

From: [REDACTED]
Subject: Comments on the CMA's Approach to Profitability and Financial Analysis (published November 1, 2024) from an international investor
Date: 27 November 2024 23:33:58
Attachments: [REDACTED]

Dear Sir Martin Coleman,

My name is Jay Hill and I am a Managing Director of Tweedy Browne, a US-based money management firm that applies a value investing strategy to global equities. Full disclosure, Tweedy Browne is a shareholder of CVS Group, plc. Therefore, we have a vested interest in the CMA's review of the UK veterinary industry and any remedies implemented to address competition concerns. We have chosen to invest a portion of our client's money in CVS Group because we believe the UK veterinary industry provides an essential local community service that benefits from secular growth (humanization of pets). We also believe the shares are inexpensively priced relative to the underlying earnings power of the business.

After reading the CMA's "Approach to Profitability and Financial Analysis" published November 1, 2024, I feel compelled to address what I believe is flawed logic related to the relationship between Return on Capital Employed (ROCE) and Weighted Average Cost of Capital (WACC). The following passages are direct quotes from the report.

Page 7, paragraph 2.4

"Firms in a competitive market would generally earn no more than a 'normal' rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run, ie the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity."

Page 13, paragraph 4.1

"As stated above, the analysis of profitability as a means of understanding competitive conditions in a market is based on the premise that firms in a competitive market would generally earn no more than a 'normal' rate of profit."

Page 13, paragraph 4.3

"The rationale for benchmarking return on capital with the opportunity cost of capital is that, in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, we would expect entry and/or expansion. This entry/expansion would serve to compete away profits in excess of the cost of capital, up until the point where efficient firms on average cover their total costs, including a market-based cost of capital and no more. Where firms persistently earn in excess of a normal return, this signals that there may be limitations in the competitive process."

I find it disheartening that the CMA appears to view persistent ROCE above WACC as signaling "limitations in the competitive process." First, barriers to entry in the vet business are low. New greenfield vet practices are opening in the UK. Second, Return on Capital Employed (ROCE) is a way of quantifying expected returns and informing whether it makes sense to spend money in order to make money. "Spend money" recognizes a company must invest in people and assets to offer a viable product or service. Capital Employed, the denominator of ROCE, seeks to reflect

cumulative investment spending. “Make money” is captured in operating profit, the numerator of ROCE. ROCE is therefore how much money a company makes divided by how much it spent to make it. The reason financial analysts compare ROCE to WACC is to ensure that returns generated from investments EXCEED the cost and risk of financing those investments. It is well understood that ROCE below WACC destroys economic value. The very purpose of a business is to generate returns that exceed the opportunity cost of capital. Without some level of confidence that a business can generate ROCE above WACC, investors would be better off owning risk-free government bonds. In the context of the UK vet industry, if one policy goal is to address the chronic shortage of practicing vets and vet nurses, the industry needs to generate positive economic returns to attract more labor. Remedies that impair industry returns will likely exacerbate a labor problem that already exists.

When Tweedy Browne seeks out new investment ideas, we actively seek to invest in businesses that generate ROCE well in excess of WACC. ROCE above WACC is a classic indicator of a healthy business and positively correlated with higher valuation multiples. In contrast, businesses with ROCE equal to or below WACC are generally not considered investable. While the magnitude of the spread between ROCE and WACC could be a signal of limitations in the competitive process of an industry, I would caution against the notion that persistent ROCE above WACC implies adverse effects on competition. The UK government should promote and encourage businesses to generate economic profits. It’s a positive attribute that attracts investment and helps efficiently allocate capital, rather than a signal of monopolistic behavior. And it is consistent with your stated goal of a market with “consumers getting a choice of good quality services at fair prices and providers receiving an appropriate return for their investment and service.”

As a global investor in publicly listed equities, Tweedy Browne has a broad array of choices in terms of allocating our client’s capital. As value investors, we are inherently attracted to the lower valuations available outside of the United States. For example, the S&P 500 currently trades at 25x P/E versus the FTSE 100 at 12x P/E. However, overprotective government regulation, frequent changes in policy (example: new national insurance scheme) and potentially clouded economic thinking leave the impression to international investors that the UK is “closed for business.”

Best regards,
Jay Hill

Jay Hill, CFA
Managing Director

[Redacted]



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