

WRITTEN SUBMISSION TO

THE COMPETITION & MARKETS AUTHORITY

**ON THEIR MARKET INVESTIGATION INTO
VETERINARY SERVICES FOR HOUSEHOLD PETS**

**RESPONSE TO APPROACH TO PROFITABILITY & FINANCIAL
ANALYSIS WORKING PAPER**

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BACKGROUND

As requested in the CMA Working Paper of 1 November 2024, we are providing comments in respect of the approach to analysing profitability and financial results for the veterinary services for household pets.

Moore Scarrott Veterinary (**MSV**), is a Chartered Accountancy practice, the Directors of which are Andy Moore, Roger Milton and Simon Biles.

As a firm, MSV acts for veterinary practices across the entirety of the UK, including England, Scotland (including the Scottish Islands), Wales and Northern Ireland. We have also undertaken consultancy work for others in Southern Ireland and on the Continent.

The Directors of MSV are all pet owners and Andy also owns farms. There is, therefore, day-to-day interaction with veterinary practices in a client capacity, in addition to an advisory capacity.

As part of our work, we have access to significant confidential financial and performance data which we analyse and use in discussions with clients.

By way of background and to ensure full disclosure:

- Andy Moore's father was a practising Veterinary Surgeon and is now retired.

Previously he was President of The Royal College of Veterinary Surgeons and President of The British Cattle Veterinary Association.

- Andy's knowledge of the veterinary sector came from spending significant time with his father in veterinary practice.
- Following qualification as a Chartered accountant, Andy developed a specialism within the veterinary sector and Moore Scarrott Veterinary has evolved for this reason.
- Andy's son is a 3rd year veterinary student at Surrey Veterinary School.
- Andy authored BSAVA Manual of Best Practice – Finance Section.
- MSV Directors have previously held special Lecturer status at Nottingham University Vet School, lecturing on finance and business matters. It is worth noting here that there is no formal business training given to Vets in their University courses due to core curriculum time constraints.
- Within Moore Scarrott Group, we also have other specialist businesses. Our commercial and audit business, historically, has undertaken non-advisory due diligence work on behalf two of the corporate veterinary acquirers, although that work has now ceased due to the corporates' cessation of acquisitions.
- MSV Directors have been working with Vets for more than 3 decades and have first-hand experience of the changes within the Veterinary Profession over that time, alongside access to unique independent data sets. They also lecture on a variety of matters such as veterinary practice buy ins, start ups, performance and profitability, tax mitigation, business structuring and succession planning amongst others.

STANDARDISATION OF FINANCIAL RESULTS

As has already been identified within the Working Paper, the financial reporting requirements for the large corporate groups (LCGs) and independently owned veterinary practices can (and will) have significant variations in how the results are presented and interpreted.

We do not have first-hand knowledge of the internal working practices of LCGs. All knowledge and information referred to is gained through working extensively with the veterinary profession and hearing and seeing what has happened and is happening within the profession.

When we are considering results for independent veterinary practices, we look to adjust these for certain factors to standardise them as far as possible in order to:

1. Allow comparability between practices; and
2. Facilitate year on year (in practice) comparison; and
3. Identify trends within any given practice and more widely within the profession

In doing this, the key adjustments are typically:

- Inclusion of a fair market rate salary for the practice owners.
- Standardisation of the property ownership costs.
- Adjustment of any one off, exceptional or individual items within the figures as required.

Taking each of those in turn:

Market Rate Salaries

The majority of independently owned veterinary practices operate through a limited company. There remain a minority that operate as sole trader, partnership or LLP. The methodology for inclusion of a market rate salary will differ based on the trading structure that has been adopted but, fundamentally, the salary included will represent a best estimate of the market rate.

Within an independent practice limited company environment, it would be typical for the Director/Shareholders to take a small salary, which is included in the profit and loss account as an expense, with the rest of their income needs funded by way of dividends.

Those salary and dividends can be controlled for managing individual tax requirements and are not a fair reflection of the market value of the input that the owners are providing to the business.

For a sole trader, partnership or LLP scenario, there would be no salary costs incurred, with no expense in the profit and loss account. The entirety of their income would be represented by a share of the profits.

When considering an appropriate market rate salary to include, this needs to reflect:

1. The clinical time that is being provided and

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2. The management, business development and entrepreneurial time that is generally dealt with in addition to normal clinical working time, but is essential to the business continuing to develop and evolve.

For LCGs, the functions in 2 above would usually be completed by a head office staff (or central resource). Therefore, if the costs of the head office function are to be considered within the staffing costs for the LCGs, an appropriate value for this time spent by business owners in independently owned practices needs to be included to allow comparability, in addition to any value of their clinical time spent working in the practice. Placing a value on that time is very difficult and will vary from practice to practice and individual to individual depending on the input and clinical skill sets of the respective owners.

Hence our approach is typically to include a clinical salary comparable to that for an experienced clinical vet, inclusive of all related costs of employment.

We understand that within LCGs, in addition to head office or central salary costs, there are layers of non day-to-day clinical staffing not found within independent practices, for example regional directors and others.

Our view would be that to obtain true comparison, only clinical and client facing salaries should be included in any standardised figures.

Properties

As has already been identified in the Working Paper, all of the LCGs lease, at least, a proportion of their properties. Subject to their respective reporting requirements, those costs would either be recognised as rental/lease payments and expensed in the profit and loss account, or capitalised as right of use assets.

Where properties are leased by independently owned practices then, in the majority of cases, those costs would all be recognised as an expense in the profit and loss account. There needs to be standardisation on how these costs are considered.

Where properties are rented at a market rate value, this should provide consistency providing the rental costs are included in the profit calculations.

However, there are a large number of veterinary practices that have held their freehold property interests for a significant period of time. As a result, the carrying value in their accounts is unlikely to be reflective of the true market value given that, generally, these need to be carried at an historical cost basis for accounting purposes and quite frequently be amortised over time, under accounting standards.

If there is no debt associated with those properties, there would be no interest charge in the accounts, and no rental payments. Therefore, the profitability of that practice, at face value, would be increased. This is purely due to the historical real estate position, rather than an underlying performance position.

In order to standardise the results, a notional rent charge needs to be included based on the current value of the property and assumed market rate rent value. If there are any funding obligations in relation to that property, those costs should be removed so as to reflect a consistent position as compared to the property being rented from a third party.

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Even where there are rental costs in the accounts, this process should still be followed as rental payments may not be at a full market rate value if the landlord is a connected party, often times relating to capital tax planning measures.

The other element to consider is where businesses are investing in new purpose-built veterinary practices or conversions. This (virtually) always results in a market value of the completed property, immediately after work has been completed, being lower than the costs i.e. there is a latent capital loss. This can, and many times is, a significant figure.

Those additional costs are incurred to allow the practice to thrive and grow. The investment rationale is for additional future profits to fund that capital investment.

These capital losses need to be recognised as an expense in the profit and loss figures, as that has been an investment (cost) that is not realised in the capital value of the property but has been made to provide appropriate facilities, which in turn will generate profits moving forward.

The period those improvements are written off over will be impacted by the accounting treatment adopted and there may need to be standardisation in the approach to this. Typically, in independent practices, we would consider those costs are amortised over a 15-year period.

There may be other specific elements relating to individual businesses that would need to be adjusted to get a true standardised profit position, but the above elements would be the primary material factors allowing any standardisation and comparison of profitability.

ADRESSING SPECIFIC POINTS RAISED

Addressed in the Working Paper as follows:

4.46

As outlined above, there would be the necessity for revaluing freehold property in line with the current market value. The carrying value of property within accounts is likely to be historical cost and not reflect the current market value. Obtaining an accurate market value of properties, especially those that have been owned for a long period of time is likely to require an independent valuation to be undertaken, incurring a level of cost.

4.47

Whilst there is a market (of sorts) for the re-selling of second-hand veterinary equipment, it is very limited. If a practice were looking to replace all assets they require in order to provide the same level of service, it is extremely unlikely that they would be able to source all of that from the second-hand market and would need to purchase a lot of it new. Critically, with the demands of the consumer for modern clinical standards, combined with the evolution of equipment, buying new is the only realistic option for a modern veterinary practice to remain up to date.

Typically, veterinary equipment is often used until such point as it is obsolete or broken and is then replaced with a modern equivalent. Depending on the individual elements of equipment, that could mean that it has been fully depreciated, so carries no value in the business accounts, but is still generating economic value in the practice for a period of time after that.

The written down value in the accounts would also be impacted by the depreciation policies adopted, which would vary from business to business and piece of equipment to piece of equipment.

The utilisation of the accounts written down value, historical cost or replacement value is likely to result in large variances in the restated capital value, which would significantly distort the results of any analysis. This would obviously impact the interpretation of any findings.

4.56

It is not clear exactly how a value, if any, is to be determined in relation to the goodwill of various businesses. There are significant differences in how practices have been valued and prices that have been paid for businesses acquired.

For independently owned practices, if there is any goodwill value on the balance sheet, this is likely to be an historical value, less amortisation, so would not reflect an accurate position of the current value.

Unless a goodwill value is to be calculated on a consistent basis for all businesses, rather than acquisition cost or balance sheet value, the difference in valuation methods would provide such a wide range of results that is likely make them meaningless. The quantum of goodwill value is such that there would be a material impact on any results generated.

Further, for most independent practices, the open market value of any goodwill is irrelevant. For those modelling on internal succession so as to preserve independence, the multiples

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applied for “buy ins” will be significantly less than the multiples offered by others for complete control over the business.

The only point at which an open market value has importance is on the ultimate sale of the entire practice. That value is only what another is prepared to pay for it, something which is personal to any purchaser. We have seen significant ranges in multiples offered for the same practice by multiple interested parties. It would, therefore, be impossible to assert with any confidence what the value is, other than using an arbitrary system, rendering the figure meaningless.

4.61

We agree that there needs to be a consistent approach to valuing internally generated intangible assets across all business types. This is not something that is recorded on the balance sheet of independently owned practices.

We do not believe that considering the marketing spend would in any way be an appropriate way of dealing with this, certainly within independent practices. There are various different ways of marketing to potential clients and those have different cost profiles and returns on investment.

One of the best ways to attract new clients is providing a high-quality service and client care to those existing clients, resulting in word of mouth recommendations. This does not have any associated costs that come within the marketing budget, but does have other investment required in staff salaries, staff retention, training, and practice facilities, which would be recognised elsewhere in the financial results.

4.78

Due to the size of the LCGs, this should lead to economies of scale for centralising functions such as, recruitment, HR, marketing and finance. Those costs are shared across all of the practices within the LCG group.

For an independently owned practice, these functions still need to be undertaken but they may not be set up in such a formal way as to have a direct cost associated with them in the accounts. For example, it would not be uncommon for the business owners to be significantly involved in the recruitment, HR, marketing and finance functions.

This would mean the costs incurred in the accounts for those items is limited, as it does not reflect a value for their time spent on these activities. This is why it is important that an appropriate value is placed on the management time of business owners in independently owned veterinary practices to achieve a reasonable comparison of the results.

4.93

We have outlined above our approach to adjusting for practice owner remuneration and also the property position.

4.96

Purchasing power is one significant advantage for the LCGs. With the volume of products they are purchasing, we understand that they agree bespoke discounts and rebates with key suppliers that reduce their overall costs and enhance margins.

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Whilst independently owned practices can utilise the services of a buying group to improve their overall position, this is not as favourable as the economies of scale enjoyed by the LCGs, given that the buying group will be taking a share of the savings generated. In addition, a number of the buying groups have been acquired by the LCGs, which only further increases their purchasing power and negotiating position.

4.107

Whilst there are differentials between business set-ups, particularly with the LCGs and independently owned practices, the core veterinary services they are providing are largely the same.

We believe that it should be possible to undertake reasonable benchmarking and margin analysis of the financial results. This is covered in more detail below.

SUMMARY

We do not believe that considering a Return on Capital Employed (ROCE) metric as part of the analysis of the profitability of veterinary practices in the UK to be in any way appropriate or that the methodology suggested would provide accurate data to interpret.

There would need to be a number of fundamental assumptions made in compiling all figures being used and, as a result, the embedded error rate would be significant.

Veterinary practices are fundamentally a professional services business. Whilst they require premises and equipment to operate, that is not the primary driver behind income and ultimately profitability. That is still reliant on the professionals providing the service to clients, at least within independent veterinary practices.

In addition, as outlined in the comments above, standardising the capital invested across different business models and practices is inherently very difficult, if not impossible. This requires a number of assumptions to be made in calculating those figures.

If property investments are standardised into market value lease costs and intangible assets are not considered, the remaining capital figure would predominately represent the value of equipment. As has been identified, there is a limited second-hand market for veterinary equipment, so trying to obtain an accurate value for this to be considered in the calculations is challenging, if not impossible.

Due to the quantum of the numbers that would be involved, the assumptions made would materially impact the calculations undertaken and result in such a wide spread of results, depending on how specific circumstances have been interpreted that it would not allow for accurate conclusions to be drawn.

In our view, a better way (and the only practical and pragmatic way) of considering the overall position would be to consider standardised benchmarking and margin analysis. This is how we would analyse practice performance for our clients.

There would still be a requirement to standardise financial results across different practices and business structures, but this should be much easier to achieve with any assumptions that need to be made having a far smaller impact on the results, to allow conclusions to be drawn.

The key areas we believe that should be considered are:

- Gross profit as a percentage of turnover
- Standardised labour costs as a percentage of turnover
- Standardised profit as a percentage of turnover (although there are significant caveats attaching to this metric as referred to below)

Gross Profit

In calculating a gross profit, we would expect this to represent turnover (professional fees, medicine sales and health plan income) less the direct costs of goods sold, but excluding any staffing costs (considered separately)

The cost of goods sold would include:

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- Medicines (net of stock adjustment, rebates and discounts ie true net net cost to the practice)
- Consumables
- Laboratory costs
- Cremation and waste disposal costs

These are figures that can be readily and accurately identified from the accounts by species work type.

The gross profit should be considered as a percentage of the total veterinary related turnover generated.

This metric shows the impact of pricing (margins applied to total costs of employment and to medicine sales) on the overall profitability of the practices and gives direct comparability.

Labour Costs

As outlined in the comments above, labour costs need to be considered on a standardised basis. For independently owned practices, this should, as a minimum, include a market rate **clinical** salary for their working time in the business. Given that the LCGs all employ senior clinical vets, there would be readily available evidence as to what level of clinical salary should be included.

If head office costs are to be included in the calculation of the staffing costs for LCGs (which we do not believe they should), additional costs would need to be included in the calculations for independently owned practices to reflect the role of the owners of those businesses performing this function.

Applying a suitable value to this work is inherently difficult and will not be standard across all businesses.

Further, LCGs operate with layers of management not seen in independent practices and any comparison where total salary costs are included would not compare like with like.

Therefore, to remove significant variations in the results, it would be more appropriate to consider the clinical costs of those individuals working directly in the veterinary practices and exclude the costs or notional costs for the management and development functions. This would allow comparability of results.

The recruitment market for veterinary professionals (both vets and nurses) is very competitive due to well documented shortages in availability. Therefore, the salary costs across the various business models should be relatively consistent.

Considering these total costs as a percentage of the turnover generated will provide an indication of employee utilisation, which is core in a professional services business, and ultimately the markup up applied to the cost of that professional time when prices are being set, which is reflected in the turnover levels achieved.

All Profit and loss information should be readily available for household pet services in relation to the above. Therefore, adopting this method of reviewing the financial results should also allow the information for small animal practices to be considered in isolation, without being distorted by other operating activities of the wider group. Within the proposal, it appears that farm and equine turnover and figures might be included. Whilst still being veterinary services,

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they are entirely different businesses to household pets (small animal) with entirely different financial performance parameters.

Profitability

In addition to the standardisation of labour costs, when considering the overall profitability levels, the property costs, including the amortisation of any excess improvement costs, needs to be standardised, as outlined above.

As is already outlined in the working paper, goodwill amortisation and financing costs would need to be excluded from the calculations. However, the write off of capital losses should correctly be included to give true comparability.

The final profitability level will be impacted by the wider structure of the business. Therefore, whilst it is important to consider this in the overall context of the results, it should be reviewed in conjunction with the other key metrics of the gross profit margin achieved and direct labour costs as a percentage of turnover generated.

The caveat to this is that a badly run business can deliver very low profits, notwithstanding high charging practices. Efficiently run, well managed businesses will always generate a higher profit than badly run inefficient businesses. That is not an indicator of excess profits but simply of a well run business.

New entrants normalising profits

When considering the consumer (which we agree is fundamentally important), pricing and availability of choice will naturally correct a market place over time. Across our client base we have seen a significant surge in independent practice start ups over the last 2 years and this trend continues. This is the natural consequence of consolidation within practice ownership removing ownership options for many senior vets. Further, the pandemic driven barriers to entry have also now gone, due to Banks returning to funding start ups.

It is simplistic to suggest that, within a market place, where individuals must hold the required qualifications to practice, market forces will bring profits achieved to a “normal” level and “excess profits” are the indicator that action is required. For that premise to hold, there must be an unlimited supply of appropriately qualified individuals available to enter the market place. Within the veterinary profession, patently this is not the case as has been well documented. It is similar within the private human healthcare profession.

Where the Banks ceased new business lending as a result of the pandemic, there was no feasible way for new entrants to come into practice ownership. A return of Banks to supporting new start ups has very rapidly changed the landscape and we see this as continuing based on our current work load and enquiries.

Following on from the above, a key issue of concern within the proposals is the time horizon being considered.

The last 5 years included Brexit and a pandemic which have fundamentally skewed the picture. It will only be the coming years ie current year and forward looking rather than retrospective, that will see this self-correct through new start-ups. On the ground, in real time, we are seeing this first hand. The limiting factor is the supply of vets working in the UK rather than others being kept out of the market place.

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The only barrier to entry is holding the appropriate qualification. There are hurdles to overcome, such as finding premises, but there is a supply of suitable premises in the UK. Even if non-veterinary owners look to enter, they must employ or engage appropriately qualified individuals to operate a veterinary practice. The question then is why would a vet choose to work for someone else rather than set up a practice? Salary is one answer. Veterinary salaries have been driven up as a result of the consolidation but, for many, salary eventually proves to not be enough. This takes time to have an impact which we are now seeing.

Whilst this is perhaps not pertinent to the review now taking place, which appears to be backward looking, in our view it does have a significant bearing on the future of independent practice, which is of prime concern.