NON-CONFIDENTIAL

22 NOVEMBER 2024

CMA MARKET INVESTIGATION INTO THE SUPPLY OF VETERINARY SERVICES FOR HOUSEHOLD PETS

RESPONSE TO
"APPROACH TO PROFITABILITY AND FINANCIAL ANALYSIS"
WORKING PAPER
DATED 1 NOVEMBER 2024

1 Introduction

1.1 Pets at Home Group Plc (**PAH**) welcomes the opportunity to comment on the CMA's Working Paper on its *Approach to Profitability and Financial Analysis* (**Profitability WP**) published on 1 November 2024.

1.2 This response builds on PAH's responses to RFI6 and RFI7 and should be read in conjunction with these submissions. Unless otherwise stated, defined terms in RFI7 have the same meaning in this response. PAH also raised concerns about the CMA's proposed profitability analysis in response to the CMA's Issues Statement.[1]

1.3 Please note that this response contains **confidential information/business secrets**, disclosure of which might significantly harm the legitimate business interests of PAH for the purposes of Section 244(3)(a), Part 9 of the Enterprise Act 2002. This information must be removed from any public version of this response. Confidential information has been redacted (i.e., **[REDACTED]**).

1.4 The CMA's Profitability WP covers a lot of ground. It outlines at a high level:

- the CMA's general approach to profitability analysis, including its intention to conduct a return on capital employed (**ROCE**) analysis and compare this against an estimate of the weighted average cost of capital (**WACC**);[2]

- the CMA's proposed approach to the profitability analysis of Large Corporate Groups (**LCGs**), including its approach to asset valuation and estimating the WACC;[3]

- the CMA's proposed approach to the profitability analysis of independent veterinary businesses (especially in light of the large number of independents in the sector and expected data challenges for independents);[4] and

- potential additional analyses (e.g. margin benchmarking[5] and inefficiency benchmarking[6]) and other cross-cutting analyses (e.g. assessment of the extent to which medicines might be cross-subsidising veterinary services).[7]

[1] See PAH Issues Statement Response submitted on 30 July 2024, paragraph 55.

[2] Profitability WP, Sections 2 and 3, and paragraphs 4.1-4.31.

[3] Profitability WP, paragraphs 4.32-4.78.

[4] Profitability WP, paragraphs 4.79-4.97.

[5] Profitability WP, paragraphs 4.98-4.107.

[6] Profitability WP, paragraphs 4.74-4.78 and 4.96-4.97.

[7] Profitability WP, paragraph 1.3(c).

1.5 The CMA also asks for views on:[8]

- allocating 'common' revenues/costs and assets/liabilities;
- the costs of a 'standalone' veterinary services provider;
- assessing potential inefficiencies; and
- whether there are any appropriate price/profit benchmarks.

1.6 PAH has already submitted views on many of these issues in its responses to RFI6 and RFI7. Therefore, in this response, PAH comments on a non-exhaustive list of issues in three sections below (**Sections 2 to 4**). Two annexes are also provided to: (i) comment in more detail on the CMA's proposed approach to estimating the market-wide WACC (**Annex A**); and (ii) help the CMA identify PAH's responses to specific CMA requests within the Profitability WP (**Annex B**).

[8] Profitability WP, paragraph 5.2.

2 Executive Summary of PAH Comments

2.1 PAH focuses its comments on First Opinion Practices (**FOPs**) in which PAH is active.

2.2 As PAH has reflected in its responses to RFI6 and RFI7, PAH has significant concerns about the reliability of economic profitability analysis in relation to FOPs. There are many reasons why economic profitability analysis is unlikely to be reliable for FOPs:

- These are service and knowledge-based businesses that rely heavily on human capital and intangible assets, which are challenging to value robustly.[9]
- There is a diversity of business models across the UK, even within the FOP segment of the market, that make robust comparisons challenging, e.g. many FOPs are owner-operated, which make them more difficult to compare against LCGs.[10]
- Many FOPs are tiny independent, owner-operated businesses with revenues under £1 million per annum, facing a different set of risks and operating costs to LCGs. For example, an independent FOP may not be able to achieve economies of scale in its operating costs.[11]
- With more than a third of the FOP market comprised of tiny businesses, it is a concern that the CMA does not expect to get reliable ROCE data from these smaller providers. This risks a selection bias and failing to get a reliable view on the experience of the '**marginal firm**' in the market.[12]

[9] The CMA itself recognises that: *"In industries with a relatively low level of tangible assets, such as **service and knowledge-based industries**, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles."* CC, Guidelines for market investigations: Their role, procedures, assessment and remedies, April 2013, Annex A, para 12 (emphasis added). The same point is made at para.4, Annex 1, of the 5.11.24 draft CMA Markets Substantive Assessment Guidance currently under consultation.

[10] Where staff have an ownership stake in the FOP, staff remuneration is made up of a mix of salary and future business earnings (and losses) e.g. dividends and exit value. PAH has seen evidence that staff with an ownership stake in the FOP often choose to take lower salaries than they may if they were fully salaried employees. This creates a comparability problem between independents (and PAH Joint Venture FOPs) on the one hand and LCGs on the other hand, in which the former may appear, at face value, relatively more profitable because of a lower share of salary costs in the remuneration of staff with an ownership stake.

[11] As part of PAH's RFI7 response, PAH submitted a paper (**Annex 001 RFI7**) showing that economies of scale within the PAH Joint Venture business model (such as procurement efficiencies) can result in a PAH Joint Venture FOP making over [REDACTED] per annum more in profit than a typical independent FOP.

[12] A discussion paper authored in December 2003 by the now Chief Economist of the CMA, Dr Mike Walker (together with co-author Professor Robert Lind), explains why the profitability experience of the **marginal firm** is so important:

> "*The theorem that in a long-run, perfectly-competitive equilibrium firms will earn zero economic profits is simply not true when applied to economic profits as one would normally measure them. Instead, what is true is that the marginal firm will earn zero profits. […]*
>
> *The theory is quite simple. In a perfectly competitive market where all firms are price takers, price is determined by the intersection of the supply and demand curves. The industry supply curve is the horizontal summation of the marginal cost curves for each firm, which are also the firms' supply curves. If firms in the industry are earning a return on investment that is above their required return, e.g., 10%, then new firms will enter the market. This will shift the supply curve to the right and the market price will fall to a point where the last firm to enter earns a 10% return. In this example the cost of capital is 10%, and entry will stop when the return to the marginal firm is just 10%. If all firms have identical costs then all firms will earn 10% and have zero economic profits. However, generally some firms are more efficient than others and so some firms have lower costs than others. The theory predicts that the marginal firm in long-run equilibrium earns zero economic profits, but firms with lower costs will earn positive economic profits.*

- The FOP market is not 'national' but rather comprises many small local markets, each with their own different dynamics and underlying costs. The profitability analysis should be conducted within the local market in question to understand the performance within that local market, rather than across markets at some aggregate level. It is not possible for a small efficient veterinary business to simply expand unless it is willing to open new FOPs in other local markets.
- Accurately estimating and understanding the profitability of FOPs requires looking at profits over a long period of time, given the time it takes to establish a successful FOP. Examining the profitability of providing FOP services over a three (or five) year period is unlikely to fully and accurately reflect the profitability of a FOP over its lifecycle. The early stages of a FOP's lifecycle can involve a long period of start-up losses, as it builds a local reputation, a customer list of registered pets, and expertise.
- The CMA says it will seek to capitalise start-up losses.[13] PAH welcomes this proposal, and provides some further evidence below, but wishes to see more detail from the CMA on how it will estimate the extent of start-up losses across the market as a whole, given the significant importance of intangible assets to building a successful FOP.

FOPs should not be conflated with other Veterinary Services

2.3 Given the complexities of analysing FOP markets, PAH is further concerned to see the CMA's proposal to simply lump FOP activities together with other veterinary services provided by the LCGs.[14] PAH understands the CMA's concerns about the challenges of allocating costs and capital within the LCGs. But looking at economic profitability in LCGs in aggregate is going to deliver distorted and unreliable results for the FOP segment of the market in which most vets operate.

2.4 For example, entry barriers, capital requirements, and competitive dynamics for FOPs are fundamentally different to those of other veterinary services such as specialist animal hospitals and referral centres, Out of Hours (**OOH**) provision, and cremation service provision. These differences will mean looking at the aggregate profitability of a LCG may tell you very little about the dynamics of the FOP market.

This implies that we should expect firms on average to earn more than their cost of capital. This should come as no surprise. Firms will only enter a market, or embark on a new investment, if they expect to earn at least their cost of capital as a return. We know as a practical matter that firms evaluate investments and choose only those they expect to exceed their cost of capital. Investments that earn just the cost of capital are breakeven and add nothing to shareholders' net worth. Firms will, of course, make some mistakes, but one would still expect many firms to earn above their cost of capital."

See: ***The (mis)use of profitability analysis in competition law cases***, CRA Competition Policy Discussion Papers 9, December 2003.

13 Profitability WP, paragraph 4.61.

14 Profitability WP, paragraph 4.38. This is further compounded by the fact that the CMA is not intending to request financial information from specific upstream providers (e.g. pharmaceutical wholesalers, Out of Hours (OOH) providers, pet cremation service suppliers). PAH's view is that this will make it difficult for the CMA to diagnose any key areas of concern in the industry.

2.5 PAH's view is that this approach risks the CMA not being able to diagnose where problems (if any) in the sector are actually being caused. PAH sees a significant risk that frontline FOPs may be unfairly caught up in discussions of excessive profitability – a reputational and trust damaging finding – because of inflated profits in activities these frontline vets do not themselves provide.

Adjustments to PAH's costs and capital will be required

2.6 If, in any event, the CMA proceeds with a profitability analysis for FOPs, several adjustments to the financial information supplied by PAH will be required, as set out in its response to RFI7. Some of the most important are:

(i) **Correctly estimating the economic value of PAH's <u>tangible</u> assets.** PAH proposes to: (i) add the capitalised value of its FOP lease obligations; (ii) estimate the replacement costs of fixtures, fittings, and equipment in its FOP portfolio, noting that there is not, in PAH's experience, a viable, liquid second-hand market for veterinary equipment in the UK; (iii) allocate to FOPs a share of the necessary capital not associated with essential IT infrastructure (e.g. [REDACTED]); and (iv) add the working capital necessary to run a FOP. Looking at the replacement costs of PAH's most recently opened 15 FOPs, the economic value of the tangible capital base would exceed [REDACTED] per FOP.[15]

(ii) **Correctly estimating the economic value of PAH's <u>intangible</u> assets.** PAH considers that its brand and reputation are valuable assets in which it invests, and through which it is able to successfully grow FOPs organically (rather than through acquisition). Valuing this brand will be important. PAH also considers a start-up loss asset (**SLA**) must be included. The value of this asset reflects economic losses incurred by a FOP as it invests in the necessary intangibles that must be accumulated during a FOP's growth phase.[16] For example, a customer list, a trusted reputation, and clinical expertise. Accounting for the SLA is necessary for the FOP to recover its costs and earn its competitive economic return over its lifecycle. PAH's expectation is that the estimated value of the intangible assets will be material relative to the value of the tangible assets required to open the FOP, as would be expected in a knowledge and services-based business. Some illustrative modelling conducted by PAH using its own FOP portfolio suggests the SLA would exceed [REDACTED] per FOP, with it taking more than [REDACTED] years to start making positive economic returns.

(iii) **Correctly reflecting the salary costs for owner-operators** (i.e. accounting for the fact that the additional work associated with running a FOP may not be taken in salary, but in later dividends or exit value). PAH estimates this would

[15] [REDACTED]

[16] A new FOP's decision to enter – and therefore invest in the necessary intangibles to become a viable FOP – only makes sense if the FOP can expect to earn sufficient returns in the future to recover its costs. Initially, a new FOP will incur economic losses, i.e. it will earn returns significantly below the appropriate competitive return (or cost of capital). In the earlier years, a FOP will even incur accounting losses, i.e. it will earn negative profits. It is possible to calculate economic losses by comparing the FOP's actual earnings to the return necessary to compensate the FOP for its cost of capital. Because a FOP will only enter if it can recover its costs – including the opportunity cost of its capital – the FOP will view start-up losses relative to its opportunity cost of capital.

increase salary costs of its own JV FOPs by around [REDACTED] per annum.[17]

(iv) **Correctly capturing the 'standalone' costs of the FOP portfolio.** PAH shares certain costs between its Vet Group and its Retail Arm. Were PAH to set up a 'standalone' veterinary business, these common costs would still need to be incurred (and now recovered only through the 'standalone' veterinary business). Indeed, PAH considers that, in the Profitability WP, the CMA is overstating the simplicity of this task in its footnote 47: "*We are able to exclude the retail operations of Pets at Home as this is structurally separate from the veterinary services operations*". PAH agrees that certain costs and capital can be separated, but there remain common costs that PAH has not allocated in full to a 'standalone' veterinary business. Further, one must recognise that there are physical synergies between the FOPs and the retail stores – more than 300 FOPs are located within a PAH retail store – and replacing a 'standalone' portfolio of FOPs in similar locations would be very expensive indeed.

(v) **Correctly capturing known future cost inflation in the sector.** PAH notes that the Government's Autumn Budget 2024 has made proposals that will significantly affect the veterinary services sector. PAH conservatively estimates that, due to increases in national insurance contributions and the national living wage, its payroll costs could increase by over [REDACTED] per annum.[18]

Adjustments needed to the applicable WACC for FOPs

2.7 The CMA proposes to estimate a 'market-based' WACC for veterinary services based on the *beta* of PAH and CVS (the two listed LCGs) and the cost of debt of the LCGs.[19] PAH does not consider that this will give a reliable or fair estimate of the market-based WACC.

2.8 *First*, the CMA proposes to estimate the *beta* using just CVS and PAH. In PAH's view, using only these two data points is unlikely to give robust conclusions. The CMA notes that it may explore the possibility of using listed veterinary services providers in other countries,[20] but the CMA itself notes in the context of its price and margin benchmarking that international benchmarking is "*unlikely to yield robust conclusions*".[21]

2.9 *Second*, most FOPs (by number) are micro-businesses with annual revenues under £1 million per annum. The CMA acknowledges that it may be appropriate to adjust the WACC when analysing the profitability of independent FOPs.[22] PAH agrees with the need to adjust the WACC upwards when analysing FOPs. As explained in PAH's

17 This adjustment is evidenced by: [REDACTED].

18 The basis for the estimate is shown in Section 3 of this response.

19 Profitability WP, paragraphs 4.65, 4.69 and 4.72.

20 Profitability WP, paragraph 4.69.

21 Profitability WP, paragraph 4.107.

22 Profitability WP, paragraph 4.65.

response to Question 7 of RFI7, a **micro-business premium** is necessary to compensate for the additional risks facing owner-operated micro-businesses (e.g. key personnel risk, illiquidity risk etc.) and this is consistent with the findings of leading academics. To be clear, PAH has deliberately used the terminology "micro-business premium" as different from small company premium.

2.10 See Annex A of this response for more detailed comments on the CMA's proposed approach to the WACC for FOPs.

Comments on the CMA's other proposed analyses

The CMA's proposed analysis of the profitability of medicines

2.11 The CMA indicated in its Issues Statement that it would seek to analyse the mark-ups applied to the most frequently sold medicines in order to understand the extent, if any, of any cross-subsidy between medicines and veterinary services.[23] In its Profitability WP, the CMA says it intends to understand the effect of discounts/rebates on the profitability of medicines sold by the LCGs through their FOPs.[24]

2.12 PAH considers that the CMA has not clearly set out how it intends to assess the extent of any cross-subsidy between medicines and veterinary services or the methodology it proposes to apply, so it is hard for PAH to comment meaningfully on the CMA's proposed analysis. However, even at this early stage, PAH can say that it considers it would be inappropriate to assess mark-ups on medicines without taking account of: (i) the cost of time spent by veterinary professionals prescribing and/or administering the medicines; and (ii) the inventory costs of sourcing and holding medicine stocks in practice. Therefore, the gross margins on medicines alone are unlikely to be a meaningful measure of the profitability of medicines if considered in isolation.

The CMA's approach to assessing potential inefficiencies

2.13 The CMA proposes to assess potential inefficiencies through an analysis of costs and a review of internal documents.[25] However, PAH believes that any such comparison of costs is unlikely to be robust as there are many legitimate reasons for costs to vary between FOPs (e.g. business models, regional mix, service/treatment mix, etc), including two reasons acknowledged by the CMA (higher costs for higher quality services, and exogenous factors such as locations).[26] Further, with respect to the independent sector, as the CMA acknowledges, there are challenges with obtaining data for independent veterinary businesses.[27] The challenges around obtaining robust information from the smaller firms potentially make conclusions on inefficiencies

23 Issues Statement, paragraphs 88 and 107(c). Profitability WP, paragraph 1.3(c).

24 Profitability WP, paragraph 4.41.

25 Profitability WP, paragraphs 4.77 and 4.96.

26 Profitability WP, paragraph 4.75.

27 Profitability WP, paragraphs 4.80 onwards.

unreliable.

2.14 PAH periodically reviews the performance of its FOPs and often intervenes to address underperforming FOPs. Therefore, PAH internal documents discussing underperforming FOPs are likely to be evidence of careful management and pursuit of improving efficiency, rather than a sign of poor performance in the market. The CMA is also aware that PAH closed or restructured many underperforming FOPs in FY20 (i.e. the year to March 2020).

The CMA's approach to profitability of independent veterinary businesses

2.15 The CMA's estimate of the number of independent veterinary businesses and practices in its Profitability WP (667 businesses and 999 practices)[28] is materially lower than its previous estimate in its Issues Statement (around 1,500 veterinary practice owners and 1,968 small chain/independent practices).[29]

2.16 PAH would like to understand the reasons for this material decline in number of FOPs and would find it helpful for the CMA to publish both its original and revised lists of practices across the UK (which should all be public information). Parties could then comment on the accuracy of this list, identifying any missing FOPs.

2.17 The CMA's proposed sampling approach to obtaining data and analysing the profitability for independent veterinary businesses[30] aims for a total of 50 responses from a random sample of 70 firms to which it will issue information requests.[31] PAH queries whether and how the CMA will ensure that its sample of independent vets will be representative, given the wide range of different types of small chains and independent vets (at different stages of the FOP lifecycle), and the variety of small local markets in which independent vets operate (with their own different dynamics and underlying costs). Even with the reduced number of independent FOPs identified by the CMA, a sample of 50 is so small as to raise significant risks on reliability.[32]

Margin benchmarking

2.18 The CMA considers that price and/or profit margin *"benchmarking is unlikely to yield robust conclusions and we therefore do not propose to pursue this avenue of inquiry further"*. [33] PAH agrees that price and/or margin benchmarking based on firms

[28] Profitability WP, paragraph 4.80.

[29] Issues Statement, paragraph 29. Consultation on proposed MIR, paragraphs 1.27, 1.29 and Table 1.1.

[30] Profitability WP, paragraph 4.83.

[31] Profitability WP, paragraph 4.87.

[32] If the CMA wants to estimate the profitability of the population of smaller players – assuming a population size of 667 businesses, a confidence level of 95%, and a margin of error of 5%, a sample size of c.240 would likely be needed. In its own survey guidance for mergers, the CMA explains that it aims to "*achieve a minimum of 100 completed interviews with any pre-defined group of interest for rigorous analysis*". See: https://www.gov.uk/government/publications/mergers-consumer-survey-evidence-design-and-presentation/good-practice-in-the-design-and-presentation-of-customer-survey-evidence-in-merger-cases

[33] Profitability WP, paragraph 4.107.

operating in different countries or sectors is likely to have limitations in relation to comparability with firms supplying veterinary services in the UK. While PAH considers that margin benchmarking presents challenges in this context, PAH's view is that this is equally true of the other ROCE and profitability analyses the CMA has proposed.

3 Conceptual challenges with robustly estimating profitability for FOPs

3.1 As set out in PAH's response to RFI7, there are significant difficulties with carrying out a profitability analysis robustly for FOPs.

Examining the profitability of providing FOP services over a three (or five) year period is unlikely to fully and accurately reflect the profitability of a FOP over its lifecycle

3.2 A new FOP is likely to incur start-up losses as it builds a local reputation, a customer list of registered pets and expertise. This period of losses can be for several years. Even within the PAH model in which the FOP is centrally supported by PAH through its growth phase, there is evidence of [REDACTED]. If this is not factored into the assessment of profitability, this would overstate the profitability of a FOP business and the market as a whole.

3.3 A FOP owner in an independent practice can make choices at different stages of maturity about whether to take a lower salary in order to keep more cash in the business to weather more difficult periods. A FOP may therefore appear to be more profitable in the short-term (if salary costs are lower) when it is making a conscious decision to build a business that can survive.

3.4 Many LCGs have sought to acquire established FOPs – FOPs that have already come through their lengthy start-up period (which may be a reason that some LCGs see value in retaining the established local brands). Over the past decade, PAH has not grown through acquisition but rather through opening over 200 new greenfield FOPs. PAH, therefore, has seen evidence of start-up losses across its FOP portfolio. It has also had to make the difficult decision to close FOPs that never make it through these years of loss-making. Some of this evidence is set out below.

3.5 Further, while PAH agrees that ideally the profitability assessment would be independent of firms' capital structures, a new entrant FOP incurs material interest costs. This lowers earnings, which are often already losses. PAH FOPs only incur these losses (including interest expenses) as they expect to be compensated for their initial investment into intangible assets.

3.6 Ultimately, PAH's key concern is that looking at the profitability of a FOP over a narrow three (or five) year window is unlikely to reflect the true economic profitability of the business over its lifetime and is likely to lead to misleading conclusions. As even gathering data for an additional two years – and looking at a five year period – does not cover the full lifecycle of a FOP, PAH has concerns over the incremental benefit of the CMA's proposal to collect an additional two years of financial information.[34]

[34] Profitability WP, paragraph 3.9.

There are a number of different business models in the sector, and the different veterinary services offered will have different revenues, capital bases and profitability

3.7 In its Profitability WP, the CMA outlines a proposed methodology that aggregates financial data across various veterinary service segments operated by LCGs, due to the other LCGs finding it in some cases complex to separate the financial data of each of the in-scope veterinary services.[35] This approach presents significant challenges in accurately assessing the profitability of frontline FOPs.

3.8 The aggregation of financial data from various veterinary service segments into a single profitability metric obscures the distinct economic characteristics of each segment, which will impede the CMA's ability to identify any specific areas of concern within the veterinary sector, potentially leading to misguided conclusions about the competitive dynamics and profitability drivers in the market.

3.9 Furthermore, the inclusion of potentially high-margin segments alongside FOPs may inadvertently inflate the perceived profitability of FOPs. Segments such as OOH services or referral centres often operate with different cost structures and profit margins compared to FOPs. By not disaggregating these segments, the CMA risks presenting a distorted and biased view of FOP profitability, which does not accurately reflect the operational realities faced by frontline FOPs.

3.10 PAH's view is that in the first instance, a segmented profitability analysis that isolates the financial performance of individual business activities within LCGs is necessary and preferable. If this is not feasible, an alternative might be to collect information from specific upstream providers (e.g. pet cremation service suppliers) that are not affiliated with the LCGs. In the last instance, the CMA should pay close attention to its segment margin analyses and be cautious in interpreting or communicating the LCGs' overall economic profitability results (and any resulting customer detriment) as reflecting that frontline vets in FOPs are excessively overcharging customers.

Different pay structures across different ownership models will affect relative profitability

3.11 JV or independent practice owners may not be receiving the same pay as they would within a corporate model, choosing to take the risk of 'pay' in dividends and ultimate exit value, rather than as a salaried senior employee (with higher base pay and bonuses). If JV or independent practice owners choose to take a lower salary than they could otherwise command elsewhere given the wider management responsibilities they take on, choosing instead to take pay in dividends and/or profit shares, this is likely to lower the apparent 'labour cost' in the P&L and overstate the practice-level profitability. The CMA experienced similar issues in the *Statutory Audit* market investigation, in which audit partners often had a higher proportion of their pay

[35] Profitability WP, paragraph 4.38(d).

based on annual dividends.[36] It was this issue, together with the high volumes of intangible assets in a professional services market, that ultimately resulted in the CMA not placing significant weight on economic profitability in the *Statutory Audit* market investigation.[37] Both issues exist also in the FOP market, which is a reason why PAH is concerned that a ROCE analysis risks being misleading for FOPs.

3.12 [REDACTED].

3.13 Indeed, there are significant differences between PAH's business model and those of the other LCGs and independent practices. PAH is unique in the FOP market in operating a JV model at scale in its FOP portfolio, whereby PAH partners with, and supports, POs to run their FOP – this is PAH's preferred model. PAH's JV business model generates material efficiencies, which were illustrated in an annex to PAH's RFI7 response: **Annex 001 RFI7**.

Cost and capital allocations are difficult in practice, particularly for common costs and capital

3.14 Different LCGs operate different business models, e.g. PAH operates retail pet stores and FOP services, whereas other LCGs operate interconnected networks of different veterinary services. Multi-product businesses often have large central and common costs, and intangible assets such as reputation/brand. Cost allocation is challenging and there is no uniquely "correct" way to allocate common costs. This means that profitability estimates will vary widely depending on assumptions, and across the different multi-product firms in the market.

3.15 The CMA recognises the challenges of standard profitability analysis in complex firm structures and professional services businesses.[38] It is clear that similar challenges exist for veterinary services.

3.16 PAH recognises these challenges of cost and capital allocation, and considers that the CMA must engage with them comprehensively and transparently if any profitability conclusions are ultimately going to be attached to FOPs. Many FOPs across the UK are not part of large integrated groups that operate ancillary veterinary services, and it

[36] CC (2013), Statutory Audit Market Investigation, Final Report, para 7.83. https://assets.publishing.service.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf CC (2013), Statutory Audit Market Investigation, Appendix 7.3: Profitability, paras 28-30. https://assets.publishing.service.gov.uk/media/5329db3740f0b60a73000027/131016_final_report_appendices_glossary.pdf

[37] In its *Statutory Audit* market investigation, the CC stated that: "*Due to the multiple layers of uncertainty, particularly the difficulty of measuring the appropriate asset base and an appropriate measure of partner cost, we did not undertake detailed economic profitability calculations using return on capital employed (ROCE).*" CC (2013), Statutory Audit Market Investigation, Final Report, para 7.84. https://assets.publishing.service.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf

[38] For example, in its *Retail Banking* market investigation, the CMA stated that: *"there were a particularly large number of allocation adjustments and assumptions necessary in order to arrive at a profit and loss account for each provider. Taken cumulatively, this would have made an objective judgement extremely difficult […] Due to these reasons, we decided not to undertake market-wide profitability analysis […]"*. CMA (2016), Retail Banking Market Investigation, Final Report, paras 2.59-2.60.https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf

would be unfair to tarnish these 'standalone' FOPs with any excess profitability findings derived from the LCGs if the profits were in fact earned in business activities in which the frontline FOPs were a 'user' rather than a supplier. For example, many FOPs have to rely on a limited number of OOH and cremation providers and have limited ability to determine the pricing of these services in negotiations. It would be inappropriate if the frontline FOP 'users' of these services were tarnished by the profitability of upstream suppliers.

The tangible asset base of FOPs is difficult to value reliably

3.17 As discussed in PAH's response to Question 1 of RFI7, there are a number of reasons why the economic value of PAH's tangible asset base is underestimated in the financial accounts. The accounting net book value (**NBV**) would underestimate the true economic cost of replacing these assets.

3.18 In its RFI6 and RFI7 responses, PAH has attempted, in the time available, and on a best endeavours basis, to separate out the veterinary business segment from the Retail segment. However, this exercise has required numerous assumptions on the allocations of cost and capital.

3.19 It is also important to understand that even when the allocations are done in the normal course of business, these remain assumptions and there is no unequivocally correct way of making common cost allocations.

3.20 On this point, PAH would caution against taking the view that, from either an accounting or economic perspective, it is straightforward to "*exclude the retail operations of Pets at Home as this is structurally separate from the veterinary services operations*".[39] Many PAH FOPs are located inside retail stores. The significant investments that PAH has made in IT infrastructure are made to support customers in seamlessly getting both their pet retail and vet needs in one place. Disentangling these physical linkages between the Retail arm and Vet Group is challenging.

Intangible assets are particularly important in the capital employed

3.21 The CMA itself recognises that: *"In industries with a relatively low level of tangible assets, such as services and knowledge-based industries, the book value of capital employed may bear little relationship to the economic value because of the presence of significant intangibles."*[40]

3.22 The provision of FOP services is characterised by the importance of intangible assets, such as the expertise, experience and upskilling of veterinary professionals, the customer lists of registered pets, and the trusted reputation of the vet (and/or the

39 Profitability WP, footnote 47.

40 CC, Guidelines for market investigations: Their role, procedures, assessment and remedies, April 2013, para 12. (emphasis added). https://assets.publishing.service.gov.uk/media/5a7c1b7340f0b645ba3c6bcc/cc3_revised.pdf The same point is made at para.4, Annex 1, of the 5.11.24 draft CMA Markets Substantive Assessment Guidance currently under consultation.

national brand of a company such as PAH). The NBV of capital employed in the accounting records will not fairly represent the economic value of these intangible assets (if at all). It is necessary to value these intangible assets, but this can be challenging in practice.

3.23 For example, within the PAH JV model, JV POs have an incentive to advance, through training and experience, into doing more specialized vet clinical work over time. This enhances the ability of vets to treat new and more complex conditions in-house within the FOP and increases the value of the FOP's *"skilled and trained workforce"*– a human capital asset. This also helps save the customer money in the long-term (by doing the more complex vet work in-house within a FOP, rather than referring the pet on to another corporate group often at a materially higher price) and helps reduce stress for the animals. However, the ROCE approach may not capture the increase in asset value created through this training and experience. The NBV may capture some new tools or equipment required to deliver the more complex treatments, but not the human capital asset. A ROCE approach could perversely penalise PAH's JV model for offering customers more complex services in a convenient manner and providing them with cost savings in the long-term.

3.24 Another example, related to the interlinkages and synergies between PAH's Retail Arm and the Vet Group, is the benefit that PAH's FOPs receive from being embedded within a large network of retail stores. Indeed, PAH's experience is that where a FOP is opened 'in-store' within a PAH retail store, it can more quickly reach maturity (and avoid some start-up losses in the early years of growth that it would otherwise face) as it benefits from higher footfall from co-location.

3.25 PAH welcomes the CMA's willingness to engage on valuing intangible assets. However, given these assets can be complex to value, there are concerns about how robust any conclusions on the ROCE analysis could ultimately be, and whether the CMA will be able to get enough information on the intangible assets of independent vets to look reliably across the market.

Necessary adjustments for a ROCE analysis in the veterinary services sector

3.26 If the CMA proceeds with a ROCE analysis, several adjustments to the financial information supplied by PAH are required. The six main adjustments are:

(i) **Using an economically meaningful estimate of the tangible and IT infrastructure asset base rather than the accounting NBVs**. For various reasons, NBVs do not accurately reflect the replacement costs of assets. Therefore, alternative valuations should be used. PAH is not aware of any material second-hand market for veterinary equipment and does not have any evidence on insurance values. PAH's estimated asset values are explained in detail in its response to Question 1 of RFI7.

(ii) **Capitalising start-up losses**. Focusing a profitability analysis on three (or five) years once a practice has reached maturity will miss the significant period in the lead-up to maturity where the practice was not earning economic profits (i.e.

not covering its economic costs). As a proxy for the intangible assets that a practice builds up (e.g. reputation, customer list) on the route to maturity, PAH's view is that economic losses should be capitalised.

(iii) **Capitalising impairment losses**. Looking at the profitability of the firms currently in the market leads one to focus solely on successful practices, which leads to a "survivorship bias" in the profitability results. One way to try and correct for this is to capitalise losses from practices that have been closed.

(iv) **Adjusting salary costs of JVs**. [REDACTED].

(v) **Estimating standalone costs and capital**. The LCGs Financial Template has been populated using allocations of cost and capital made on a "fully allocated" basis. These do not reflect the standalone costs of a veterinary services provider.

(vi) **Future cost changes to the sector in light of Budget**. The Government's Autumn Budget 2024 has made proposals that will significantly affect the veterinary services market. PAH conservatively estimates that, due to increases in national insurance contributions and the national living wage, its payroll costs could increase in gross terms by over [REDACTED] per annum.

Adjustment 1 – Using an economically meaningful estimate of the tangible and IT infrastructure asset base rather than the accounting NBVs

3.27 PAH explained in its response to Question 1 of RFI7 that its asset base would need to be revalued relative to the NBV figures in the accounts. PAH provided asset value estimates for different types of assets drawing on:

(i) **Property**: Estimates of capitalised leases were submitted as a follow-up response to RFI6 on 11 October 2024. On this point, PAH welcome the CMA's intention to capitalise operating leases.[41] One important point to clarify is that the capitalised lease value is materially higher for a new FOP compared to an existing FOP. For PAH the remaining tenure for a new entrant FOP is typically [REDACTED], which is around [REDACTED] than the remaining tenure across PAH's full portfolio ([REDACTED]). This implies that a new entrant FOP will have a materially larger capital employed than the average FOP. To explain:

(A) PAH's follow-up response to RFI6 submitted the capitalised lease values for PAH's full portfolio, which averages over older FOPs and younger FOPs. In many instances, the original lease is nearing termination. In other instances, the FOP has moved from its initial longer lease onto a shorter rolling lease. As a result, the average tenure of the capitalised lease values is around [REDACTED].[42]

(B) By contrast, a new entrant will sign an initial lease, typically much longer

[41] Profitability WP, paragraph 4.45.

[42] It is possible to calculate the remaining tenure using the data provided by PAH to the CMA. To be specific, remaining tenure is calculated as lease value divided by the yearly depreciation charge.

than [REDACTED] and will thus have more capital employed.[43] Focusing on PAH's 15 most recently opened FOPs, the median tenure at opening (i.e., applicable to a new entrant FOP) is around [REDACTED].[44]

(ii) **Fixtures, Fittings, Tools and Equipment**: PAH provided an estimate of its asset base drawing on the acquisition costs of equipment in PAH's 15 most recently opened FOPs. The precise methodology is explained in more detail in PAH's response to Question 1 of RFI7. This remains PAH's best estimate of the replacement cost of an FOP asset base.

(A) PAH is not aware of any meaningful second-hand market for veterinary services equipment in the UK. When PAH replaces its assets, these are purchased new.

(B) PAH does not have any readily available information on insurance values. In theory, insurance values and re-build estimates might provide some estimate of asset values in the absence of any other information. However, PAH does not have data that separately identifies FOP insurance values – for example, in stores, insurance is often arranged at the level of the whole retail store (including the vet practice) rather than separately priced for the vet practice.

(iii) **IT infrastructure**: Estimates of the value of PAH's IT infrastructure are provided in response to Question 1 of RFI7. These can also be found in the underlying tabs to the populated LCGs Financial Template submitted in response to RFI6. [REDACTED].

(iv) **Working Capital**: Estimates of the value of PAH's working capital are provided in response to Question 1 of RFI7. These can also be found in the populated LCGs Financial Template submitted in response to RFI6.

Adjustment 2 – Capitalising start-up losses

3.28 The CMA suggests that *"start-up losses in a situation of organic growth might be a reasonable way to encapsulate a brand and/or reputation asset value, using a cost-based approach".*[45] PAH agrees that start-up losses should be estimated and added into the capital employed. The CMA must also consider that some new FOPs never make it through to financial maturity, and so the CMA risks only observing the survivors of the competitive process.

3.29 PAH considers that its model gives a very strong platform on which to grow successful FOPs – PAH has opened over 200 new FOPs over the past decade. PAH provides

43 Typically, a new retail store or standalone will sign an initial lease of [REDACTED]. Thus, a FOP in a new retail store will have a lease of [REDACTED]. A retail store could operate for some time before adding a FOP. In this case, the lease tenure will be [REDACTED].

44 This is calculated using the same methodology explained above but for the 15 FOPs set out in Question 1 of RFI7. The median remaining tenure is [REDACTED], which is consistent with most initial leases being around [REDACTED].

45 Profitability WP, paragraph 4.60.

significant operational support to the FOP (e.g. services procured centrally) and through the established PAH brand. [REDACTED]. Yet, even with this very strong foundational support, it is PAH's experience that cohorts of FOPs take [REDACTED]. PAH has also had to close FOPs that never make it to profitable performance.

3.30 Figure 1 below, for example, illustrates the average earnings per FOP of different ages within the PAH portfolio, with the data pooled over FY20-FY24 to give a more representative sample in each age cohort. [REDACTED]). As cohorts of FOPs progress through the growth curve (i.e., due to their ongoing investment in intangibles and the economies they achieve with scale), they begin to earn relatively higher profits each year.

3.31 Figure 1 provides a generous view of profitability as it reports EBIT [REDACTED].

Figure 1: [REDACTED]

Graph: [REDACTED]

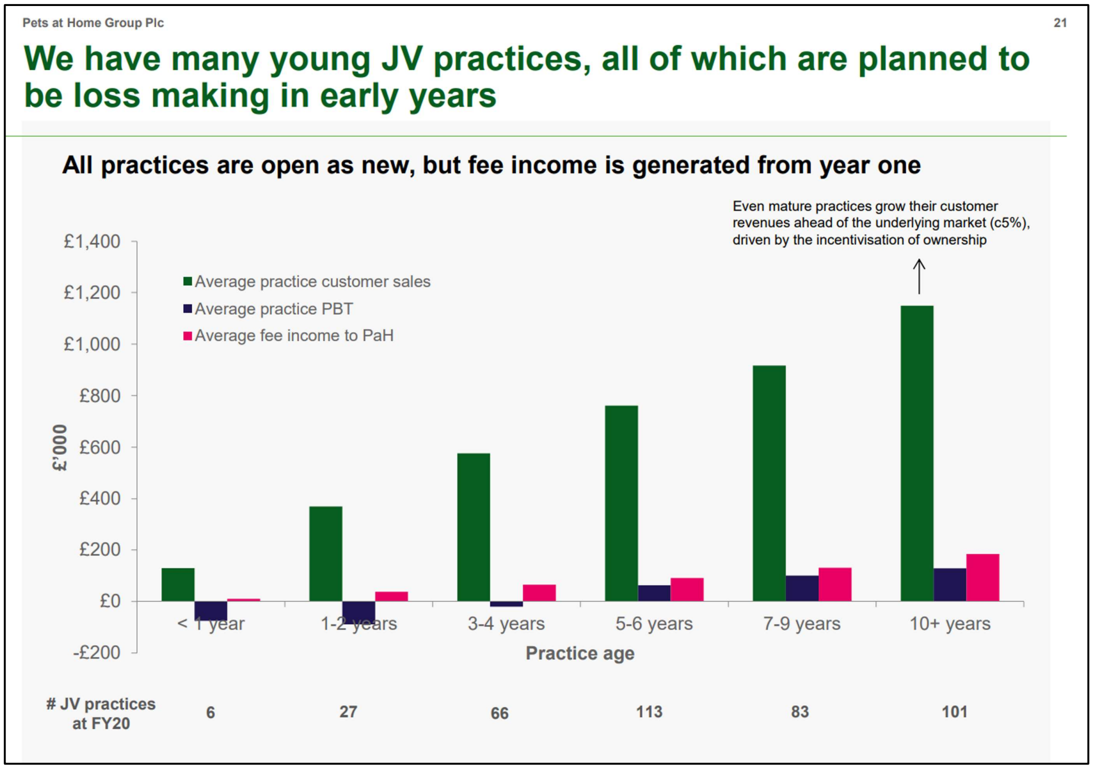
Source: [REDACTED]

3.32 Figure 2 below is a slide from a PAH Group Investor presentation in 2021.[46] It shows that, on average, it is not until the fifth year of operation that JVs start earning positive profits before tax. An updated version of this chart is shown in a PAH Group presentation of FY23 Interim Results in 2022.[47] This also shows that if one includes management fee costs, FOPs are not profitable – in accounting terms – until the fifth year of operation. Figure 2 below shows the earlier chart as it easier to interpret the practice-level view.

46 Pets at Home Investor Presentation, January 2021, slide 21. https://www.petsathomeplc.com/media/v3ae14yg/general-investor-presentation-january-2021.pdf

47 Pets at Home, FY23 Interim Results Presentation, November 2022, slide 25. https://www.petsathomeplc.com/media/kf0halmf/fy23-interims-presentation-vfinal.pdf

Figure 2: Average income generated a given number of years after opening



Source: *Pets at Home Investor Presentation, January 2021, slide 21.* [*https://www.petsathomeplc.com/media/v3ae14yg/general-investor-presentation-january-2021.pdf*](https://www.petsathomeplc.com/media/v3ae14yg/general-investor-presentation-january-2021.pdf)

3.33 Therefore, even for PAH FOPs with the benefits of support from the PAH platform, there is a period of start-up losses. PAH would expect this period could be even longer for a small independent that would not benefit from the financial and operational support that PAH can offer its new FOPs.

3.34 As mentioned, PAH agrees that start-up losses should be estimated and added to the capital employed. Estimating the capitalised value of start-up losses requires modelling based on assumptions. Three main variables determine the value of the capitalised SLA:

(i) *First*, the capital employed for a new entrant FOP. The tangible asset base of a new FOP will include: the necessary fixtures, fittings and equipment; a long-term lease agreement of around [REDACTED]; plus working capital and IT costs.

(ii) *Second*, the relevant cost of capital. This will be the cost of capital applicable to the owner-operator that assumes the risk of the FOP.

(iii) *Third*, the expected profile of earnings. For example, as shown in Figure 1 above, noting that this figure reports the average EBIT per FOP. There will be wide variation in earnings across FOPs and some FOPs will exit due to losses.

3.35 From the perspective of a new entrant FOP, investment – and therefore entry – only makes sense if it can recover its costs over its lifetime. That is, it only makes sense to invest in the necessary intangibles to become a viable FOP, if the FOP can expect to earn sufficient returns in the future to recover its costs. The second and third variables above determine the expected return a new entrant FOP would need to earn to recover its costs and be compensated for its investment.

3.36 Initially, a new FOP will incur economic losses, i.e. it will earn returns significantly below the economic return necessary to cover its costs. In the earlier years, a FOP will even incur accounting losses, i.e. it will earn negative profits. It is possible to calculate economic losses by comparing the FOP's earnings (i.e., the third variable above) to the return necessary to compensate the FOP for its cost of capital. Because a FOP will only enter if it can recover its costs – including the opportunity cost of its capital – the FOP will view start-up losses relative to its opportunity cost of capital.

3.37 Illustrative modelling by PAH suggests that capitalised start-up losses are likely material. Assessing the EBITDA profiles of PAH's own cohort of FOPs over the period FY20 to FY24 (and assuming conservative parameters for the three variables above) indicates that a new FOP would take between [REDACTED] years to start earning a positive economic return (considering economic depreciation and cost of capital). Over this period, a PAH FOP would be expected to accumulate a start-up losses intangible asset valued at over [REDACTED]. The estimated value of the intangible assets is likely to be larger than the value of tangible assets required to open the FOP, which is as expected in a knowledge and services-based business.

Adjustment 3 – Capitalising impairment losses from FOPs that have been closed

3.38 In addition to the start-up losses that one might expect a typical FOP to incur over its lifetime, it is important to understand that by looking at the profitability of the businesses currently in the market, one is focusing solely on successful FOPs, which leads to a "survivorship bias" in the profitability results.

3.39 [REDACTED].

3.40 [REDACTED]. One approach to correct for this survivorship bias in the profitability analysis would be to capitalise these losses incurred from closing down underperforming FOPs.

Adjustment 4 – Payroll of owner-operators is understated as owner-operators take their salary compensation (in part) through dividends rather than salary.

3.41 [REDACTED].

3.42 [REDACTED][48]:

(i) [REDACTED].

(ii) [REDACTED].

(iii) [REDACTED].

3.43 Based on values submitted in response to RFI7, PAH estimates that adjusting owner-operator salaries to reflect a market rate salary cost will increase PAH's total salary cost by around [REDACTED] ([REDACTED] of total payroll cost). This is material as the higher payroll cost would reduce PAH's EBIT by around [REDACTED]. As explained, this difference is well supported by benchmarking reports, business valuation assessments, and the salaries that PAH needs to pay Group Managed Practice Leads.

Adjustment 5: Estimating the 'standalone' costs of a FOP

3.44 In its Profitability WP, the CMA requests input from operators on *"[t]he appropriate basis on which to make an adjustment to firms' operating costs to reflect the 'standalone basis' element, in order to ensure that sufficient costs are allocated such that a standalone firm could operate with the level of central costs included"*.[49]

3.45 In its RFI6 and RFI7 responses, PAH attempted, in the time available, and on a best endeavours basis, to separate out the veterinary business segment from the Retail segment. This exercise required numerous allocations of cost and capital.

3.46 These allocations of cost and capital (as well as those carried out in the normal course of business that indirectly feed into the financial data submitted to the CMA in PAH's responses to RFI6 and RFI7) are made on a "fully allocated" basis. That is, splitting the central costs fully between the two business segments (Retail and Vet Group), even though two standalone entities serving each business segment on a standalone basis would likely have to incur more than 100% of these central costs (in other words, certain central cost items, e.g. central head office costs, would need to be incurred in full by both standalone entities).

3.47 Due to the supply-side efficiencies associated with supplying more than one business segment, PAH would expect that a standalone operator of veterinary services would have to incur higher costs than shown in PAH's populated LCGs Financial Template (because some costs currently sitting within PAH Group centrally and the Retail segment would need to be incurred by a standalone operator of veterinary services). Therefore, obtaining a standalone cost figure would require several adjustments.

3.48 Regarding the P&L, in its populated LCGs Financial Template, PAH in the first instance

48 Basing the salary adjustment on market salary rates ensures that only the fair and reasonable salary cost of the extra work put in by owner-operators is captured (i.e., separate from the return on capital profit share of being an owner).

49 Profitability WP, paragraph 5.2(c).

provided the practice level view of costs, including the management fee costs that PAH FOPs would otherwise have to incur themselves to procure business support services. [REDACTED].[50] These allocations of central costs [REDACTED] likely understate the costs that the FOP portfolio would need to occur if it had to operate on a separate, standalone basis.

3.49 Regarding the balance sheet and the capital employed, there are various central and common capital costs associated with PAH providing veterinary services alongside its Retail segment ([REDACTED]).[51] In its consolidated response to RFI7 dated 28 October 2024, PAH explained that the following items should be included in its capital employed in FY24:

(i) [REDACTED];[52]

(ii) [REDACTED];[53]

(iii) [REDACTED].[54]

3.50 With respect to [REDACTED], it is PAH's view that a standalone operator would require at least a similar level of capital.[55]

3.51 With respect to [REDACTED], PAH considers that a standalone operator may have to incur a much higher level of cost. This is because there are some costs that would still have to be incurred in full, but without allocating some share of those costs to another business segment. With respect to the specific categories of [REDACTED] listed above:

(i) PAH would expect a standalone operator to have to incur [REDACTED].[56]

(ii) In the time available, PAH has not been able to review [REDACTED].[57] [REDACTED].

Adjustment 6: Forward-looking profitability could change in light of Autumn Budget 2024

3.52 On 30 October 2024, the Government announced its Autumn Budget 2024. This included increases to employer national insurance contributions (**NICs**), as well as an

50 [REDACTED].

51 PAH response to Question 1 of RFI7, Table 8.

52 PAH response to Question 1 of RFI7, Table 4.

53 [REDACTED].

54 [REDACTED].

55 PAH assumes here that a "standalone" operator would still be trying to mimic PAH's model of embedding its FOPs within its retail stores (e.g. as a Starbucks coffee shop might embed itself inside a Sainsbury's supermarket).

56 [REDACTED].

57 [REDACTED].

increase to the national living wage (**NLW**).

3.53 PAH conservatively estimates that the gross and net impact of the Budget changes will be to increase the payroll costs of its practices by around [REDACTED] and [REDACTED] per annum, respectively. This is made up of:

(i) A [REDACTED] increase in salary costs owing to the NLW increasing to £12.21 per hour. This is a conservative estimate of the impact, as the increase in the NLW may have an upward pressure on salaries above it as well.

(ii) A [REDACTED] gross increase in NICs owing to:

(A) the contribution percentage increasing from 13.8% to 15%;

(B) the thresholds for NICs decreasing from a salary of £9,100 to £5,000; and

(C) the higher salary base from the increase in the NLW.

(iii) A [REDACTED] decrease in NICs (bringing the net increase in NICs to [REDACTED]), owing to the employment allowance increasing from £5,000 to £10,500.

3.54 These are significant increases in the cost base going forward that could impact the profitability of veterinary services across the market.

4 Comments on Other CMA Analyses

4.1 The CMA intends to investigate several points that are in part related to understanding the economic profitability of the sector. PAH wishes to comment on the analyses relating to: (i) medicines cross-subsidising veterinary services; and (ii) assessing inefficiencies. The CMA has also set out its approach to analysing the profitability of independent vet businesses and its intention not to carry out margin benchmarking.

Medicines cross-subsidising veterinary services

4.2 The CMA indicated in both its Issues Statement and Profitability WP that it intends to assess a possible cross-subsidy between medicines and veterinary services.[58]

4.3 PAH considers that the CMA has not clearly set out a cross-subsidy theory of harm or explained its proposed methodology. Why would a cross-subsidy necessarily signal or contribute to an adverse effect on competition (**AEC**)? And, how much of a cross-subsidy would need to be present for there to be an AEC? These are important questions to ask because cross-subsidisation is a normal business practice in competitive markets. It is not necessarily anticompetitive. Therefore, PAH asks the CMA to explain why this analysis would be informative and determinative of an AEC.

4.4 The CMA says it may analyse the mark-ups applied to the most frequently sold medicines and potentially assess costs, rebates, and discounts. It says also that it may use this to consider how scale affects profitability. This could signal various possible avenues of analysis, and it is not clear how any findings would be interpreted. PAH therefore would welcome the CMA to clarify this theory of harm.

4.5 In relation to the mark-ups on the most frequently sold medicines, PAH considers that it would be inappropriate to assess gross margins by themselves.

4.6 In the first instance, this does not account for the costs of the time spent by veterinary professionals prescribing and/or administering the medicines (people costs, which are to a large extent fixed costs, are the largest costs to the FOPs) and the inventory costs of sourcing and holding stocks of the medicines. Therefore, gross margins are not a meaningful measure of the profitability of medicines.

4.7 A FOP is also not a retailer of medicines in the same way that a pharmacy is. A FOP sells medicines only to its own patients (rather than a wider group of consumers) and provides a service of diagnosing the condition, writing the prescription or administering the drug (e.g. an injectable in practice), and providing convenience through dispensing. The medicines may be part of the bundle of services provided to the pet owner, and often can be provided only after the ‘hands-on’ consultation.

4.8 Finally, FOPs have relatively high fixed cost bases (i.e. clinical payroll, lease payments, equipment, plus other investments) and all services need to contribute to recovering these fixed costs in the long term. The high fixed cost base, alongside the fact that services are purchased together, means that it is not informative to assess the gross margins of medicines (or indeed specific medicines such as the most frequently sold)

[58] Profitability WP, paragraph 1.3(c). Issues Statement, paragraphs 88 and 107(c).

in isolation.

Approach to assessing inefficiencies

4.9 In its Profitability WP, the CMA proposes to assess potential inefficiencies of veterinary services suppliers, as low profitability could potentially conceal ineffective competition.[59] One of the ways the CMA proposes to assess inefficiencies is through an analysis of costs.[60]

4.10 PAH believes that any such analysis would be very difficult to conduct robustly as there are many legitimate reasons for costs to differ between providers as well as between different industries. The CMA acknowledges two legitimate reasons for variations in costs:[61]

(i) Higher costs coinciding with a higher quality of services; and

(ii) Exogeneous factors such as location.

4.11 In addition, PAH believes that cost variations may be explained by a different mix of services provided (some FOPs offer more advanced treatments, some LCGs operate referral centres, OOHs, and/or crematoria). The differences in business structure may also lead to apparent cost differences – such as, the differences in salary costs between 'owners' and 'employed' senior staff detailed above, or differences in the types of services a FOP is able to do 'in house' because it is not required to refer a pet on to another part of its group.

4.12 Therefore, controlling for all the legitimate reasons for cost variation is very challenging, even if the CMA could get sufficient representative data from a broad range of market participants.

4.13 It would also be a significant concern if this analysis did not include a representative number of smaller FOPs. Independent FOPs tend to be small in revenue terms and may not be able to achieve the economies of scale of the larger groups. Therefore, failing to have them properly represented in the analysis will risk underestimating the efficiencies of larger groups.

4.14 PAH has itself sought to analyse cost differences between providers. As the CMA will have seen in PAH's internal documents, it assessed how its own JV business model can deliver cost efficiencies. For example, as part of its RFI7 response, PAH included a paper (**Annex 001 RFI7**) explaining internal analysis conducted before the CMA market investigation, which quantified that PAH's joint venture model, together with economies of scale, was able to deliver [REDACTED].

[59] Profitability WP, paragraph 4.74.

[60] Profitability WP, paragraph 4.77.

[61] Profitability WP, paragraph 4.75.

Approach to profitability of independent practices

Material change in the CMA's number of independent practices

4.15 In its Profitability WP, the CMA estimates that there are 667 independent vet businesses, comprising 999 clinics.[62] The CMA explains that, as there is no existing complete list of veterinary practices within the UK, it has created its own list from a range of sources and conducted further research to understand the ownership structures of these practices. The CMA says this has resulted in a list that includes most independent vet businesses in the UK and which it believes to be sufficient for the purpose of its sampling approach to profitability analysis of independent vets (excluding the four mid-tier firms).[63]

4.16 The CMA's estimate of 667 independent vet businesses comprising 999 independent vet practices is **materially lower** than the CMA's previous estimate of around 1,500 owners of vet practices (ranging from large groups to independent vets with single practice)[64] and 1,968 small chain/independent practices (comprising 340 smaller chains accounting for just over 900 individual FOPs, and around 900 single-clinic practices).[65]

4.17 PAH would like to understand the reasons for this material decline in the CMA's estimated number of independent vet practices in the UK. Indeed, it would be helpful for the CMA to publish both its original and revised lists of practices across the UK (which should all be public information), as this would be useful to the industry as a whole and would also allow parties to identify and add any missing practices.

Representativeness of sample of independent practices

4.18 The CMA considers it is not feasible to assess the profitability of every independent vet, given the limited publicly available data and the fragmented nature of this portion of the market. Therefore, it proposes to conduct a profitability analysis of the four mid-tier firms and to adopt a sampling approach to obtaining data and undertaking profitability analysis for the remaining independent vets.[66]

4.19 The CMA will aim for a total of 50 responses, drawing a random sample of 70 firms with which to issue information requests to achieve this.[67] In drawing the sample, the CMA notes that it can stratify by variables that are likely to impact on firms' profitability[68] and it intends to further stratify the sample to ensure that the selected vet businesses

[62] Profitability WP, paragraph 4.80.

[63] Profitability WP, paragraph 4.84.

[64] Issues Statement, paragraph 29. Consultation on proposed market investigation reference, paragraph 1.27.

[65] Consultation on proposed market investigation reference, paragraph 1.29 and Table 1.1.

[66] Profitability WP, paragraph 4.83.

[67] Profitability WP, paragraph 4.87.

[68] Profitability WP, paragraph 4.86.

are proportionately geographically distributed.[69]

4.20 PAH queries whether and how the CMA will ensure that its sample of independent vets will be representative, given the wide range of different types of small chains and independent vets (e.g. the CMA previously estimated there to be around 340 smaller chains, accounting for just over 900 individual FOPs, ranging in size from 2 practices to around 50, and around 900 single-clinic practices)[70] and the variety of small local markets in which independent vets operate (with their own different dynamics and underlying costs).

4.21 This is also particularly important considering the relatively small sample size the CMA is aiming for (50 out of its revised estimate of 667 independent vet businesses). Indeed, taking the CMA's revised population size of 667, a confidence level of 95%, and a margin of error of 5%, a sample size of c.240 would likely be needed. In its own survey guidance for mergers, the CMA explains that it aims to *"achieve a minimum of 100 completed interviews with any pre-defined group of interest for rigorous analysis"*.[71]

4.22 The representativeness of the sample is important because the CMA proposes to extrapolate the profits made by the smaller vet practices in the sample to the portion of the market comprising smaller vet practices.[72]

Margin benchmarking

4.23 The CMA explains that it has *"considered whether broader price and/or profit margin benchmarking may provide useful insight into the extent to which the LCGs' prices and/or profits reflect those that one would expect to see in a well-functioning market"*.[73] However, the CMA concludes that *"benchmarking is unlikely to yield robust conclusions and we therefore do not propose to pursue this avenue of inquiry further"*.[74]

4.24 PAH agrees that price and/or margin benchmarking based on firms operating in different countries or sectors is likely to have limitations in relation to comparability with firms supplying veterinary services in the UK. While PAH considers that margin benchmarking presents challenges in this context, PAH's view is that this is equally true of the other ROCE and profitability analyses the CMA has proposed to conduct.

4.25 As the CMA has outlined its intent not to pursue margin benchmarking, in the time available, PAH has focused its efforts on commenting on the analyses the CMA is

69 Profitability WP, paragraph 4.88.

70 Consultation on proposed market investigation reference, paragraph 1.29.

71 See: https://www.gov.uk/government/publications/mergers-consumer-survey-evidence-design-and-presentation/good-practice-in-the-design-and-presentation-of-customer-survey-evidence-in-merger-cases

72 Profitability WP, paragraph 4.94.

73 Profitability WP, paragraph 4.105.

74 Profitability WP, paragraph 4.107.

intending to carry out.

Annex A. An Appropriate WACC for FOPs

A.1. The CMA proposes to estimate a 'market-based' WACC for veterinary services based on the *beta* of PAH and CVS (the two listed corporate groups) and the cost of debt of the large corporate groups.[75] In PAH's view, there are risks in relying mainly on PAH and CVS as the basis for estimating the 'market-based' cost of capital and not considering the differing funding and risk profiles of independent FOPs.

There are risks of relying on PAH and CVS betas for FOPs

A.2. Using only two data points creates risks about whether they are representative. Both CVS and PAH comprise activities that are not related to FOPs (both being services not provided by FOPs and, in the case of CVS, being services supplied outside the UK), meaning that their betas will not robustly measure FOP risks in the UK.

A.3. [REDACTED].

There are risks of relying on the cost of debt of the LCGs

A.4. Using a cost of debt based on the LCGs ignores the likely possibility that the small independent FOPs face a higher cost of debt than the LCGs.

Market-wide WACC should include a micro-business premium

A.5. The CMA commented that it may be appropriate to adjust the WACC when analysing the profitability of independent FOPs.[76]

A.6. Most FOPs (by number) are micro-businesses, and PAH agrees with the need to adjust the WACC upwards when analysing the independent vets segment. A **micro-business premium** is necessary to compensate for the additional risks facing owner-operated micro businesses (e.g. key personnel risk, illiquidity risk, etc.).

A.7. Whether it is the 'market' cost of capital, or an adjusted cost of capital for independent FOPs, the CMA needs to determine a reasonable cost of capital to assess firm profitability against that will allow competition to function and necessary investment to continue.

A.8. The UK is a mixed market in which some LCGs operate, while approximately 40% of the market (by number of FOPs) is supplied by smaller independents that are privately owned.

A.9. Small, privately owned FOPs are micro-businesses (most with annual turnover under £1 million) that have different ownership structures to, and face a different set of risks to, those of the larger, more diversified groups. For instance: (i) smaller FOP

[75] Profitability WP, paragraph 4.65, 4.69, 4.72.

[76] Profitability WP, paragraph 4.65

revenues would be less diversified in terms of products and geographic markets served – they typically serve just their local market, and the specialties their veterinary surgeon(s) can offer; (ii) smaller FOPs would face greater key-person risk (losing the key vet for the business would be very damaging to the reputation and viability of the practice); and an interest in a privately-held FOP may be less easy to trade than an interest in a publicly traded company (particularly where this is intertwined with the key person risk that the new owner would need to be confident the practice can continue without the person who built it).

A.10. Therefore, the benchmark cost of capital used should be set at a level that allows these small privately-owned FOPs, or a new entrant practice, a reasonable return to survive in the market.

A.11. PAH considers that the CMA should (i) estimate a cost of debt appropriate to the independent FOPs and (ii) should include a “microbusiness” and/or an “illiquidity” premium to the WACC. PAH is deliberately referring to a **microbusiness premium**, rather than a small company premium (as explained below).

Microbusiness premium

A.12. Most small independent FOPs have revenues under £1 million per annum. These are tiny businesses. PAH recognises that the CMA has considered the “small company premium” in other contexts, but some of its reasoning does not, in PAH’s view, apply for microbusinesses.

A.13. In the *Funerals* market investigation, the CMA faced a situation in which many of the suppliers in the market were small businesses that tended to be owner-operated. The CMA decided not to apply a small company premium to the WACC in that case (despite the factual evidence that smaller funeral homes faced higher costs and risks), setting out its reasons in paragraph 80 of Appendix R.[77]

A.14. In that decision, the CMA noted first that CAPM was the most widely used tool by regulators to estimate WACC. The CMA noted that CAPM did not recognize the need for investors in smaller firms to receive higher returns than those in larger firms as the “*only risk for which investors require additional return (over and above the market risk) is covariance with the broader market, measured by beta*”.[78]

A.15. The CMA noted second that customers should not pay more to use a smaller firm than a larger one, even though very small firms may incur higher costs of capital (and there may be reduced ability for their investors to diversify risk):[79]

> *“While in practice very small firms may incur higher costs of obtaining capital, and/or the investors in such firms may have a reduced ability to diversify their risks, allowing a higher*

[77] CMA (2020) Funerals Market Investigation Final Report: Appendix R, paragraph 80.

[78] CMA (2020) Funerals Market Investigation Final Report: Appendix R, paragraph 80.

[79] CMA (2020) Funerals Market Investigation Final Report: Appendix R, paragraph 80.

> *cost of capital for smaller firms in our analysis would imply that, in a well-functioning market, customers should pay more in order to be served by a smaller firm than by a larger one. We do not agree that this is appropriate in a market where both larger and smaller firms offer the same product or service [Footnote 40].”*

A.16. Footnote 40 stated:

> *“To the extent that a particular size of business generates efficiencies – either operating or financing – we would expect this model to predominate in a well-functioning market. In our assessment, we think it is appropriate to reflect the efficient costs of financing, rather than reflecting higher (actual) costs.”*

A.17. The CMA noted third that historical evidence of the small company premium has become more limited over time.

A.18. Respectfully, PAH thinks there are reasons not to use these arguments in estimating a WACC for a well-functioning veterinary services market.

A.19. *First*, estimating the cost of capital using the CAPM model is only robust if *beta* can be accurately estimated, and it is not clear if this is possible in the FOP market(s).

A.20. *Second*, if there is virtue in having a mixed market (which the CMA has previously indicated) then the cost of capital benchmark needs to be set at a level that allows competition to function across the full market. Smaller firms have to be allowed to enter and survive.

A.21. *Third*, using a cost of capital derived from the two listed vet groups would mean dismissing actual costs and risks faced by smaller FOPs in practice. The CMA would in effect be holding the industry to a hypothetical and idealised threshold of competition.

A.22. On the CMA’s first comments about the reliability of CAPM, PAH notes:

(i) CAPM is a theoretical model that works well where one can accurately and robustly estimate beta. It is not clear that beta for smaller independent FOPs can be robustly estimated in this market(s). Even for a large company like PAH, the comparators available tend to be public companies in other countries and offering other services (such as pharmaceuticals). They are not comparators that offer predominantly first opinion veterinary services to household animals in the UK. Relying on CAPM where the key parameter – *beta* – cannot be robustly estimated clearly creates risk of error. In particular, using listed comparators of larger sizes and more diversified revenue streams will most likely underestimate the *beta* for FOPs, since the smaller FOPs would likely have higher operating leverage and profit variability resulting in higher *beta*.

(ii) Saying that CAPM should be used because it has been used by regulators in other cases is also a weak justification if it was, in fact, easier to estimate *beta* robustly in those other settings. Many regulated sectors have much larger public firms operating than are present here in the FOP market(s). The CAPM derived WACC estimate for those regulated firms may well be appropriate. But this does not immediately imply CAPM is appropriate in a market with hundreds of independent micro-businesses.

(iii) The CAPM model itself has been extended over time to account for the size of companies, for example, the Fama-French three-factor model.

A.23. On the CMA's second comment about using a more efficient WACC than applicable to the smaller businesses:

(i) The CMA notes explicitly the corporatisation of the FOP market in the last decade:[80]

> *"A major development in the veterinary sector over the last 10 years has been the rapid, significant, and ongoing growth of a few large corporate suppliers. In 2013, around 10% of vet practices belonged to large groups, but that share is now almost 60%, and many of the large groups have expressed an intention to continue expanding their business through the acquisition of independently owned practices."*

The CMA seems keen to preserve a mixed market in which firms with different business models can compete.[81] This would be put at risk if the CMA sets a WACC at which it would not be possible for smaller independents to operate.

(ii) If a firm's business model allows it to operate more efficiently than others, and so become an infra-marginal supplier in the market, able to make a producer surplus at the competitive price level, then profits are the reward for its efficiency. It is not a sign of a poorly functioning market. The CMA Market Investigation Guidelines 2013 note that even in a competitive market, some firms earn higher profits because of 'superior efficiency':[82]

> *"In practice, a competitive market would be expected to generate significant variations in profit levels between firms and over time as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of the firms involved. At particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency."*

In a competitive market, the 'marginal' firms are the price setters. Therefore, the cost of capital of these marginal firms are the relevant metric to estimate and benchmark.

[80] CMA (2024), *Veterinary services for household pets in the UK: Issues Statement*, July 2024, paragraph 59.

[81] CMA (2024), *Veterinary services for household pets in the UK: Issues Statement*, July 2024, paragraph 109.

[82] CMA (2013), *Market Investigation Guidelines*, paragraph 117.

(iii) When the CMA is choosing to overlook actual costs that firms 'in practice' face, it is in effect imposing an 'idealised' standard of competition in the market. The CMA Market Investigation Guidelines 2013 say:[83]

> *"In its market investigation reports the CC uses the term 'a well-functioning market' in the sense, generally, of a market without the features causing the AEC, rather than to denote an idealized, perfectly competitive market."*

As the market-wide WACC estimate is used as 'the benchmark' in the profitability analysis, imposing a WACC level that is below what most of the suppliers in the market can achieve is, in effect, setting an idealised benchmark.

A.24. On the concerns about the small company premium not being borne out in more recent historical data, there has been discussion on this in the academic and practitioner community. There is some evidence that the small company premium has narrowed, but there is also empirical evidence it remains significant for the smallest firms. For example, a 2022 Kroll report on international cost of capital examines data for small European firms (including the UK) over the period 1990 to 2021.[84] It concludes (page 159):

> *"Using various measures of firm size ... small company shares have likely outperformed large company shares, on average, suggesting that investors perceive smaller European firms as riskier, and thus demand a 'size' premium to compensate for this additional risk. This evidence also indicates that the relationship between firm size and returns **is strongly non-linear**, and that the **size premium is significant only for the smallest companies**".*

A.25. In the Kroll study the smallest firms are still large by comparison to a FOP.

A.26. Professor Damodaran from the Stern School of Business in New York has raised concerns about the reliability of the small company premium in historical data.[85] However, even in his critique, Professor Damodaran notes several important things.

A.27. *First*, he recognises that there is evidence of a 'microcap' premium but not a 'small cap' premium, Professor Damodaran stating that "*even over the long time period that provides the strongest support for existence of a small cap premium, one study finds that removing stocks with less than $5 million in market cap causes the small firm effect to vanish. In effect, what you have is microcap premium, isolated in the smallest of stocks, not just small stocks*."[86] Most of the FOPs would likely be closer to the microcap end of the market where there is evidence of a premium.

83 CMA (2013), *Market Investigation Guidelines*, paragraph 30.

84 See: Kroll (2022) *Valuation Handbook International Guide to cost of capital: 2022 summary edition*, June 2022, pages 147-160, https://www.cfainstitute.org/-/media/documents/article/industry-research/igcc-summary-edition-2022.pdf

85 See for example: https://aswathdamodaran.blogspot.com/2015/04/the-small-cap-premium-fact-fiction-and.html

86 See: https://aswathdamodaran.blogspot.com/2015/04/the-small-cap-premium-fact-fiction-and.html

A.28. *Second,* he recognises that the small cap premium may be picking up an issue of illiquidity, which PAH discusses below.

A.29. *Third*, Professor Damodaran says that, in his view, a small cap premium is not required in valuation because, although he believes small cap companies are more exposed to some risks than large cap companies, there are better ways to incorporate risks faced by small companies into the valuations of those companies.[87] That is, Professor Damodaran agrees that small companies do face higher risks, but the areas of disagreements are around how to take account of the small cap risk premium in the valuation. Indeed, Professor Damodaran lists a number of reasons why small companies face higher risks (e.g. they are capital constrained, they have a greater chance of failure, they have a greater illiquidity risk, etc.), but he argues there are better ways to incorporate risks faced by small companies into the valuations of those companies (e.g., probability weighting outcomes, adjusting growth rates, using an illiquidity discount, etc.).

A.30. However, this 'company-specific' tailoring clearly is not possible in the context of a market investigation including hundreds of small entities. So, incorporating some premium into the benchmark to reflect the realities of the market would be a reasonable adjustment.

A.31. Small private firms are generally less liquid compared to publicly traded companies. Therefore, illiquidity risk should be considered in calculating cost of capital as it can be considered systematic (as illiquidity increases when the market is down). This is particularly true for vets as the market for selling a vet practice is not usually the general market. There may be greater concern also about whether the practice can continue to operate successfully if the original owner/vet leaves the practice.

A.32. For example, a 2023 study by BNP Paribas shows that US private equity buyouts outperformed the S&P 500 by 2.3% to 3.4% a year between 1986 and 2017 and the Russell 2000 index (small-cap US listed companies) by 2.3% to 4.3% a year.[88] One could attribute this difference to illiquidity and add it on as the "illiquidity premium" for private companies.

87 Professor Damodaran note, for example: *"I do believe that small cap companies are more exposed to some risks than large cap companies but there are other more effective devices to bring these risks into valuation. If it is that they are capital constrained (i.e., that it is more difficult for small companies to raise new capital), I will limit their reinvestment and expected growth (thus lowering value). If it is that they have a greater chance of failure, I will estimate a probability of failure and reflect that in my expected value."*

88 See https://viewpoint.bnpparibas-am.com/the-illiquidity-premium-in-private-asset-markets/

Annex B. Index of PAH comments in this response on specific CMA requests

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