NON-CONFIDENTIAL REDACTED VERSION

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

Start-Up Losses as a Proxy for the Investment Required to Build the necessary Intangible Assets in the Start-Up Period: [REDACTED]

Green: [Confidential information]

INTRODUCTION

1. In its working paper on the approach to profitability and financial analysis (**CMA's Working Paper**), the CMA states that it is considering two alternatives to estimate the replacement cost of firms' brands and/or reputations.[1]

2. As stated in Medivet's response to the CMA's Working Paper (**Medivet's response**),[2] Medivet considers that the start-up losses approach[3] is more likely to offer an accurate reflection of the requirement to create a sustainable veterinary site.

3. Medivet's view is based [REDACTED] it is [REDACTED] less cost-efficient to set up a greenfield site than to acquire an existing vet site.

4. Medivet provides evidence of the challenges in setting up greenfield sites in this annex. In particular, it discusses:

    a. [REDACTED];

    b. [REDACTED]; and

    c. The use of start-up losses as a proxy for the investment required to build the intangible assets of a viable site.

[REDACTED]

5. In 2022, Medivet set up three greenfield vet sites:

    a. Basingstoke in February 2022;

    b. West Bridgford in April 2022; and

    c. Whitstable in May 2022.

1 Paragraph 4.61

2 Paragraph 43.

3 In Paragraph 4.61, the CMA describes its approach as relying on start-up losses as a proxy for the investment required to build the necessary intangible assets to support profitability in the start-up period.

6. Medivet identified all three greenfield clinics as strategic opportunities located in promising areas. The areas were favourable due to a combination of their demographics and the combination of residential and commercial developments in the area. In addition, Basingstoke was particularly promising due to an assessed shortage of vet capacity in the local area.

7. All three greenfield sites required a significant initial investment, which ranged between [REDACTED], as shown in Figure 1. These initial investments largely covered the upfront costs related with the fit out of the site and basic equipment needed to open a vet clinic. They also covered investments in intangibles needed to set up a new vet clinic, such as initial local marketing, staff training and hiring costs and software costs associated with setting up the new clinic in Medivet's practice management system ('**Freedom'**). The consistency of these initial investment costs provides a strong indication that around [REDACTED] would be an appropriate sunk cost for opening a new vet clinic.

[REDACTED]

8. All greenfield sites incurred [REDACTED] costs in the first few months after opening, while experiencing [REDACTED] revenues (see Figure 2).[4] The [REDACTED] in costs reflects the need to establish a vet clinic which, from day one of operation, has the capacity to attract and serve a significant customer base, even though such customer base will take considerable time to build.

[4] *[REDACTED]*

9. After the first few months of operation, costs [REDACTED] across the three sites. While all three sites see an [REDACTED] in revenues, [REDACTED].

[REDACTED]

Source: Frontier Economics based on data provided by Medivet.
Note: [REDACTED]

10. The trends in costs and revenues provide the basis for the [REDACTED] experienced by greenfield sites during their initial years of operation (see Figure 3). [REDACTED].

[REDACTED]

Source: *Frontier Economics based on data provided by Medivet.*
Note: *[REDACTED].*

11. The [REDACTED] of the greenfield sites highlight the [REDACTED] associated with opening new veterinary sites. The [REDACTED].

12. The [REDACTED].

[REDACTED]

13. The challenges faced by greenfield sites [REDACTED] in building the necessary intangible assets to become a viable site, such as customers list, brand and reputation. These intangible assets are key drivers of revenue generation of a veterinary site. In fact, the [REDACTED]. To the extent there are [REDACTED].

[REDACTED]

Source: Frontier Economics based on data received by Medivet.
Note: [REDACTED]

14. Where these sites [REDACTED] behind other Medivet sites is on customer acquisition. As stated in Medivet's response,[5] word-of-mouth based on sustained excellence is the primary form of marketing in the veterinary industry. Replicating the customer base needed to achieve profitability requires significant effort over a long period of time, and is not always successful. In fact, as shown above, of the three greenfield sites, [REDACTED].

15. The figure below provides evidence of the link between profitability and customer base. In particular, it shows that:

    a. [REDACTED];

    b. [REDACTED]; and

    c. [REDACTED].

[5] Paragraph 42.

[REDACTED]

Source: Frontier Economics based on data received by Medivet.
Note: [REDACTED].

16. The figure above also shows that the number of active customers of greenfield sites is [REDCATED] than the average for Medivet FOP sites in the same region. [REDACTED].

17. This once again illustrates the difficulties in building the intangible assets – in particular, in the form of a scale customer base – needed to become a viable site and explains the LCGs' acquisition-based growth strategy.

THE USE OF START-UP LOSSES AS A PROXY FOR THE INVESTMENT REQUIRED TO BUILD THE INTANGIBLE ASSETS OF A VIABLE SITE

18. As already stated in Medivet's response,[6] [REDACTED] 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 start-up losses and time.

6 Paragraph 44.

19. The difficulty in building the necessary intangible assets for a site to be viable is reflected in the goodwill value on acquisition of sites. This is because acquiring an existing site provides immediate access to the intangible assets needed to profitably operate a site. As a result, the CMA cannot exclude goodwill from its profitability analysis; doing so will remove the value of intangible assets necessary to operate a commercially viable site, in particular, the value of reputation and customer acquisition costs.

20. Medivet's view is that, of the approaches proposed by the CMA to estimate the replacement cost of firms' brands and/or reputations,[7] the start-up losses of greenfield sites are the most likely to offer a relevant proxy for the costs of creating the intangible assets that are essential for the viability of a vet site.

21. Based on [REDACTED], Medivet's estimates the total start-up losses of opening a greenfield site to be [REDACTED] (in addition to the sunk cost of the tangible investments to open a new clinic).[8] Medivet notes, however, this estimate is likely to be a lower bound. This is because:

    a. [REDACTED]

    b. [REDACTED].

    c. [REDACTED].

22. Medivet notes that the start-up losses above do not reflect the initial investment [REDACTED]. Part of this initial investment also covers investments in the intangibles assets needed to set up a new vet clinic. These initial investments in intangibles should not be ignored in CMA's proxy for the valuation of the intangible assets required to support a commercially viable site.

23. The CMA should take the points above into consideration when estimating start-up losses and make the appropriate adjustments to any methodology which aims to rely on these to proxy for the investment required to build the necessary intangible assets to support profitability.

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02 December 2024

[7] Paragraph 4.61

[8] [REDACTED].