NON-CONFIDENTIAL VERSION

Medivet's response to CMA working paper dated 1 November 2024 on Profitability and Financial Analysis (*the 'Working Paper'*)

Green: Confidential information

A. INTRODUCTION

1. Medivet appreciates the opportunity to respond to the CMA's Working Paper setting out its proposed approach to profitability and financial analysis dated 1 November 2024.[1] More generally, Medivet welcomes the chance to respond on important topics that arise over the course of the Market Investigation. An open dialogue between the CMA and the entire veterinary community is essential to ensure a clear understanding of the complexities of the market and assist the CMA in its analysis.

2. Medivet notes that the CMA has considered in its Working Paper the feedback it received about the availability of data during its initial consultation phase. At the same time, Medivet requests the CMA to remain mindful of the burden that the provision of information places on Medivet's business teams. Medivet encourages the CMA to adopt a proportionate approach to data collection, and to consider which data is most critical to ensure that the investigation proceeds efficiently without overburdening Medivet and other vet practices.

3. This response will address the various issues identified by Medivet in the Working Paper, on an issue-by-issue basis.

B. THE ROLE OF PROFITABILITY AND FINANCIAL ANALYSIS

THE CMA'S DIAGNOSIS OF THE MARKET

4. The CMA notes that sustained excess profits may indicate potential competition issues.[2] However, the CMA should note that if some firms are earning excess profits while others earn subnormal profits, then this would provide at most a weak indication of competitive problems across the market as a whole. Such a scenario is more likely to reflect a healthy competitive environment where the success of firms can differ.

5. Moreover, Medivet agrees with the CMA's assessment that the veterinary market has been significantly affected by COVID-19 and Brexit. These shocks could materially distort profitability analyses.[3] Medivet therefore urges the CMA to give careful consideration to the impact of these shocks when undertaking its profitability analysis. This is particularly important when considering

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1 CMA, *Veterinary Services for Household Pets: Approach to profitability and financial analysis*, 1 November 2024.

2 Paragraph 2.5, Paragraph 4.7 of the Working Paper.

3 Paragraph 3.11, Paragraph 3.12 of the Working Paper.

an extended scope of analysis during the COVID-19 years. Medivet discusses this point further below.

6. In addition, Medivet notes that where some firms exhibit what the CMA considers to be supernormal rates of return, while others are failing to meet their cost of capital, remedies designed to reduce the returns of the most profitable providers would risk others falling even further behind their required rates of return, or into loss. In such circumstances the CMA should be cautious about applying remedies which would have market-wide impacts.

C. SCOPE OF THE ANALYSIS

FIVE YEARS OF FINANCIAL INFORMATION

7. Medivet has already provided the CMA with three years of historical financial information in its responses to the CMA's various RFIs. In the Working Paper, the CMA has indicated that it intends to request two additional years of data. Medivet believes this to be unnecessary and impractical, for the reasons set out below.

8. The two additional years to be requested, which for Medivet would be [REDACTED], are not representative due to the impact of COVID-19 and its associated restrictions, which heavily distorted both demand and the ability to supply veterinary services. This is acknowledged by the CMA in the Working Paper.[4] Therefore, even if data for those years were to be provided, the CMA would not be able to derive any relevant and up to date conclusions on profitability based on that data. It is therefore unclear that there are any benefits to the CMA undertaking analysis over a five-year period, even if the CMA considers it appropriate to conduct financial analysis over the longest possible period.

9. In the context of the various RFIs which it has issued, the CMA had agreed to receiving three years of historical data. Medivet has therefore responded to all RFIs where historical data was requested by providing data for the last three financial years. This was due to [REDACTED] and proportionality of the request. In particular:

   a. Medivet's central accounting systems containing [REDACTED]. As a result, Medivet cannot guarantee that [REDACTED], or that it would be able to collate such data in a timely fashion.
   b. The period [REDACTED] covers a time in which [REDACTED]. As a result, Medivet cannot guarantee that comparable data at a practice level would be available for the financial years [REDACTED]. More generally, [REDACTED].
   c. The FY20 and FY21 auditors' reports were qualified. As such, the accounts in these years may be materially inaccurate.[5] Therefore, Medivet cannot guarantee the reliability of such data, even if it can be extracted from legacy systems.

4 See paragraph 3.11of the Working Paper.

5 Medivet annual report FY20, page 7.

d. The extraction of the data from [REDACTED] is very costly and cumbersome and will be unable to be undertaken quickly even on a best endeavours basis.

10. In summary, even if Medivet is able to obtain some data for [REDACTED], Medivet [REDACTED], and the CMA should not place any weight on results derived from any such data.

USE OF FORECAST DATA ON PROFITABILITY

11. The CMA has set out in the Working Paper that it intends to gather forecast data to supplement its analysis of historic financial performance.[6] In the context of profitability analysis, the use of forecast data is unnecessary and impractical, as set out below.

    a. Historical data should take precedence over forecast data when assessing profitability. This is because historical data reflects actual performance, costs, revenues and profits. Medivet considers that the historical data provided sufficiently illustrates past profitability trends and using additional forecast data will add little analytical power to the CMA's work.

    b. Forecast data involves assumptions about future events which can be highly uncertain and inaccurate. Any departure from those assumptions might render forecasts obsolete. Furthermore, forecasts are created for different purposes and can be based on relatively optimistic or conservative assumptions, generating predictable biases. For instance, forecasts targeted towards investors may be relatively optimistic. As a result, relying on forecasts in a profitability analysis could lead to misleading results or incorrect conclusions. Therefore, Medivet considers that the CMA should not attribute meaningful weight to forecasts.

12. Medivet further notes that Medivet [REDACTED]. Thus, there is no way to adjust for distortions in [REDACTED] figures as a result of COVID-19. Forecasts can only be provided to the CMA [REDACTED].

D. APPROACH TO PROFITABILITY ANALYSIS FOR THE LARGE CORPORATE GROUPS ('LCGS')

SEGMENTING OF VETERINARY SERVICES

13. In the Working Paper, the CMA states that it is not seeking to separately assess the economic profitability of different types of veterinary services.[7] Medivet agrees that it would be excessively time consuming and complex to attempt to segment the LCGs' businesses into different lines of business for which Medivet's management accounts and internal reporting do not already offer such segmentation.

14. As provided by Medivet in [REDACTED], Medivet's financial accounts segment Medivet's business in terms of [REDACTED]. Providing further segmentations [REDACTED] would be excessively time consuming and complex and such exercise would likely require arbitrary allocations of both

[6] Paragraph 3.13 of the Working Paper.

[7] Paragraph 4.38 of the Working Paper.

common costs and revenues which would not offer an accurate view of the profitability of the different lines of business.

15. In particular, Medivet considers that it would be very challenging to segment the business between [REDACTED]. Medivet's internal systems do not permit an easy allocation of [REDACTED]. Similarly, for those Medivet clinics which either currently or previously offered [REDACTED][8].

16. Medivet notes that while assessing profitability at the group level would be appropriate for Medivet – given that the vast majority of its business is FOP – this is not necessarily the case for other LCGs. This is because other LCGs have different compositions of veterinary services which affect their group profitability. For instance, Medivet considers that profitability of cremation services and online pharmacy services cannot be used to draw conclusions regarding the profitability of FOP or OOH. Both animal crematoria and online pharmacies have staff, asset bases, and revenues which Medivet understands to be easily separable from services offered by vets working in veterinary clinics.

17. Medivet therefore considers that the CMA should adjust its approach to separate at least these services, which can be individually assessed for those LCGs which offer both types of service. This would prevent any distortions to profitability assessments if the returns of these distinct lines of business are different to those in the FOP market.

ALLOCATION METHOD FOR JOINT AND COMMON COSTS

18. In the Working Paper, the CMA explicitly seeks views on the appropriate basis for the allocation of costs that are not associated with a single activity.[9] Medivet's position is that for the large majority of veterinary services there is no allocation method for joint and common costs that is both robust and practical, meaning that the CMA should assess profitability on a basis wide enough to ensure that there is no requirement to engage in an allocation exercise.

19. [REDACTED]. Medivet notes, however, that these approaches were developed for internal purposes only and cannot be assumed to be appropriate for the purposes of a profitability analysis based on economic cost drivers. Allocating costs and revenues to different lines of business for a profitability analysis would require the development of a bespoke allocation system in line with the underlying economics, which is disproportionate given the complexity and resource requirements involved.

ADJUSTING OPERATING COSTS TO REFLECT STANDALONE FIRM REQUIREMENTS

20. The CMA is keen to assess profitability on a 'standalone basis'.[10] The vast majority of Medivet's business is FOP. Medivet does not consider [REDACTED]. Accordingly, in Medivet's case the CMA should allocate all central and common costs [REDACTED].

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8 Medivet adopts the CMA definition in RFI9 for 'Household Pets' here.

9 Paragraph 5.2a of the Working Paper.

10 Paragraph 5.2c of the Working Paper.

21. Medivet does not consider that further segmentation would be reflective of the realities of the industry, including the relevant regulation. For instance, regulation requires FOP practices to arrange for OOH services of their patients, and where OOH is offered by Medivet clinics, this is from the same clinics that offer FOP. Therefore, FOP and OOH should not be considered separately. Medivet invites the CMA to reflect these realities when considering its approach to assess profitability on a ‘standalone basis’.

ASSET VALUATION

22. First and foremost, Medivet would like to emphasise that its asset valuation is in line with all accounting standards. Any possible differences between Medivet’s accounting valuations and the asset valuations that would be appropriate for the purposes of an economic profitability analysis are a product of accounting rules being designed to ensure (without a disproportionate effort) consistency, comparability, and compliance rather than to reflect the dynamic economic realities that are behind the economic value of assets.

23. Secondly, Medivet notes that any adjustments that might need to be made to accounting valuations to perform an economic profitability analysis should not necessarily be applied uniformly. Accounting rules have different standards for different types of assets and different assets are used differently over time and generate economic benefits in different ways.

24. Medivet provides below its views on some of the likely issues the CMA will need to address when valuing assets for the purposes of an economic profitability analysis.

TANGIBLE FIXED ASSETS

25. Medivet re-iterates its position, set out in its response to [REDACTED], that Net Book Value (‘**NBV**’) is not a good approximation for the cost of replacing its assets and that there is no liquid suitable market for second hand veterinary equipment which would be relevant for Medivet. [REDACTED].

26. Medivet further notes that there are some cases where assets have been (effectively) fully depreciated but are still in use and have economic value. Such assets [REDACTED]. Medivet considers that where this is the case, the CMA should adjust the value of such assets by inflating their value to reflect their economic value as part of an economic assessment of profitability.

27. Therefore, Medivet generally agrees with the views expressed by other corporates set out in the Working Paper that accounting asset valuations are likely to be lower than economic valuations. Given this, it is likely that the CMA will need to uplift NBV and accounting valuations to determine economic profitability. Medivet does not follow any such approach internally since this would not be in line with accounting standards

11 [REDACTED]

LEASED PROPERTIES

28. [REDACTED] Medivet's approach to the treatment of property leases is consistent with IFRS16.

29. Therefore, Medivet will be able to provide the CMA with valuations of operating leases in line with this, as it is Medivet's standard accounting procedure. For the purpose of an economic profitability analysis, the CMA will need to adjust any Medivet internal valuations as needed to reflect economic valuations instead of accounting valuations.

INTANGIBLE ASSETS

30. The veterinary sector is not a tangible asset-heavy sector. Intangible assets are an integral part of this sector and drive much of its profitability. Therefore, these assets need to be appropriately reflected in any economic profitability analysis.

31. Medivet agrees with IVC that there are important intangible assets (including goodwill) which should be appropriately valued as part of any economic profitability analysis[12] and that intangible assets within the veterinary sector are substantial, and are a key reason for the LCGs' acquisition-based growth strategy.[13]

32. Given this, Medivet considers that the approach to goodwill and brand and reputation assets that the CMA sets out in the Working Paper do not reflect the specific features of the vet industry.[14]

IT SYSTEMS AND SOFTWARE DEVELOPMENT COSTS

33. Medivet has undertaken significant investment to develop [REDACTED].

34. At the time of its acquisition by CVC in 2021, [REDACTED]. Medivet can provide this [REDACTED] to the CMA, along with details of further expenditure on development of the platform. This can provide a capitalised value of [REDACTED], which the CMA can then amortise accordingly, and to which further investments in system development can be added.

35. Medivet notes that the depreciation and amortisation method selected by the CMA needs to take into account the economic life of the asset.

GOODWILL, BRAND AND REPUTATION ASSETS

36. Disregarding goodwill, brand, and reputation assets from the economic profitability analysis would exclude assets which are integral to the operations of the business and would portray an inaccurate picture of economic profitability, from which no meaningful conclusion can be derived.

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12 Paragraphs 4.49 of the Working Paper.

13 Paragraphs 4.51 of the Working Paper.

14 Paragraphs 4.55-4.62 of the Working Paper.

37. Goodwill, brand and reputation assets represent virtually all the value of an acquired vet site. This is because when acquiring a vet site:

   a. Most of the value of the vet site is derived from intangible assets, such as its customer lists, brand, reputation, know-how and internal processes. These assets cannot be individually recognised and attempting to individually measure these would be a highly complex and challenging (likely impossible and certainly disproportionate) exercise. [REDACTED]; and

   b. The market value of tangible assets is generally negligible. It amounts to some, often heavily depreciated, fixtures and fittings. [REDACTED].

38. Consequently, the goodwill on Medivet's balance sheet [REDACTED].

39. The CMA should take this into account in its assessment of goodwill in the context of its economic profitability analysis. In particular, rather than interpreting goodwill on acquired vet sites as representing excess profit, the CMA should recognise that goodwill reflects the [REDACTED] of the intangible assets that contribute to the overall value of existing vet sites. Any profitability analysis will have to disaggregate balance sheet goodwill into its constituent elements before assessing whether any of the goodwill reflects a capitalisation of excess profitability.

40. [REDACTED]

E. MARKETING COSTS AND START-UP LOSSES AS ALTERNATIVES TO ESTIMATING THE VALUE OF ACQUIRED VET SITES

41. The CMA is considering two alternatives to estimate the replacement cost of firms' brands and/or reputations. The two approaches are:

   a. Marketing costs, as a proxy for the value of a firm's customer relationships; and

   b. Start-up losses, as a proxy for the investment required to build the necessary intangible assets to support profitability in the start-up period.[15]

42. While Medivet welcomes the CMA's recognition that the replacement cost of firms' brands and/or reputations need to be considered, Medivet's view is that the marketing costs approach is likely to underestimate the costs of starting a new vet site. This is for the following reasons:

   a. Word-of-mouth based on sustained reputation is the primary form of marketing in the veterinary industry, which is a key reason for the LCGs' acquisition-based growth strategy. Marketing costs in such industries tend to be lower than in industries with marketing strategies which rely on traditional advertising.

15 Paragraph 4.61 of the Working Paper.

b. However, building an organic word-of-mouth presence requires significant time and effort to gain to gain customer trust and loyalty. Effectively, marketing costs become embodied in start-up losses which are required before a firm establishes its reputation.

c. Therefore, marketing costs will not reflect the true extent of the investment required to establish a customer base and grow a viable business. In particular, the costs of building such customers relationships will also be reflected in operational costs (e.g. costs related to offer certain levels of customer service and quality).

43. Medivet's view is that the start-up losses approach is more likely to offer an accurate reflection of the requirement to create a sustainable business. [REDACTED], it is [REDACTED] less cost-efficient to set up a greenfield site than to acquire an existing vet site, [REDACTED].

44. [REDACTED] underscore how the value of an existing vet site lies primarily in its intangible assets, such as its customer lists and reputation, which require large investments in terms of resources and time.

45. The difficulty to build the necessary intangible asset base to have a viable site, such as customer lists and reputation, is reflected in the value of the goodwill on acquisition of clinics. This is because acquiring an existing site provides immediate access to the intangible assets needed to profitably operate a site.

46. The start-up losses of greenfield sites therefore [REDACTED] reflect the costs of creating the intangible assets that are essential for the viability of a vet site. As a result, the CMA should take these losses into account in its assessment of economic profitability.

ALLOCATION OF ASSETS ACROSS VETERINARY SERVICES

47. Medivet holds the same view on the allocation of assets across veterinary services as it set out above regarding the segmentation of veterinary services and the allocation method for joint and common costs.

48. Medivet summarises the key points below:

a. [REDACTED].

b. Medivet's position is that there is no allocation method for joint and common assets across veterinary services that is both robust and practical.

c. Therefore, such allocation would require the development of a bespoke allocation system, which is disproportionate given the complexity and resource requirements involved.

d. Medivet notes, however, that the vast majority of Medivet's business is FOP. As such, [REDACTED].

INEFFICIENCY

49. In the Working Paper, the CMA outlines that it aims to supplement its profitability analysis with an assessment of potential inefficiencies through an analysis of costs and a review of internal documents.[16]

50. Medivet would like to clarify that it sees no basis for any inefficiencies in its operations. Medivet's incorporates rigorous operational oversight in its operations and ensuring a high level of efficiency is a focus of its strategy.

51. Medivet [REDACTED], and the competitive pressures it faces from other LCGs and independent vets provide a strong incentive to keep costs as low as practically feasible. There is no reason to believe that Medivet is incurring costs beyond what is strictly necessary for the operation of the business. [REDACTED]. Medivet notes that there have been increases in veterinary wages in recent years, but this reflects market forces on the labour market for vets and veterinary nurses rather than any inefficiency of the LCGs.

52. [REDACTED].

53. The CMA should support any claims of inefficiency with specific, factual evidence and benchmarked against the costs incurred by other LCGs and independent veterinary clinics. Additionally, the CMA should ensure that it adjusts for business conditions that influence cost levels.

54. In particular, the CMA must take into consideration the geographical distribution of vet sites at each LCG and its comparators. For instance, a higher proportion of vet sites in London and the South-East is likely to drive higher rents and salaries, exerting upwards pressure on operating costs. The CMA should appropriately adjust for these regional variations to ensure a fair and accurate assessment of cost efficiency.

55. The CMA should also support any claims of inefficiency related to over- or under-provision of treatments. Medivet's clinicians have a duty of care to patients and to offer appropriate level of treatment to patients. In particular, when providing care, veterinary surgeons and veterinary nurses should:[17]

    a. "*ensure that a range of reasonable treatment options are offered and explained, including prognoses and possible side effect*s"; and

    b. *"make decisions on treatment regimes based first and foremost on animal health and welfare considerations, whilst providing contextualised care and exercising professional judgement*

16 Paragraphs 4.77 of the Working Paper.

17 See Section 2.2 of the Supporting guidance: https://www.rcvs.org.uk/setting-standards/advice-and-guidance/code-of-professional-conduct-for-veterinary-surgeons/supporting-guidance/veterinary-care/.

about what is best for the animal in each individual case, taking into account the needs and circumstances of the client."

56. Further, as stated by Medivet in response to the issues statement, the overall quality of care provided across the UK veterinary sector has consistently improved in recent years. Improvements in the quality of care provided and the treatments available to customers and their pets do not indicate 'weak competition', rather evidencing how competition is delivering good outcomes for customers and their pets.[18]

F. APPROACH TO PROFITABILITY ANALYSIS FOR INDEPENDENT VETS

57. Medivet believes that the approach the CMA sets out for its proposed profitability analysis of independent vets is flawed.[19]

58. First, the CMA plans to issue information requests to 70 independent veterinary practices as the basis for its analysis. While it acknowledges that some of these requests may not yield eligible responses, it aims to secure a total of 50 responses. This suggests an implicit assumption of a response rate exceeding 70%, with no disproportionately low response rate from certain regions, given the need to reflect regional differences between clinics. Medivet considers these assumptions to be unrealistic. To obtain a truly representative sample of independent veterinary practices, the CMA will likely need to contact significantly more than 70 practices.

59. Second, Medivet wishes to emphasise that independent vet sites may not operate with the same capital intensity as the LCGs, as they may have lower asset bases. It is therefore inappropriate to benchmark margins from independent vet sites against LCGs without the CMA first acquiring evidence on, and correcting for, relative levels of capital expenditure and asset bases.

60. Third, to ensure a like-for-like comparison, the CMA should exclusively target independent vets that offer FOP services. It should not approach any veterinary practice for which farm animals and equine services represent a large proportion of their revenue, as there may be differences in underlying levels of profitability and asset usage in these different markets. This may imply that the CMA will need to carry out a pre-screening questionnaire to obtain an appropriate sample.

61. Finally, on staff remuneration, the CMA's proposed approach is likely to underestimate the comparable salary of independent vets who own their clinics. Independent vets are free to choose how they are paid, and will receive tax advantages from taking pay in the form of dividends or capital gains rather than wages. This could overestimate both their efficiency and profitability compared to corporates, distorting any comparisons unless the CMA undertakes appropriate adjustments.

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18 Medivet's response to the CMA's Issues Statement issued on 9 July 2024, paragraph 32a.

19 Paragraphs 4.79 – 4.88 of the Working Paper.

G. ADDITIONAL ANALYSIS FOR DIAGNOSIS OF PROFITABILITY LEVELS IN THE LARGE CORPORATE GROUPS

REVIEW OF ACQUISITIONS

62. Medivet recognises the view of the CMA that LCGs have grown through the acquisition of vet sites, and that this can involve investment appraisals.[20]

63. However, the CMA should reflect that the Internal Rate of Return ('**IRR'**) used in investment appraisals for the acquisition of individual vet sites is not solely based on the expected profitability of the site. Several factors can influence the IRR:

    a. Some LCGs will project the IRR of an individual vet site acquisition not exclusively based on the site's current or projected cash flows, but rather on its overall valuation as part of the LCG's wider portfolio of vet sites. This includes the anticipated returns from an assumed future exit by divestment and any synergies due to economies of scope or scale across clinics. It is essential the CMA takes this into account to avoid a misleading interpretation of the financial prospects of the acquisition of a single vet site.

    b. The IRR may also be influenced by the capital structure of the acquisition, particularly the debt-to-equity ratio. The return on equity may be amplified in acquisitions with substantial debt financing, contributing to a higher IRR. The CMA should ensure that its approach is neutral to different funding structures, and take into account the varying levels of risk and return associated with different capital structures.

64. Rather than assessing the IRR for the acquisition of individual vet sites, a more appropriate benchmark for the CMA to consider would be [REDACTED].

MARGIN BENCHMARKING

65. The CMA has indicated it is open to receiving suggestions of price and profit benchmarks from other countries.[21] Medivet does not have any specific suggestions to offer in that regard.

66. However, Medivet wishes to emphasise that, should the CMA decide to pursue this approach, it must adopt a robust methodology to account for country-specific differences. In particular, the CMA should consider among others the following factors:

    a. Veterinary labour markets. The CMA must take into account variations in the availability of vet staff and the differences in salary levels across countries. These factors can have a significant impact on operational costs and profitability.

    b. Distinction between FOPs and farm animal vet services. The share of the total vet sector between FOPs and farm animal vet services may differ between countries. When

[20] Paragraph 4.101 of the Working Paper.

[21] Paragraph 4.107 of the Working Paper.

benchmarking the UK vet market against that of other countries, it should ensure that this differing mix is taken into account. Practices providing services to different animal sectors must not be compared without considering the differing levels of costs and revenues associated with each sector.

c. Regulatory framework. The CMA must take into account variations in the regulatory framework across countries. Regulations can have a significant impact on operational costs and profitability.

d. Demand (and any other supply) conditions. The CMA must take into account demand and supply drivers of veterinary services across countries. These can have a significant impact on operational costs and profitability.

67. Medivet requests that, if the CMA decides to pursue this analysis, it first consults on the methodology it plans to use to control for these country-specific differences.

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22 November 2024