

CMA veterinary services for household pets market investigation

Linnaeus response to the CMA's paper on "Approach to profitability and financial analysis", dated 1 November 2024

22 November 2024

1. INTRODUCTION AND SUMMARY¹

1. This response sets out Linnaeus' views on the proposed profitability analysis which the CMA intends to carry out in the market investigation into veterinary services in the UK, as set out in the CMA's paper on "Approach to profitability and financial analysis", published on 1 November 2024 (the **CMA's Profitability Paper**).
2. This Section 1 provides a brief overview and summary of Linnaeus' comments, as described in greater detail through the rest of this paper.
3. **In Section 2, Linnaeus provides its overarching comments on the general principles set out in the CMA's Profitability Paper.** Linnaeus welcomes the opportunity to be able to comment on the CMA's proposed methodology, and, at a high level, agrees with the scoping, timing and overall conceptual approach being proposed. There are, however, some important aspects of this approach which require further consideration in order to avoid reaching conclusions that are at odds with market reality. *First*, Linnaeus agrees with the CMA that it is necessary to examine profitability over a sufficiently long period to obtain a representative picture. However, even the results of a 5-year lookback period will need to be examined very carefully in order to properly account for the volatility which the veterinary industry has faced as a result of the COVID-19 pandemic, higher labour costs and a difficult economic environment. *Second*, and as described further below, although Linnaeus broadly agrees with the proposed approach of comparing ROCE to WACC in order to measure profitability, it is critical to ensure that the inputs feeding into this methodology are sound. For example, the valuation of assets should reflect their true economic value and the notional WACC should reflect the cost of capital of a standalone provider of veterinary services.
4. **In Section 3, Linnaeus considers the CMA's proposed approach to the computation of operating profit** (for the purposes of using this figure in its calculation of ROCE). Linnaeus agrees with the CMA's approach of starting with the accounting figures in the profit and loss accounts, and then making adjustments to reach an economically meaningful figure. Linnaeus explains the various elements of cost included in its reported operating profit and **[Redacted - Confidential]**.
5. **In Section 4, Linnaeus considers the CMA's proposed approach to the valuation of tangible fixed assets.** Linnaeus supports the CMA's proposal to adjust the NBV to reflect the current economic value of tangible assets. The NBV on the balance sheet **[Redacted - Confidential]**.

¹ Defined terms used in this paper have the same meaning as in the CMA's Profitability Paper.

6. Insurance values and set-up costs for new sites can serve as proxies for replacement costs of tangible assets. [**Redacted - Confidential**].
7. **In Section 5, Linnaeus considers the CMA's proposed approach to the valuation of intangibles.** Linnaeus is concerned that the CMA appears to be proposing a bottom-up cost-based approach that will significantly undervalue intangible assets. *First*, under the CMA's approach, it is important to ensure that all relevant assets, such as customer relationships, brand reputation, IT systems and software, accreditation and training initiatives are included to avoid underestimating the true value of intangibles. *Second*, with regards to customer relationships, direct marketing costs alone are insufficient as a substantial proportion of marketing efforts and investments may not be fully compensated or recorded under marketing. Linnaeus illustrates the difficulties of this approach in the information provided below.
8. Linnaeus proposes that intangible assets can instead be valued using a "build versus buy" framework, building on the CMA's suggested approach of using start-up losses to value intangible assets. This framework considers the costs a firm would incur to build a business from scratch versus buying an established one, highlighting the substantial value of intangibles that allow a firm to bypass initial losses and achieve steady-state profits more quickly. For example, [**Redacted - Confidential**]. A narrow focus on direct marketing costs alone would ignore market reality in this area.
9. **Finally, in Section 6, Linnaeus comments on the CMA's use of WACC, comparisons between WACC and IRR, and inefficiencies.**
10. *First*, while Linnaeus agrees in theory with the use of WACC as a competitive benchmark for profitability analysis, Linnaeus notes that [**Redacted - Confidential**].
11. *Second*, Linnaeus notes several reasons that give rise to legitimate differences in cost structures between LCGs and smaller independent practices (such as differences inherent in smaller practices being staffed by practice owners, the absence of formalised quality assurance and other procedures, and a lighter fiscal reporting burden for smaller practices), and from one LCG to another (such as differences in service provision and geographic coverage). As such, finding variations in costs between market participants should not be equated with inefficiencies.
12. *Third*, Linnaeus emphasises that IRRs should not be expected to equal WACC, given any investment documents will predict an IRR higher than WACC (as no firm would be willing to make an investment that is expected make a return which is lower than the cost of capital). [**Redacted - Confidential**]. Linnaeus explains this data in more detail below.

2. COMMENTS ON GENERAL PRINCIPLES

Scope of the CMA's analysis

13. Linnaeus broadly agrees with the CMA's proposed scope for its profitability assessment, as set out in the CMA's Profitability Paper. In particular, Linnaeus agrees that (as noted at paragraph 4.38 of the CMA's Profitability Paper), given (i) the limitations of the data which is available, (ii) the complexities in separating the various in-scope activities, and (iii) the difficulty of comparing these across the various LCGs and independent veterinary services practices, it is likely not feasible to assess the economic profitability of the different types of veterinary services.
14. That said, Linnaeus notes that in order to ensure the robustness of the analysis it would be advisable for certain activities, namely pet cremation services and the online pharmacies (which are not in scope), to be removed from the overall results for veterinary services to the extent possible. While these activities are not provided by Linnaeus itself, Linnaeus considers that these activities are likely to have

a significantly different business model, with different cost and profitability structures. These therefore risk skewing the overall profitability results for the market.

Time period under consideration

15. Linnaeus agrees with the CMA that it is necessary to examine profitability over a sufficiently long period to provide a representative picture of profitability. Linnaeus also agrees that in theory, a 5-year lookback period is an appropriate time period. However Linnaeus notes that as previously flagged to the CMA, **[Redacted - Confidential]**.²
16. Linnaeus also notes that even using the last 5 years may not be sufficient to achieve a stable view of the industry profitability going forward given the significant changes seen over this period. Specifically, as the CMA's Profitability Paper acknowledges, both COVID-19 and the increased labour costs during the last five years have had a significant and continuing impact on the level of profitability, and as such these macro-economic factors cannot be disregarded in its assessment.
17. With respect to the COVID-19 pandemic, as the CMA points out, this had a mixed effect on the veterinary services industry, with the significant uptick in pet ownership leading to increased revenues during that period, and in particular during 2021. Between 2020 and 2021 **[Redacted - Confidential]**. This means that the years during and immediately after COVID (i.e. 2020 and 2021) should not be seen as reflecting the normal rate of return or profitability.
18. The second main macro issue that has impacted Linnaeus **[Redacted - Confidential]**.

Overarching conceptual approach / ROCE Methodology

19. Linnaeus agrees with the CMA's proposed approach of measuring profitability using the return on capital employed ("ROCE") and comparing it to a competitive benchmark like the WACC.³ However, there are two important caveats.
20. First, when estimating the ROCE, all relevant costs and assets, including intangible assets, must be considered, and the valuation of assets should reflect their true economic value. Absent this, the ROCE methodology is unlikely to provide meaningful answers to the question of whether the market is making high profits. To support the CMA in this, Linnaeus has provided additional comments on valuing tangible and intangible assets in section 4 and section 5, respectively.
21. Second, the CMA is planning to use the WACC of a 'notional provider' as a benchmark for all LCGs and compare it to LCGs' internal estimates as a sense check. In this regard, Linnaeus notes that **[Redacted - Confidential]**. The CMA should take this into account when estimating the notional WACC which should reflect a standalone provider's cost of capital. In addition, where LCGs' internal WACC estimates show a wide range, the CMA should take this into account by adopting a more generous threshold within which the return on capital would not be considered excessive. Linnaeus provides more detailed comments on the WACC in section 6.1.

² See also **[Redacted - Confidential]**.

³ CMA's Profitability Paper, para 4.1-4.11.

Materiality

22. Linnaeus agrees with the CMA's approach to materiality and complexity.⁴ Specifically, Linnaeus shares the CMA's view that any value that is capable of changing the outcome of a profitability analysis is material. As submitted to the CMA previously, [**Redacted - Confidential**].
23. Irrespective of what Linnaeus does internally, the appropriate threshold for the revaluation of assets should depend on the threshold which the CMA intends to use with respect to its profitability assessment. For example, if the CMA was to consider that a ROCE which is even nominally higher than the WACC is excessively profitable, then obviously any incorrect valuation of an asset may well be material in terms of the CMA's consideration. To assist the CMA with assessing materiality, Linnaeus has provided data where available to illustrate the size of the adjustments proposed in this response.

3. CALCULATING PROFITABILITY

24. As part of the CMA's profitability methodology, the ROCE must be calculated using operating profits and net operating capital employed. This section outlines Linnaeus' operating profit and explains the costs included in this measure.
25. Linnaeus summarises below its level of operating profit that relates to the provision of veterinary services in the UK. The information provided below is based on the data submitted to the CMA.⁵

Table 1: Linnaeus operating profit (£), 2019-2023

[**Redacted - Confidential**]

26. All the revenue and costs presented in the table above relate to the provision of veterinary services by Linnaeus and therefore should be considered for the purpose of the profitability analysis. Specifically, the following items are included:
- **Revenue:** the revenue represents the pre-tax amount receivable from customers for the provision of veterinary services, net of discounts.
 - **Cost of sales (materials):** these costs comprise pharmaceuticals and other consumables, net of rebates and discounts.
 - **Direct personnel costs:** this refers to the cost of personnel working at individual sites. This includes the total compensation (i.e., wages plus bonuses) of all contracted veterinary surgeons, nurses and administrative staff (e.g. permanent, temporary and locums).
 - **Site-related operating costs:** these are operating costs related to individual sites such as rent, repairs and maintenance, site running costs, staff training, insurance, lease of equipment, and more.
 - **Other operating costs:** the main other operating costs relate to central support costs, including support office staff, marketing, IT, legal, finance, etc. These central support functions are specific to the provision of veterinary services.

4 CMA's Profitability Paper, para 4.29-4.31.

5 See response to RFI6, financial template for years 2021 to 2023. The data have been extended to cover 5-year period.

- **Depreciation:** this comprises of depreciation costs for individual sites as well as central support, mainly in relation to property, fixtures, and fittings used for the provision of veterinary services.
- **[Redacted - Confidential].**

27. **[Redacted - Confidential].**

28. More generally, **[Redacted - Confidential]**:⁶

29. **[Redacted - Confidential].**

30. **[Redacted - Confidential].**

31. For the purposes of calculating economic profitability, all relevant costs should be included, **[Redacted - Confidential]**.

32. **[Redacted - Confidential].**

33. **[Redacted - Confidential].**

34. **[Redacted - Confidential].**

35. **[Redacted - Confidential].**

4. APPROACH TO THE VALUATION OF TANGIBLE FIXED ASSETS

36. For the purposes of its economic profitability analysis, the CMA proposes to include tangible fixed assets (comprising mainly buildings, fixtures and fittings and medical equipment) in the capital employed. Consistent with the CMA guidelines, the CMA's Profitability Paper states that these assets should be valued according to the current opportunity cost of owning the asset or the value to business ("VTB").⁷ The CMA also accepts that the accounting values of these assets as reflected in the net book value ("NBV") on the balance sheet may not reflect the VTB therefore adjustments to the NBV may be needed to reflect this.

37. Linnaeus welcomes the CMA's openness to make adjustments to the accounting values of tangible assets to reflect their economic value. Linnaeus has reviewed the NBV of its tangible assets and considers **[Redacted - Confidential]**. It is important that these values are correctly adjusted in order to undertake a meaningful economic profitability analysis. In the remainder of this section, Linnaeus explains why **[Redacted - Confidential]** and then provides comments on the CMA's proposed adjustments to ensure that an economically meaningful value is used.

6 See also response to RFI6.

7 The VTB is typically the current replacement cost of the asset or more precisely, the replacement cost of a Modern Equivalent Asset ("MEA") determined in a fully competitive market and allowing for the asset's useful life. The MEA value is the cost of replacing an old asset with a new one with the same service capability. See CMA's Profitability Paper, paras 4.17-4.25.

4.1. Issues with using the NBV values on the balance sheet

38. The CMA accepts that the NBV values on the balance sheet may not be a good approximation for the current economic (or Modern Equivalent Asset (“MEA”)) value.⁸ Linnaeus considers that **[Redacted - Confidential]**:

- First, Linnaeus, and the business it has acquired, records assets at their historical cost on the balance sheet, rather than their current or replacement cost.
- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.

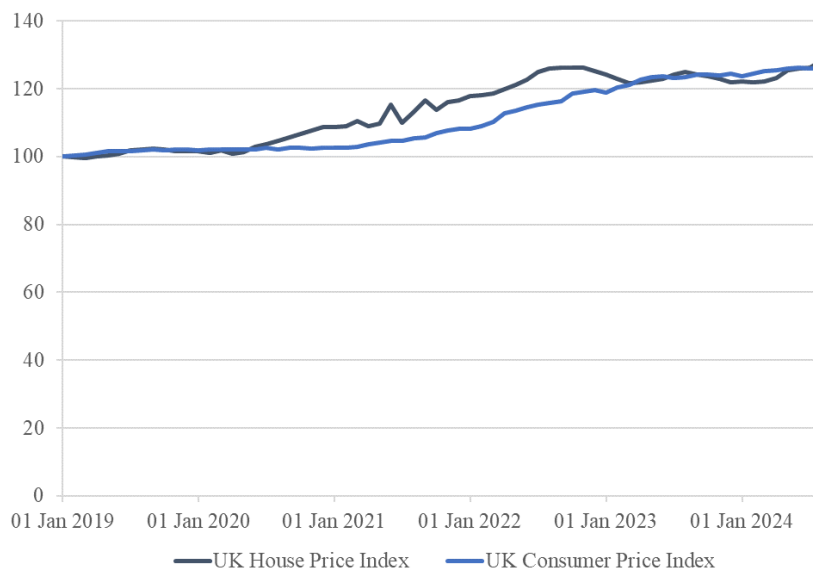
39. Each of these are discussed in greater detail below.

4.1.1. Assets are recorded at historical cost on the balance sheet

40. For accounting purposes, **[Redacted - Confidential]**.

41. Evidence shows that property prices and lease rates have increased considerably over time. For example, the figure below shows trends for the UK House Price Index (HPI) and Consumer Price Index (CPI) – proxies for changes in property prices and lease rates respectively – over the last five years.⁹

Figure 1: UK House Price Index and Consumer Price Index, 2019-2024



Source: <https://www.gov.uk/government/statistical-data-sets/uk-house-price-index-data-downloads-august-2024> and

Notes: January 2019 = 100.

⁸ CMA’s Profitability Paper, para 4.43 et seq.

⁹ **[Redacted - Confidential]**. In previous investigations, the CMA has looked at both HPI and CPI when looking to revalue owned property (including properties owned or held under long finance lease). See for example, the CMA’s approach in the Funerals Market Investigation, Appendix S, paras 57 to 73.

42. The figure above shows that over the last five years, both house and consumer price inflation increased by over 25%. This means that properties or lease rates on the balance sheet that have not been revalued over the last five years **[Redacted - Confidential]**.

43. **[Redacted - Confidential]** Linnaeus has looked at examples of key assets on its balance sheet and considered what their actual replacement cost would be relative to the NBV.

*Examples of **[Redacted - Confidential]** freehold assets*

44. In relation to freehold assets, **[Redacted - Confidential]**:^{10,11}

- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.

45. **[Redacted - Confidential]**.

*Examples of **[Redacted - Confidential]** leased assets*

46. In addition to freehold assets, leased properties on the balance sheet **[Redacted - Confidential]**.

- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.

[Redacted - Confidential]

47. **[Redacted - Confidential]**.

4.1.2. Depreciation does not reflect the true economic life of assets

48. A second reason as to why the NBV of tangible fixed assets is not a good approximation for the cost of replacing the assets is the fact that some assets on the balance sheet are depreciated over a period which is shorter than their true economic life. This means that assets may appear on the balance sheet as **[Redacted - Confidential]** and therefore attributed a **[Redacted - Confidential]** NBV even though they are still in use and hence have a positive remaining useful economic life. For accounting purposes, Linnaeus **[Redacted - Confidential]**.

49. This issue is most relevant for machinery and equipment, which for accounting purposes are depreciated over a period of **[Redacted - Confidential]** (depending on the type of equipment). However, the useful economic life of these assets is often **[Redacted - Confidential]**. For example:

- **[Redacted - Confidential]**.
- **[Redacted - Confidential]**.¹²

50. **[Redacted - Confidential]**.

10 **[Redacted - Confidential]**.

11 A reinstatement valuation is similar to estimating the replacement cost as it seeks to assess the cost of rebuilding the asset from scratch at the present time.

12 **[Redacted - Confidential]**.

4.1.3. Unrecorded assets

51. [Redacted - Confidential].

52. [Redacted - Confidential]:

- [Redacted - Confidential].
- [Redacted - Confidential]¹³, [Redacted - Confidential]¹⁴ [Redacted - Confidential].
- [Redacted - Confidential].
- [Redacted - Confidential].
- [Redacted - Confidential].

4.1.4. Linnaeus' [Redacted - Confidential] approach to capitalising assets

53. Finally, as explained above, [Redacted - Confidential]:

- [Redacted - Confidential].
- [Redacted - Confidential].
- [Redacted - Confidential].

4.2. Comments on the CMA's approach to the recognition of tangible assets

54. The CMA's Profitability Paper acknowledges that the asset books may significantly underestimate the value of the tangible assets. This subsection provides comments on each of the main elements of tangible assets and sets out relevant evidence in order to provide the CMA with a view on the extent to which these areas of assets may be undervalued.

4.2.1. Freehold assets

55. As explained above, freehold assets [Redacted - Confidential] as they are generally recorded at their historical cost, which reflects the value of the original cost of the asset inherited through acquisition. For this reason, Linnaeus welcomes the CMA's openness to revaluing the freehold assets on the balance sheet and agrees that this is the correct approach.¹⁵

56. Linnaeus has not undertaken a recent revaluation of its freehold properties to estimate the replacement cost of these properties. However, as explained in section 4.1.1, [Redacted - Confidential].

[Redacted - Confidential]

57. [Redacted - Confidential].

4.2.2. Leased assets

58. In the CMA's Profitability Paper, the CMA proposes to capitalise leases in order to include them in the capital base. This would also apply to companies who under UK GAAP do not recognise these leases on their balance sheet.¹⁶ Linnaeus agrees with this general approach. For leased assets Linnaeus bears

13 [Redacted - Confidential].

14 [Redacted - Confidential].

15 CMA's Profitability Paper, para 4.46.

16 CMA's Profitability Paper, para 4.45.

substantially all the benefits and risks of ownership therefore it considers that it is appropriate to capitalise these assets.

- 59. However, Linnaeus considers that, similarly to other asset classes, it is also very important that adjustments are made to the lease values so that they reflect their current replacement cost value. To the extent these leases are not revalued regularly, and lease rates **[Redacted - Confidential]**.¹⁷ For this reason, Linnaeus encourages the CMA to review these leases and make adjustments to their NBV value so that they reflect their replacement cost value, similar to the revaluation of freehold properties.
- 60. In addition, **[Redacted - Confidential]**.¹⁸ Therefore, as suggested in the CMA's Profitability paper, a meaningful evaluation of these assets requires further investigation.

4.2.3. Machinery and equipment

- 61. The CMA accepts that the NBV is not a good approximation for the MEA value of fixtures, fittings and equipment and states that it will seek further information and consider the most appropriate approach such as using the insurance values, re-build estimates, identifying missing assets etc.
- 62. Linnaeus welcomes this approach and highlights that the issues identified above have **[Redacted - Confidential]**. Specifically, Linnaeus provided some examples above which demonstrate that **[Redacted - Confidential]**, it considers that the insurance values and the re-build estimate provided in the next section provide a good proxy for their replacement cost.

4.3. Alternative methods to estimate overall value of tangibles

- 63. As explained in the previous subsection, Linnaeus has not carried out a revaluation exercise to estimate the replacement cost of each category of tangibles assets. However, Linnaeus has considered two alternative methodologies (i) insurance values and (ii) set up costs for new sites, both of which can in theory provide a meaningful proxy for the true value of Linnaeus' tangible assets. However, as explained below **[Redacted - Confidential]**.

4.3.1. Insurance values

- 64. Linnaeus has used its feedback on the annual insurance questionnaire as a proxy for the replacement cost of most of the tangible fixed assets on its balance sheet. The insurance replacement value of the main categories of assets comprising buildings, leasehold improvements and site contents between 2021 and 2023 is summarised in the table below and compared against their NBV as recorded on the balance sheet.¹⁹

Table 2: Comparison of NBV and insurance value of Linnaeus fixed tangible assets, 2021-2023
[Redacted - Confidential]

- 65. The table above shows that **[Redacted - Confidential]**.²⁰
- 66. **[Redacted - Confidential]**.

17 See examples provided in section 4.1.1.
18 **[Redacted - Confidential]**.
19 **[Redacted - Confidential]**.
20 It is typically the landlord's responsibility to insure the building itself, **[Redacted - Confidential]**.

4.3.2. Historic estimates on set up costs for new sites

67. An alternative proxy for the replacement cost of tangible assets can be derived based on historical estimates of how much it cost to set up a new site or move an existing site. This can be used to provide a view of the replacement cost of the Linnaeus business (with appropriate assumptions regarding depreciation).
68. Linnaeus does not hold information systematically on the set-up cost of its clinics. However, Linnaeus has three recent examples on the fit-out cost of sites.²¹ In particular:
- Linnaeus had a cost plan for a completed new primary care site when the **[Redacted - Confidential]** site was relocated in 2022. The total spend for this site was estimated to be around **[Redacted - Confidential]**, comprising property fit-out cost of **[Redacted - Confidential]**, machinery and equipment cost of **[Redacted - Confidential]**, office and furniture equipment (**[Redacted - Confidential]**), and IT hardware **[Redacted - Confidential]**. This does not include the costs for a CT scanner, which Linnaeus estimates to require an additional **[Redacted - Confidential]**. Linnaeus considers that **[Redacted - Confidential]** is a representative example (in terms of size), which can be extrapolated to derive a replacement cost for its primary care estate.²²
 - Linnaeus also had a cost plan for a completed new primary care site **[Redacted - Confidential]** that opened on **[Redacted - Confidential]**. Similar to **[Redacted - Confidential]**, the total spend for this site was estimated to be around **[Redacted - Confidential]**. This consisted mainly of the property fit-out cost of **[Redacted - Confidential]** and machinery and equipment cost of **[Redacted - Confidential]** (excluding a CT scanner), as well as costs related to office and furniture equipment (**[Redacted - Confidential]**) and IT hardware (**[Redacted - Confidential]**).²³
 - Lastly, Linnaeus had a cost plan for a completed new referral centre when **[Redacted - Confidential]**. It was estimated that the total spend for this site amounted to around **[Redacted - Confidential]**, comprising of costs related to the property fit-out (**[Redacted - Confidential]**), machinery and equipment (**[Redacted - Confidential]**), office and furniture equipment (**[Redacted - Confidential]**), and IT hardware (**[Redacted - Confidential]**). **[Redacted - Confidential]** however is an example of a relatively small referral centre. **[Redacted - Confidential]**. Given this, Linnaeus considers that a mid-point estimate between **[Redacted - Confidential]** is likely to be a conservative estimate of typical set up costs across the Linnaeus referral centre estate (i.e. **[Redacted - Confidential]**).²⁴
69. The costs for the sites above can be extrapolated to derive an approximate replacement cost estimate for all sites in Linnaeus' estate. This estimate is conservative as it only includes the fit-out cost of setting up these properties, not the replacement cost of acquiring the property. Specifically, the average set-up costs for **[Redacted - Confidential]** and **[Redacted - Confidential]** (i.e. **[Redacted - Confidential]**) can be multiplied by the total number of Linnaeus primary care sites (**[Redacted - Confidential]**) and the mid-point set-up cost estimate between the **[Redacted - Confidential]** and **[Redacted - Confidential]**

21 Note, the fit-out cost does not include the cost of acquiring the property.

22 **[Redacted - Confidential]**.

23 **[Redacted - Confidential]**.

24 This is a conservative approach as an adjustment based on square footage would imply a greater uplift to the **[Redacted - Confidential]** site's cost **[Redacted - Confidential]**.

Confidential]referral centres (i.e. **[Redacted - Confidential]**) can be multiplied by the total number of Linnaeus referral centres (**[Redacted - Confidential]**).²⁵

70. To account for the fact that the primary care practice assets in Linnaeus' estate are not all new, **[Redacted - Confidential]**
71. Table 5 below shows how the extrapolated replacement cost estimates for Linnaeus' sites compares to their P13 2023 NBV.

Table 3: Comparison of NBV and extrapolated set-up costs for primary care practices and referral centres²⁶

[Redacted - Confidential]

72. **[Redacted - Confidential]**.
73. Linnaeus' view is that the figures above provide strong evidence that the asset values on the balance sheet are **[Redacted - Confidential]** the current replacement cost (even if at this stage they are based on a small but meaningful sample). Accordingly, the available evidence shows it is appropriate to adjust the balance sheet value of the land and buildings as well as machinery and equipment assets.

5. APPROACH TO THE VALUATION OF INTANGIBLES

74. The CMA proposes to include certain intangible assets in the capital employed for the purpose of the economic profitability analysis where the following criteria are met:²⁷
- It must comprise a cost that has been incurred primarily to obtain earnings in the future;
 - This cost must be additional to costs necessarily incurred at the time in running the business; and
 - It must be identifiable in creating an asset separate from any assets arising from the general running of the business.
75. Linnaeus welcomes the CMA's approach to consider the inclusion of intangible assets in the capital employed. However, Linnaeus has some concerns that the CMA's proposed methodology in this regard, which appears to be based on valuing intangibles on a bottom-up cost basis, may significantly undervalue their true value. To show this, this section first explains why the value of intangibles is likely to be substantial using a simple "build versus buy" thought experiment, before using Linnaeus' startup costs for greenfield sites to provide an estimate of the magnitude of intangibles. The section then explains why the bottom-up costs of customer acquisition approach of the CMA is likely to significantly underestimate the value of intangibles.

5.1. Using "build versus buy" decision to estimate the value of intangibles

76. The CMA proposes using start-up losses as a proxy for the cost of developing the intangible assets.²⁸ However, in addition to the explicit costs incurred, there is also an implicit loss during the start-up phase in terms of making lower profits than a mature business would. This section proposes a framework

25 The number of primary care sites and referral centres is based on the RF14 response. For the purpose of this exercise, **[Redacted - Confidential]**.

26 **[Redacted - Confidential]**.

27 CMA's Profitability Paper, para 4.50 and CC3 (Revised), Annex A, paragraph 14.

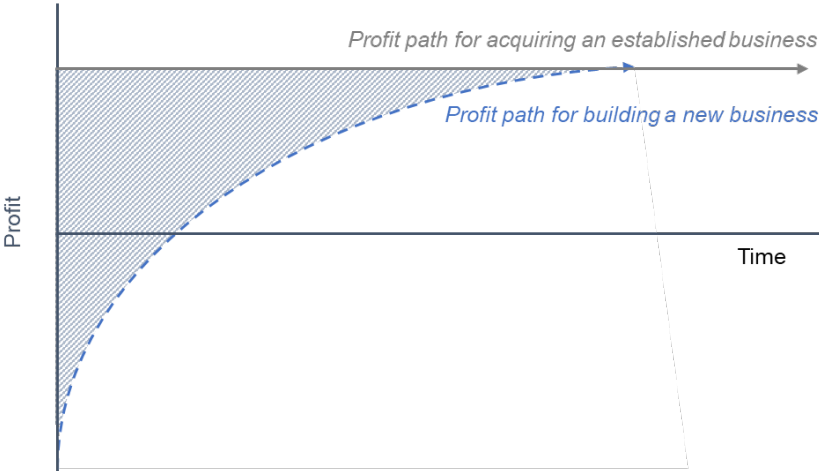
28 CMA's Profitability Paper, para. 4.60.

based on this concept of foregone profits to estimate the value of intangibles. Then, the framework is applied to data from Linnaeus on the financial projections for new sites to provide a rough estimate of the value of intangibles for Linnaeus which demonstrates that intangible assets in a firm which has acquired vet sites can be significant.

5.1.1. Framework for estimating value of intangibles

- 77. The magnitude of the intangible value can be demonstrated by reference to the replacement cost principle, which involves considering the amount that a firm would be willing to pay for an established business in a competitive bidding market. A firm’s willingness to pay for an established business will be up to the level of what it would cost to build that business itself. At any level lower than this ‘build’ cost, it will be optimal to buy the established business, as that business will provide additional value versus building a new business from scratch. Similarly, it will never be willing to pay more than the build cost for acquiring a firm, as it would create more value by building the business independently than purchasing it.
- 78. In valuing an established business, the business’ value will factor in all of the tangible assets that have been invested in and allow the firm to make future profits. However, buying an established business creates an additional benefit versus building it from the start. This is because buying an established business allows the firm to bypass the losses and lower profits associated with starting a new business until it reaches maturity.
- 79. This difference is set out in Figure 2 below. The solid grey line represents a mature business that is generating some level of steady state profit. If a firm was to buy the business, this is the level of profit that it would make going forward. However, when building such a business, a firm will not be able to instantly obtain that level of profit. Initially there are likely to be losses, as the firm will have to make investments without the associated revenue streams. For example, it takes a significant amount of time to establish a mature book of business, customer relationships, brand recognition etc. However, costs such as buildings, equipment, as well as the marketing and brand investments needed to generate those longer-term benefits are incurred immediately. The result is that profits will only increase slowly, often starting off negative in the short run, until a firm may finally breakeven, and then increase to a mature, steady level once it has established itself. This is denoted by the dotted blue line in Figure 2.

Figure 2: Illustration of “build versus buy” decision



- 80. Returning back to the question of valuation, a firm acquiring an established business therefore acquires not only the ability to make future profits, but also the ability to bypass the losses and lower profits that would be incurred if it was to build the business itself. In a competitive bidding market, the firm will be

forced to pay, not only the value of the established business, but also the shaded area in Figure 2 which represents the difference between steady state profits and the lower start-up profits/losses. Whilst it would clearly like to bid a value that did not incorporate this shaded area, (allowing it to expropriate the investments the firm made to build the business), in a competitive bidding market there will be another firm that can bid higher, and still prefer to buy the established firm rather than build it itself. The competitive equilibrium in this market will therefore result in a competitive acquisition price that includes not only all of the existing tangible assets to produce the level of profit going forward, but also all of the shaded area below. This value is not made up of any tangibles, as the physical infrastructure that is being bought is identical in the build and buy scenario – it is made up of intangibles.

- 81. The size of these intangibles depends on how much it costs to develop the business (e.g., to develop the software, acquire customers, build the brand etc.), how long it takes to set-up and grow the business, and the rate of growth. For accounting purposes, the value of all these elements will be reflected in the value of the intangible assets. These assets **[Redacted - Confidential]** if they were developed organically, particularly if a business is a small business, **[Redacted - Confidential]**. However, from an economic and indeed from the buyer's perspective, these assets have a clear value that is separable from the day-to-day operations of the business and commands a premium in a competitive market. As such they clearly should be included in the capital base when conducting a profitability analysis.
- 82. The above framework also provides a methodology to estimate the value of intangible assets. The difference between the steady state level of profit, and the 'build' level of profit (i.e. the shaded area), provides a direct estimate of the level of intangible assets. As discussed further below, this can be estimated directly using P&L projections for greenfield sites prepared in the normal course of business.

5.1.2. Estimating intangible assets based on the set-up costs of new sites

- 83. As explained above, the start-up losses in a situation of organic growth can offer a complete view of the cost of building up the intangible assets during the start-up phase. **[Redacted - Confidential]**.
- 84. **[Redacted - Confidential]**.
[Redacted - Confidential]
- 85. **[Redacted - Confidential]**
[Redacted - Confidential]
- 86. **[Redacted - Confidential]**.
- 87. **[Redacted - Confidential]**. Such a high level of intangibles cannot be ignored under the CMA's materiality principle.
- 88. In comparing this to the amount of intangibles on Linnaeus' balance sheet, which was **[Redacted - Confidential]** in 2023, Linnaeus notes that the **[Redacted - Confidential]** in the table above is **[Redacted - Confidential]**.²⁹ There are three main reasons for this.
- 89. *First*, as set out in the previous section on tangible assets, a substantial portion of the intangibles figure of **[Redacted - Confidential]** on the balance sheet **[Redacted - Confidential]**. Specifically, as the CMA's Profitability Paper acknowledges, goodwill (which for Linnaeus is valued at **[Redacted -**

29 See response to RFI6, financial data template for 2023.

Confidential) is often **[Redacted - Confidential]** a balancing figure within consolidated statements.³⁰ **[Redacted - Confidential]**.

90. *Second*, the methodology outlined above only includes the value of intangibles as at the time of acquisition, excluding intangibles that Linnaeus develops organically. This is because, for accounting purposes, a company capitalises assets only when there is a trigger, such as an acquisition. Assets that Linnaeus may have developed organically include the **[Redacted - Confidential]**. This means that the **[Redacted - Confidential]** is likely to be an **[Redacted - Confidential]** of the true value of the intangibles.
91. *Third*, **[Redacted - Confidential]**. This is another reason why **[Redacted - Confidential]**.
92. For all of the reasons above, the **[Redacted - Confidential]** is likely to be a **[Redacted - Confidential]**.
93. The methodology and resulting estimates above make the implicit assumption that the projected EBITDA profit is achieved in a competitive environment and therefore does not reflect any excess profits. The CMA may potentially be concerned that, if the level of EBITDA profits is higher than the competitive level, estimating the level of intangibles on the basis of EBITDA may be circular. Linnaeus has two comments on this issue.
94. *First*, the greenfield site will face significant competition once launched. **[Redacted - Confidential]**.
95. *Second*, even if the CMA was to reject the notion that the estimates above reflect competitive conditions, such a concern could be relatively easily dealt with still within the framework above. The CMA could use an alternative competitive benchmark that it considers is consistent with a normal rate of profits (e.g., a measure based on a nominal WACC) as the basis of the long run steady state of profit, and then perform the same calculation of foregone profits during the period it takes to reach this level. This would remove any potential circularity in the estimate, without negating the validity of the methodology.

5.2. Concerns with estimating intangible assets based on a bottom-up cost-based approach

96. As set out in the previous section, Linnaeus considers that the above methodology provides an economically coherent and simple framework to calculate the aggregate value of intangibles. This is consistent with the start-up loss approach that the CMA outlines and its emphasis on lack of unnecessary complexity.³¹ Linnaeus notes that the CMA also outlines an additional approach in relation to the valuation of brand and customer relationships, that is using the marketing costs as a 'bottom-up' approach. Linnaeus considers that there are substantial practical issues and obstacles in the implementation of this approach, which generates a substantial risk that this approach will produce estimates that will significant understate the overall true value of intangibles. These concerns are set out for each category of intangibles below.

5.2.1. Customer relationships

97. The CMA states that it will consider brand and reputation assets as an intangible asset. The CMA considers that brand and reputation assets could include customer lists, trade names, and know-how.³² Further, the CMA proposes to use the marketing costs as a proxy for the replacement cost of customer

30 CMA's Profitability Paper, para 4.55.

31 CMA's Profitability Paper, para 4.61 and 4.31.

32 CMA's Profitability Paper, para 4.57.

relationships (and as an alternative to the start-up losses approach). Linnaeus has several comments in this regard.³³

98. *First*, Linnaeus views customer relationships as being distinct from brand and reputation. Intuitively, a business could offer to buy a vet practice's customer lists only, brand/trade name only, or both. The fact that customer relationships are bought alongside the underlying business in most cases is not sufficient evidence on its own to conclude that they are not a separate asset as the CMA suggests.³⁴ Indeed, the CMA cites two counterexamples of Medivet buying customer relationships without the underlying business and assets, which is enough to show that customer relationships *can* be bought separately.³⁵ Other clearly separable assets, like medical equipment, are also often included in the sale of an entire vet business. This goes to show that whether or not an asset is often included in the sale of a business is not a useful test to assess asset separability.
99. *Second*, the value of customer relationships is likely to be significant. Linnaeus customer relationships are valued at **[Redacted - Confidential]** on the balance sheet.³⁶ **[Redacted - Confidential]**. While the CMA may wish to satisfy itself that there is no circularity inherent in the quantum of this valuation, the fact that customer relationships are included separately and with a significant value on Linnaeus' balance sheet is clearly indicative of customer relationships being an important intangible asset with material value.
100. *Third*, and most importantly while in theory a bottom-up cost-based approach avoids the risk of capitalising any 'excess profits' that may be reflected in the purchase price (and hence the purchased customer relationships), the marketing costs **[Redacted - Confidential]**.
101. For the reasons listed above, Linnaeus considers that customer relationships are an important intangible asset, but direct marketing costs alone will significantly understate their value. The CMA should aim to capture the cost of all the initiatives and marketing efforts aimed at building a customer base should it wish to apply a cost-based bottom-up approach. This is likely to be practically difficult to achieve, hence Linnaeus' preference for the "build versus buy" methodology discussed above.

5.2.2. Trademarks (brand and reputation)

102. The CMA lists trade names as another component of brand and reputation assets, alongside customer lists and know-how.³⁷ However, Linnaeus considers trademarks as an intangible asset, distinct from customer relationships. As explained above, the fact that in the vast majority of acquisitions, a tradename or brand were purchased alongside the underlying business and assets is not sufficient to show it is not a separate asset. As such, Linnaeus encourages the CMA to consider and value this asset separately.
103. Tradenames are currently valued at **[Redacted - Confidential]** on Linnaeus' balance sheet.³⁸ This relates to the reputation and industry recognition of the trade names of the acquired businesses. **[Redacted - Confidential]**. This is typically **[Redacted - Confidential]**.

33 CMA's Profitability Paper, para 4.61.

34 CMA's Profitability Paper, para 4.59.

35 CMA's Profitability Paper, footnote 59.

36 See response to RFI6, financial data template for 2023.

37 CMA's Profitability Paper, para 4.57.

38 See response to RFI6, financial data template for 2023.

104. Linnaeus notes that the CMA does not propose an approach to estimate this asset separately. If the CMA was minded to estimate the value of trade names using a bottom-up cost-based approach, Linnaeus notes that all direct and indirect costs in developing a trade name would need to be considered, rather than just the costs that are recorded on financial statements (e.g. marketing costs). Given these issues,, Linnaeus considers that the “build versus buy” methodology set out in the previous section is likely to be a more appropriate methodology.

5.2.3. Other intangible assets

105. Linnaeus considers that there are some other categories of assets that should be included in the capital employed for the purposes of a profitability analysis. This includes assets which are implicitly contained in the goodwill figure on the balance sheet or generated internally and hence not captured in the acquired businesses’ balance sheets.
106. *First*, as explained in the response to RF17, an important asset for Linnaeus which is not captured in the acquired businesses’ balance sheet [**Redacted - Confidential**].
107. [**Redacted - Confidential**].
108. *Second*, with respect to the cost of acquiring and/or developing [**Redacted - Confidential**], the CMA accepts that these meet the criteria for the recognition of an intangible asset in that they represent an investment in the business incurred primarily to obtain earnings in the future.³⁹ Linnaeus does not have accurate estimates on the cost of acquiring and/or developing system for a start-up company. However, Linnaeus has incurred investments in [**Redacted - Confidential**], which are in addition to the day-to-day running of the business. For example, [**Redacted - Confidential**].
109. [**Redacted - Confidential**] all these investments on [**Redacted - Confidential**] are [**Redacted - Confidential**]. For this reason, Linnaeus considers that they should be included as an asset in the capital employed for the purpose of a profitability analysis.

6. APPROACH TO WACC, IRR AND INEFFICIENCIES

110. The CMA proposes to use WACC as a competitive benchmark for the return that a company would be expected to achieve under normal competitive conditions. Further, the CMA plans to review the internal rate of return (IRR) anticipated at the time of previous acquisitions and views IRRs that significantly exceed WACC as a potential indicator of excess profits. The CMA also considers that a lack of competition could lead to incumbents being inefficient and therefore having high costs.
111. In this section, we explain: (i) that we agree with the use of WACC as a competitive benchmark and provide a calculation of Linnaeus’ WACC; (ii) why IRRs should not be expected to equal WACC even under normal competitive conditions; and (iii) why the CMA’s approach to inefficiencies runs a risk of circularity.

6.1. Use of WACC as a competitive benchmark

112. Linnaeus agrees with the CMA that in theory, the WACC is a reasonable competitive benchmark as it reflects the opportunity cost of investing in a certain asset, and therefore the return that investors expect

³⁹ CMA’s Profitability Paper, para. 4.54.

on their investment.⁴⁰ Linnaeus also agrees with the use of a pre-tax WACC⁴¹ and that the CMA should only be concerned when ROCE exceeds WACC for a sustained period of time, as year-to-year variations may be caused by one-off events rather than reflecting the state of competition.⁴² Finally, Linnaeus agrees with the CMA's general proposed approach to estimating a WACC for a notional standalone provider of veterinary services for household pets, **[Redacted - Confidential]**.

113. Linnaeus has provided to the CMA an estimate for its own WACC **[Redacted - Confidential]**.⁴³ Table 7 below presents the underlying calculations for this estimate and shows that this translates to a pre-tax WACC of **[Redacted - Confidential]**.⁴⁴

Table 4: **[Redacted - Confidential] WACC estimates for Linnaeus Group Limited**

[Redacted - Confidential]

114. Linnaeus expects that the WACC estimate of **[Redacted - Confidential]** derived by **[Redacted - Confidential]** is **[Redacted - Confidential]** the WACC of a notional standalone provider of veterinary services. Specifically, **[Redacted - Confidential]**.
115. *Finally*, on the CMA's proposal to cross check its WACC estimate for notional provider against LCGs' internal estimates of their individual WACC, Linnaeus notes the following. First, for the reasons explained above, the CMA should take into account that the internal estimate of **[Redacted - Confidential]**. Second, where the internal estimates show a wide range across LCGs, this would indicate that using the notional provider WACC may not be equally appropriate for all LCGs. For example, the largest amongst the other LCGs may be able to access capital at significantly lower rates than the smallest LCGs. Finding a wide range of WACCs should prompt the CMA to increase the threshold that it thinks would signal excess profits and competition concerns to account for firm heterogeneity.

6.2. Response to the CMA's comments on inefficiencies

116. The CMA's Profitability Paper states that a finding of low profitability may not necessarily signify that competition is working well, as weak competition may allow firms to be inefficient, inflating their costs.⁴⁵ The CMA's Profitability Paper proposes to consider whether there are inefficiencies by analysing the costs of Parties, alongside internal documents.
117. Whilst the CMA does not state exactly how it would examine the costs of firms, Linnaeus considers that comparing costs across firms is unlikely to be meaningful. Different firms are likely to have different ways of measuring and accounting for costs, particularly with respect to significant cost items such as wages and equipment. In such a case, it would be wrong for the CMA to conclude that because there were significant variances between firms' costs, some firms must be inefficient.

40 CMA's Profitability Paper, para. 4.2.

41 CMA's Profitability Paper, para. 4.12.

42 CMA's Profitability Paper, para. 4.7.

43 Response to RF17, question 5.

44 The formula for pre-tax WACC is $g \times R_d + 1/(1 - t) \times R_e \times (1 - g)$ where g is gearing; R_d is the cost of debt; R_e the post-tax cost of equity; and t is the corporation tax rate.

45 CMA's Profitability Paper, para 4.74.

118. Such issues are likely to be particularly acute when comparing larger practices with smaller independent practices. As set out in more detail below, smaller independent practices may have lower costs, but their costs are not directly comparable. In Linnaeus' experience, **[Redacted - Confidential]** smaller practices will have lower costs due to a number of reasons.
- First, they are often owned by one or more vets. These vets may prefer to pay themselves through the profits of the business rather than paying themselves a high salary.
 - Second, Linnaeus **[Redacted - Confidential]**.
 - Third, certain regulations, such as off-payroll tax rules (IR35) relevant for locums, only apply to businesses above a certain size. Many practices fall below this size, which would reduce their costs.
119. All of these factors will tend to result in independent vets having lower costs, even at an individual site level, than larger corporate practices. However, none of these differences provides evidence that the LCGs have inefficiently incurred costs.
120. Even within LCGs, there could be differences in costs that are not explained by inefficiencies. As the CMA acknowledged, higher quality services (where consumers can make informed decisions) and exogenous factors such as location could produce legitimate variations in costs.⁴⁶ This means that LCGs could have different costs if their practices provide different quality services on average or have a different geographical distribution. In addition, the mix of customer/pet types, services (e.g., FOP vs referral), treatment types, and size of practice are all features capable of giving rise to legitimate differences in costs. Finally, the corporate structure could influence costs: for example, some groups may be able to obtain certain inputs at lower prices due to economies of scope if these inputs are used in the corporate's other activities. As such, any comparison of LCG costs must take into account all fundamental sources.
121. The CMA also states that it would consider whether there has been over provision of certain services in the market.⁴⁷ Linnaeus has provided analysis by **[Redacted - Confidential]** showing that there is no evidence of Linnaeus providing higher cost treatments to patients relative to independent practices.⁴⁸ **[Redacted - Confidential]** carried out two analyses comparing the usage of so-called advanced treatments offered by Linnaeus's brands before and after they were acquired by Linnaeus:
- The first analysis showed that Linnaeus does not proportionately refer more pets to its referral centres (which often provide more sophisticated treatments) when compared to third party FOPs, and that referrals have not disproportionately increased following Linnaeus' acquisitions of FOP practices; and
 - The second analysis looked at MRI machine usage as a proxy for 'advanced treatments', and showed that MRI usage is generally constant or decreasing following acquisition by Linnaeus.⁴⁹
122. Both findings are inconsistent with Linnaeus providing higher cost treatments to patients relative to independent practices which are not part of integrated groups.

46 CMA's Profitability Paper, para 4.75.

47 CMA's Profitability Paper, para 4.76.

48 **[Redacted - Confidential]**

49 **[Redacted - Confidential]**

6.3. Use of Internal IRRs to consider profitability

123. As a complementary piece of analysis to the CMA's core analysis of ROCE to determine the level of profitability, the CMA has stated that it will be reviewing acquisition documents. The CMA has stated that as a point of principle, where the IRR is significantly larger than the CMA's estimate of WACC, this may be a signal of high profitability.⁵⁰
124. The nature of IRR estimates in acquisition documents, and the context in which they are prepared, are important points to bear in mind when considering a comparison of these IRR estimates against the CMA's estimate of WACC. IRR is a tool to measure return on investment and it is a function of the initial investment and future projected cash flows. Projected cash flows are usually based on forecasts prepared by the seller, which are expected to be overly optimistic. Higher projected cash flows in turn result in a higher IRR, all else equal. Further, IRR is typically employed as an investment appraisal tool, meaning IRR estimates are prepared *before* the investment is undertaken and may not correspond to the *actual* return. Against this background, Linnaeus has several comments with respect to the CMA's proposed analysis comparing IRR to WACC.
125. *First*, the investment documents that the CMA sees will not be representative of all potential investments available in the market, but rather a selective sample of the investments that Linnaeus (and others) view as being the most attractive. Any review of investment returns should therefore consider a large sample of investment documents (acquisitions or otherwise) which will partially, but not fully, account for this because it will not include investments that were not considered attractive.
126. *Second*, expected returns may not necessarily be realised, so a high expected IRR is not sufficient to indicate excess profits. Investments are by their nature uncertain ex-ante in the return that they will make, and whilst all documents will predict an IRR higher than WACC (as no firm would be willing to make an investment that was expected to make a return lower than the cost of capital), some of these investments may not be successful. The CMA acknowledges that whether the expected return has been realised is a relevant consideration.⁵¹
127. *Third*, as Linnaeus has previously set out in its RF17 response, a comparison between expected IRR and WACC will not be meaningful because **[Redacted - Confidential]**

50 CMA's Profitability Paper, para. 4.102.

51 CMA's Profitability Paper, footnote 73.

APPENDIX A START-UP [*REDACTED - CONFIDENTIAL*] FOR OTHER GREENFIELD SITES

[*Redacted - Confidential*]. Table 9 estimates the value of intangible assets based on [*Redacted - Confidential*].

[*Redacted - Confidential*]