Based on 'proof of concept' approaches for start-up losses and marketing costs approach.

and **start-up losses**, as a proxy for the investment required to build the necessary intangible assets in the start-up period"⁶⁵ (emphasis added).

5.13 IVC agrees with both of these approaches in principle (where sufficient data exists and the CMA is able to develop a robust methodology), and both offer a cost-based method for valuing brand and reputation assets.

- (i) Start-up losses capture the investment in intangibles over the initial years of a vet practice, until the practice reaches a sustainable competitive level. Start-up losses should reflect the economic (rather than accounting) losses incurred until a sustainable and competitive level of EBIT or revenue is reached. This approach captures all intangible assets in the vet practice. It does not however, capture the unpaid time invested by the vet when starting up the clinic, which has a further opportunity cost. The value of this time should also be considered, as vets invest this with the expectation that this will be returned either through higher profits, or when the practice is sold.
- (ii) Marketing costs provide a proxy for the intangible value of customer relationships only. This uses the acquisition cost per customer, scaled up to the full customer base.

Suggested CMA next steps

5.14 As the CMA is aware, IVC has developed 'proof of concept' approaches for both of these methods and has shared them with the CMA, including initial inputs and analysis.⁶⁶

5.15 The CMA should develop these approaches further (including by collecting more data points) by taking the following next steps:

Start-up losses:

- (i) Request annual site-level financial information (i.e. P&Ls) from LCGs and independent clinics for any recent new greenfield site openings from the year of opening to the current financial year. Given the LCGs' acquisition-based model, there may be relatively few instances of LCG new site openings, and information from independent new entrants (of which there are hundreds over the last few years) will likely be required.
- (ii) Use these financial inputs to build a start-up losses model with which to estimate the typical capitalised start-up loss of a veterinary practice (this can be expressed

⁶⁵ CMA Working Paper, para. 4.61

⁶⁶ See Sections 3 and 5 of IVC's EPA submission.

as a percentage of a clinic's 'steady-state' revenue to account for differences in practice size).^{67,68}

- (iii) Scale this up across each LCG's portfolio of clinics to provide an estimate of the capitalised start-up losses to be added to the capital base in the economic profitability analysis.⁶⁹

Marketing costs:

- (iv) Request information from LCGs and a sample of independents and mid-tier firms that would allow the CMA to estimate a marketing acquisition cost per customer. Given there are many approaches used for direct marketing, this may include (but is not limited to): leafleting, online direct marketing spend (e.g. pay-per-click, online advertising, etc.) or promotional / introductory offers. Information on both the spend on direct marketing and an estimate of new customers acquired from that spend is required to estimate acquisition cost per customer.
- (v) Scale up the estimate of acquisition cost per customer across each of the LCG's customer bases to estimate the intangible value of an LCG's customer relationships, to be added to the capital base in the economic profitability analysis.⁷⁰

IT systems and software development costs

- 5.16 The CMA recognises that developing IT systems meets two of the CMA's three criteria for intangible assets and will consider further whether it is a separable asset.
- 5.17 **IVC agrees that IT systems and software represent an intangible asset.** Particularly for the LCGs, developing a practice management system (PMS) which is able to record and manage patient and customer data requires significant investment. Given the LCGs have grown through acquisition, further time and resources are involved in onboarding

⁶⁷ Broadly, three key data inputs are required for a given clinic: i) annual start-up losses as a percentage of steady state revenue, ii) the number of years taken to reach steady state revenue, and iii) the firm's WACC. EBIT and revenue trends can be used to determine when a clinic has reached 'steady state', or a benchmark for EBIT margin could also be used for example. The difference between the 'steady state' EBIT or revenue level and the actual level of EBIT or revenue in each year, provides the annual loss. These losses can then be capitalised using the firm's WACC and summed over the years prior to steady state being achieved. The value of these losses as a proportion of steady state revenue indicates the size of the unquantified intangible assets, and can be used to scale up across an operator's clinic estate.

⁶⁸ A 'qualitative' lens may also be required to assess which new site openings are appropriate to include within the analysis. For example: (1) in IVC's experience some new sites never reach break-even (or have not done to date), so it is not possible to include these sites in the model; (2) new sites that are part of an existing practice group may not be good examples in that they may be an underestimate of start-up losses. This is to the extent that these clinics already benefit from some of the brand and reputation assets of their practice group (e.g. well established local reputation; or customer list 'overspill').

⁶⁹ These figures would reflect the full value of the intangible assets which are necessary to operate a vet practice sustainably. These assets arguably have an indefinite economic life, i.e. they do not erode over time. Brand and reputation assets will arguably increase over time. As such, these intangibles should not be amortised.

⁷⁰ While individual clients will churn over time, assuming the customer base is in steady state over time (i.e. new customers replace old ones) it is reasonable to argue that the value of this intangible has an indefinite economic life and therefore should not be amortised. To be consistent with this direct marketing costs in the P&L should be excluded.

each individual clinic onto this system. For example, new clinics must firstly move existing data onto a new PMS, and then also adopt the consistent treatment coding for recording data going forward. This requires resources from both IT teams and the clinics themselves. This asset is separable as software can be licensed to other practices and does not need to be acquired through acquiring an entire vet business.

6. Approach to calculating WACC

6.1 The key takeaways from this section are as follows:

- (i) IVC requests the CMA provides a detailed proposed approach on WACC well ahead of the next Working Paper, such that IVC and others are able to provide a meaningful response on this. The current Working Paper provides no detail on the important technical choices it will make. The CMA's suggestion of only providing its proposed approach on WACC around the same time as the profitability working paper would undermine the procedure followed by the CMA with respect to its analysis on profitability.
- (ii) IVC disagrees with the CMA's proposal to estimate beta using Pets at Home. Pets at Home is predominantly a retailer and is not representative of a stand-alone veterinary provider.

6.2 The CMA intends to benchmark ROCE estimates against an estimate of WACC to determine the level of profits relative to the 'normal' level of return. The CMA notes that it will consider its own market estimate of WACC, relying on the Capital Asset Pricing Model (CAPM) for the cost of equity and a combination of actual debt costs and market indices for the cost of debt. The CMA will also consider the WACC values used by the LGCs.

6.3 IVC agrees in principle with the CMA's high-level proposed approach, namely, the use of the CAPM for estimating the cost of equity. However, IVC has concerns regarding: i) the technical choices to be made across all parameters; and ii) the CMA's approach on beta.

6.4 **Technical choices:** Whilst the CMA's approach seems reasonable at a high-level, there are multiple technical choices which must be made when estimating each WACC parameter, which the CMA has not yet provided any detail on. For example, the CMA notes that within the cost of equity, it will estimate the risk-free rate and equity risk premium "*using market data and follow regulatory precedent in this area to the extent that this is still valid*".⁷¹ This does not provide any insight as to the CMA's intended approach for these parameters. Similarly, for the cost of debt, the CMA states that it will consider the actual cost of debt faced by the LGCs, as well as "*relevant debt indices*".⁷² However, there is no explanation as to what indices will be used, or what time interval will be considered. These choices can have a material impact on the WACC estimate and will be challenging to estimate for such a varied sector (many different firms of varying sizes and not all active in the same segments).

6.5 **Beta:** The CMA notes that it intends to rely on CVS and Pets At Home (as the only two listed companies). IVC acknowledges that there is a lack of publicly listed veterinary service providers and that the CMA is therefore somewhat constrained by available data. However, Pets At Home is not an appropriate comparator. IVC understands that Pets At Home operates 457 retail outlets and 339 grooming salons alongside its 444 FOP practices, with only 10% of its revenue from veterinary services, and the remaining from

⁷¹ CMA Working Paper, footnote 64

⁷² CMA Working Paper, para. 4.72

retail.⁷³ Pets At Home's beta does not therefore reflect the risks faced by clinical veterinary service providers, which the CMA also acknowledges.⁷⁴ Pets At Home should therefore be excluded from the beta estimation.

6.6 Additionally:

- (i) The CMA notes that it will consider whether adjusting the average beta is appropriate given the risk profile of in-scope activities relative to the comparator data set. IVC considers it is important that the beta estimates are adjusted. The CMA has stated that it is looking to estimate the WACC for a notional stand-alone veterinary services provider so the beta must reflect the risks of this activity. CVS is a multi-national company which can diversify risk across a variety of different business areas, including pet insurance and online retail – both of which are inherently less risky than FOP or other clinical services. The beta estimates obtained by using CVS's data will therefore bias estimates downwards. Considering suitable international comparators, which the CMA notes its intention to do, may be able to alleviate this issue but only where the comparators used reflect clinical markets with a similar risk profile to the UK.
- (ii) Given the very different assets, costs and therefore risk profiles of the various in-scope activities, IVC is of the view that profitability should be assessed for clinical and non-clinical activities separately. This should also be taken into account when considering the appropriate beta adjustment and WACC benchmark.

6.7 IVC requests the CMA provides a detailed proposed approach on WACC in advance of the next Working Paper, such that IVC and others are able to provide a meaningful response on this prior to the CMA finalising its profitability Working Paper.⁷⁵

⁷³ Pets At Home Annual Report and Accounts 2023, page 3.

⁷⁴ The CMA states that "*Pets at Home's beta will reflect the risks faced by a listed retailer and to a lesser extent that of a provider of veterinary services*" (CMA Working Paper, para. 4.70).

⁷⁵ IVC notes that, in its email of 19 November 2024 to Slaughter and May, the CMA currently intends to provide its proposed approach on WACC around the same time as the profitability Working Paper.

7. Assessment of potential inefficiencies

7.1 The key takeaways from this section are as follows:

- (i) IVC disagrees with the CMA's proposal to attempt to assess potential inefficiencies on both practical and theoretical grounds.
- (ii) One of the benefits of corporatisation within the vets sector is to increase efficiency.

7.2 IVC disagrees with the CMA's proposal to attempt to assess potential inefficiencies on both practical and theoretical grounds:

- (i) Practically, given the complexities of the industry and company knowledge required, any efficiency assessment made by the CMA will be highly speculative and not likely to reflect the underlying drivers of cost metrics at a practice or group level.
- (ii) Theoretically, any competitive market will involve firms with a temporary efficiency advantage over rivals, and these firms should expect to be able to earn a return in relation to this competitive advantage.

7.3 More generally, IVC would note that one of the benefits of corporatisation within the vets sector is to increase efficiency. IVC veterinary practices benefit from central clinical and business support (e.g. HR and finance) which reduce the burden on individual clinics and allow veterinary clinicians to focus on providing veterinary care. Additionally, IVC veterinary practices gain access to the latest research and development (which IVC invests heavily in), as well as scale efficiencies for procurement. These aspects both improve clinical outcomes and reduces costs.

7.4 IVC has also invested heavily in the salaries, benefits and development for professional staff in recent years in response to the systematic national shortage of veterinary surgeons and nurses in the UK, and to reflect recent high levels of economy-wide inflation.⁷⁶ IVC's Vet Academy for example provides additional clinical and business development. The aim of this has been to help improve both the recruitment and retention of professional staff within the sector.

7.5 As outlined in IVC's response to RF12, in order to monitor performance internally, IVC uses a Balanced Scorecard. This looks at clinical, client, people and financial KPIs.⁷⁷ Some of these measures are cost focussed and can give an indication of efficiency, but cannot be considered in isolation and may not be appropriate for the purposes of the CMA's analysis. For example, payroll as a percentage of revenue shows how much a clinic is spending on staff costs proportionately, but it does not show the drivers of these costs. For example, costs may be high for a clinic where illness cover is required and there is therefore a reliance on locums. IVC's management therefore uses its

⁷⁶ See IVC's response to Question 12 of RF17 for further detail.

⁷⁷ See IVC's response to Question 38 of RF12 for further detail.

understanding of the business to make judgements in interpreting these metrics and to what extent action is required operationally.

8. Approach to profitability analysis for the independent vet businesses

8.1 The key takeaways from this section are as follows:

- (i) IVC notes that the same data challenges are also relevant to LCGs, and there is no conceptual reason why the CMA could not estimate a ROCE for smaller vet businesses using the same revaluation approaches it will adopt for the LCGs.
- (ii) The CMA will need to make appropriate adjustments to ensure the profit margins of smaller vet business are comparable to the LCGs (e.g. reflecting different accounting approaches).
- (iii) The CMA will also need to appropriately account for the fact that many “owner-vets” pay themselves a below market rate salary and receive their remuneration via dividends and/or capital on sale. This will understate costs in the P&L.

8.2 The CMA notes it plans to assess the profitability of the independent vet businesses by conducting profitability analysis of the four mid-tier firms and a sample of the remaining firms. However, its profitability analysis will be on a profit margin rather than ROCE basis, due to challenges faced by independents in collecting asset value information. It will also look at the veterinary businesses as a whole without separating out different types of service.⁷⁸

8.3 IVC accepts that it is practical to consider the profitability of a sample of independents, particularly given the remaining time available to undertake the analysis. However, it should be noted that:

- (i) **The sample of independents must be representative** of that portion of the market, and the CMA should take care to ensure this is the case.
- (ii) **The same asset valuation issues apply to independents as they do for the LCGs.** Specifically, one of the main issues with IVC’s asset register is that it has been inherited from independents who do not have processes in place to record data properly. There is no reason why the CMA cannot apply the same alternative valuation approach to for the independents as it does for the LGCs, which would allow ROCE to be estimated for the independents as well.
- (iii) **Most independents only provide clinical services.** As noted above, for comparability purposes, sector profitability should be assessed based on activities which are most common, i.e. clinical and non-clinical, in order to obtain any meaningful insights.
- (iv) If the CMA does assess profitability by comparing the margins of the independents to the calculated ‘normal’ margin required by the LGCs, as the CMA suggests, **it is vital that i) the WACC estimate used as a benchmark reflects the in-scope activities and ii) the accounting approach used by**

⁷⁸ Unlike for LCGs, this is unlikely to make a material difference as most independent and mid-tier firms only offer clinical veterinary services and are not active in other parts of the supply chain.

independents is considered. If independents use different accounting standards or recording methodologies, this will affect the comparability of EBIT margin. These elements must be comparable, with a consistent benchmark used across the industry.

- 8.4 **The CMA will need to give further thought to how it treats staff remuneration.** IVC is aware of cases (following acquisition) where independent vets who have an equity stake share in the vet practice have paid themselves a “below market rate” salary. This is generally on the assumption that the owner / vet will recoup this underpayment via dividends or through capital when the vet sells the practice. The implication is that independent vets are not always paying the market rate, so when splitting out any dividend payments, salary costs may also need to be adjusted.

9. Conclusion

There are significant data and methodological challenges in conducting a ROCE analysis in the vets sector

- 9.1 **The CMA intends to conduct an economic profitability analysis using a ROCE versus WACC methodology**, including calculating absolute economic profits.
- 9.2 **Accounting data is a wholly inadequate starting point** for an economic profitability analysis, and **would result in incorrect and implausible ROCE estimates**, as demonstrated in IVC's previous submission.
- 9.3 A ROCE analysis in the vets sector will face **significant data and methodological challenges**. These challenges include:
- (i) NBV is a very poor approximation for the replacement cost of IVC's tangible assets.
 - (ii) Intangible assets are material in the vets sector, but are not fully reflected on the balance sheet.
- 9.4 Both of these issues also explain why **goodwill is a substantial component** on the corporates' balance sheets, **reflecting both the value of intangibles and unmeasured tangibles**. This must be taken into consideration.
- 9.5 **If the CMA is to continue with a ROCE approach, it is imperative that the CMA's methodology for asset revaluation robustly addresses these challenges**. This is essential if the CMA's analysis is to provide economically meaningful and reliable ROCE estimates.
- 9.6 **If the CMA is unable to develop a robust approach to asset valuation, then the CMA cannot place any weight on this analysis in its assessment of the market.**
- 9.7 **IVC welcomes the CMA's recognition of the challenges**, and that the CMA is considering the appropriate approaches to valuing tangible and intangible assets appropriately. However, **IVC is keen to impress upon the CMA the significance and fundamental nature of these challenges**. The solutions to these challenges are not straightforward nor is the information to address them readily available "off the shelf."
- 9.8 In IVC's view the most appropriate valuation approaches include: (1) rebuild cost estimates; (2) start-up losses; and (3) marketing / customer acquisition cost approach. IVC has previously shared 'proof of concept' methodology and analysis for these approaches with the CMA, and IVC is keen to engage further with the CMA to support it to develop its methodology and analysis.

It is not appropriate to assess the profitability of LCG's veterinary businesses in aggregate

- 9.9 **The CMA outlined in its Working Paper that it is considering to not look "separately [at] the economic profitability of the different types of veterinary services."** The CMA proposes "to assess the profitability of the veterinary services operations of each

LCG” and not “*assess separately the economic profitability of the different types of veterinary services.*”⁷⁹

- 9.10 **IVC strongly disagrees with the CMA’s approach. In IVC’s view it is important to distinguish between clinical veterinary services (FOP, referral centres, animal hospitals, OOH) and non-clinical veterinary services** (pet crematoria, online pharmacies, external diagnostics laboratories). The CMA should assess profitability focusing on the core clinical veterinary services.

Next steps and the need for ongoing engagement

- 9.11 In IVC’s view, given the challenges the CMA faces, the publication of the CMA’s Working Paper needs to be the start of an intensive period of engagement and collaboration between the CMA and the LCGs.
- 9.12 **In IVC’s view, an important next step is for the CMA to host a roundtable with LCGs now as it starts to develop its methodology in more detail**, and IVC repeats its request to the CMA to engage with this suggestion.

⁷⁹ CMA Working Paper, para. 4.38