Veterinary services for household pets in the UK

VetPartners' response to the CMA's working paper on the approach to profitability and financial analysis of 1 November 2024

(submitted 22 November 2024)

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1 Introduction

1.1. VetPartners welcomes the opportunity to submit comments on the CMA's working paper on profitability and financial analysis dated 1 November 2024 (the "Working Paper"). As previously mentioned, we believe that the investigation provides a unique opportunity for the CMA to achieve meaningful improvements for the benefits of consumers and pets, and the people working in the veterinary sector. As before, we look forward to continuing to work closely with the CMA in order to help protect consumers and ensure that pet owners have access to high standards of veterinary care, including innovative treatment techniques at an affordable price.

1.2. Our comments below are not exhaustive and seek to deal with the key areas in the Working Paper where comments were requested. The fact that VetPartners does not expressly respond to a point in the Working Paper does not necessarily imply that VetPartners agrees with it.

1.3. Consistent with the CMA's stated desire to be mindful of the impact of its public communications by ensuring that its communications are evidence-based and measured,[1] it is worth making a comment on terminology at the outset. As mentioned previously to the CMA, VetPartners believes that the term "large corporate group" is inaccurate and implies a negative frame due to the natural association with cold and clinical office environments (which are anathema to VetPartners' and other groups' practices). Instead, VetPartners asks the CMA to use the term "large veterinary groups" ("LVGs") in its public communications going forward. This better reflects the nature of the VetPartners practices that, as VetPartners has shown, each have a distinctive character and approach, as well as the role played by VetPartners in the industry and the improvements it brings to the acquired practices, through additional investments in the employment terms for its teams, training, equipment, human resources, health and safety ("H&S") requirements and regulatory compliance.

1.4. VetPartners notes that Table 1 on page 21 of the Working Paper indicates that VetPartners owns diagnostic laboratories. However, as previously explained to the CMA, VetPartners does not own any diagnostic laboratories that are relevant to the scope of the market investigation.[2]

[1] See for example para 43 of the Issues Statement and para 3.6 of the CMA's decision to make a market investigation reference of 21 May 2024.

[2] VetPartners' response to the CMA's draft s.174 Notice RFI relating to diagnostic laboratories of 22 October 2024 (submitted on 25 October 2024).

1.5. As a final introductory remark, in addition to commenting on the Working Paper in writing, VetPartners would welcome an opportunity for its external economic advisers to discuss some of the more technically complex aspects of the methodology directly with the CMA's economists. This could, for example, be done in a roundtable format with the CMA and economic/financial advisers to the parties involved in the investigation or a sub-group of them.

2 Approach to assessing in-scope activities

2.1. In its Working Paper the CMA proposes to assess the profitability of each LVG as a whole, without seeking to (i) exclude revenues and costs that are not related to small animals, or (ii) assess separately the economic profitability of different types of veterinary services. It is not clear whether the proposed approach implies that profitability would be estimated at the group level including or excluding non-UK operations. If it is the latter, the CMA should include an allocation of IFRS adjustment for the right-of-use ("RoU") assets from the group level to total UK. As discussed previously,[3] the RoU assets are only reflected at the group level and are not apportioned to the UK total.

2.2. As mentioned in previous submissions,[4] apportioning these central assets in a manner consistent with the CMA's initial proposal would be complex and the information required to do so would not be readily available. However, VetPartners is able to provide a breakdown of the IFRS16 adjustments at a practice level.

3 Profitability of medicines

3.1. The CMA proposes to analyse the effect of discounts and rebates on the profitability of the pharmaceuticals sold by the LVGs.[5] As mentioned in previous submissions,[6] **[✂]**. As such, the profitability of medicine sales should not be viewed in isolation, as it provides only a partial picture and does not reflect the true economic profitability of a practice.

3.2. In addition, cost savings from discounts and rebates on medicines may be used to cover additional overhead and staff costs incurred at the practices that VetPartners has acquired, for example to ensure compliance with regulatory requirements and professional standards. **[✂]**.

3.3. In addition, it is important to carefully consider how any imposed changes in pricing structures could impact both the accessibility to care and the overall wellbeing of animals. For example, if the practice of cross-subsidising between medicines and veterinary services that may exist at some practices, were to end, it could lead to an increase in veterinary fees. The concern is then that this change would inadvertently discourage some pet owners from seeking timely care for their pets, potentially resulting in delayed visits until pets are severely unwell. Such a change could, therefore, have various unintended consequences,

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[3] Response to the s.174 Notice RFI 6 of 6 September 2024 (submitted on 27 September 2024).

[4] See VetPartners' response to the s.174 Notice RFI 6 of 6 September 2024 (submitted on 27 September 2024), "Comments on the challenges associated with conducting a reliable profitability analysis in the veterinary sector".

[5] Working Paper, para 4.41.

[6] See VetPartners' response to CMA's MR-RFI 1 of 13 September 2023 (submitted on 11 October 2023), paras 27.1–27.4.

such as for animal welfare, as early intervention is often key to ensuring best clinical outcomes.

3.4. At paragraph 4.95 of the Working Paper, the CMA suggests the possibility of looking into scale effects of independents' purchasing of medicines. VetPartners would indeed encourage the CMA to look into this aspect. As mentioned on several previous occasions, many buying groups of which independents are members can (and, as far as VetPartners is aware, do) achieve scale effects close to LVGs' purchasing operations.[7]

4 Analysis window

4.1. In the Working Paper, the CMA proposes to cover a five-year historical period in total (i.e. FY20–24). VetPartners notes that information as provided in its previous submission for the FY22–FY24 period can be obtained for FY20 and FY21 on a comparable basis. However, as VetPartners discussed in its previous submission, VetPartners only started using its current financial reporting system in FY 2022.[8] Therefore, consistency between FY20-FY21 and FY22–FY24 data is by no means certain. Furthermore, while VetPartners provided the non-financial data for FY22–FY24 in response to the RFI6 financial template, it may not be feasible to provide similar data for FY20, as the necessary systems and processes for gathering such information were not in place at that time.

4.2. VetPartners notes that the COVID-19 pandemic took place in the time period on which the CMA proposes to focus. This had long-term impacts due to the spike in pet ownership, which increased demand in the post-pandemic years, and which continues to affect demand, as puppies and other young animals purchased during the pandemic move into a stage of their lives that typically requires less intervention.

4.3. Whilst the CMA acknowledges the recent disruption,[9] VetPartners is concerned that using the time period proposed by the CMA will not provide an accurate picture of profitability due to these factors. The expected fall in revenues as the post-Covid spike in demand ends, combined with higher costs following fiscal changes announced in the Government's recent Autumn Budget may well result in lower industry profitability than has been seen in recent years.[10] VetPartners, therefore, agrees with the CMA that supplementing the historical analysis with forecast data can help guide the interpretation of historical results, but also notes that it would not be reasonable for the CMA to draw any strong conclusions based on profitability in the period FY20-FY24.[11]

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[7] For example, para 4.12 of VetPartners' response to the CMA's Issues Statement of 9 July 2024 (submitted on 30 July 2024), paras 4.5 and 12.2 of VetPartners' response to s.174 Notice RFI on Prescribed Veterinary Medicines of 5 August 2024 (submitted on 19 August 2024) and para 28.4 of VetPartners' response to s.174 Notice RFI 1 third batch of 23 May 2024 (submitted on 18 June 2024).

[8] See VetPartners' response to s.174 Notice RFI 6 of 6 September 2024 (submitted on 27 September 2024), para. 4.5 (a).

[9] Working Paper, paras 3.11–12.

[10] The COVID-19 pandemic caused a surge in demand for dogs, [✂]. However, post-pandemic, the number of new dogs declined, returning to pre-COVID levels. [✂].

[11] Working Paper, para 3.13.

5 Standalone costs

5.1. In the Working Paper, the CMA states that it welcomes input on the appropriate basis for allocating central costs on a standalone basis.[12] VetPartners notes that assessing the level of central costs that would be incurred by a standalone small animal operator is a complex task that may involve a rather arbitrary exercise. Instead, VetPartners proposes that a simple solution would be to include all the central costs incurred by VetPartners as an upper bound of the estimate of the central costs needed to run the standalone firm. This approach would ensure that the CMA's results are not sensitive to the basis of allocation of central costs. This assumption also aligns with VetPartners' expectation that, on a standalone basis, nearly all central costs and revenues are essential to the operation of small animal practices.

6 Re-valuation approach for fixtures and fittings, and equipment

6.1. In previous submissions, VetPartners has presented an approach to estimate the replacement cost for property, fixtures, fittings (including leasehold improvements) and equipment (excluding IT equipment). In particular, VetPartners proposed to use cost plans for recent construction projects to calculate an average replacement cost per square metre, and then apply this to the total footprint of VetPartners' small animal practices. As the cost of motor vehicles and IT equipment is not included in the cost plans, the replacement cost for these items needs to be estimated separately. Using provisional figures, VetPartners estimated a replacement value nearly **[✂]** higher than the corresponding net book value ("NBV").[13]

6.2. In addition, as previously submitted, there is no active and sufficient second-hand market for equipment. **[✂]**. In addition, VetPartners noted that buying sophisticated equipment from a second-hand market would be riskier for pet welfare, and that the lack of a second-hand market is an additional reason why replacement cost tends to be significantly higher than NBV.[14]

6.3. As discussed in previous submissions, the asset register of acquired practices may not have been complete at the time of acquisition by VetPartners. In these cases, the value of the acquisition goodwill will be higher than in cases where the asset register is complete. In any case, including when the asset register is complete, the NBV underestimates the real value of the assets, which is instead better measured by replacement costs. VetPartners has estimated that about **[✂]** of VetPartners' practices have negative capital employed, if the NBV is used in the calculation, and goodwill is not accounted for.

6.4. It is submitted that the CMA should consider the re-build approach discussed in paragraph 6.1 above to inform its estimate of the replacement cost for fixtures and fittings, and equipment. This approach would ensure that the asset value reflects both current market conditions, and the actual assets needed by VetPartners to provide its services, including those assets that are missing from the accounts.

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[12] Working Paper, para. 5.2 (c).

[13] See VetPartners' response to s.174 Notice RFI 7 of 23 September 2024 (submitted on 7 October 2024), Question 2.

[14] See VetPartners' response to s.174 Notice RFI 7 of 23 September 2024 (submitted on 7 October 2024), paras 1.1(c)-(d).

7 Intangible asset valuation

7.1. As highlighted previously to the CMA, VetPartners and other companies in the veterinary industry have grown through acquisitions of independently owned practices.[15] In the course of these acquisitions, VetPartners has recognised certain intangible assets on the balance sheet, consistent with accounting standards, namely customer relationships and brand names.[16] Due to the conservative nature of accounting standards, a material amount of goodwill has also been recognised.

7.2. For VetPartners, the accounting entries for intangible assets and goodwill reflect the costs of acquiring a functioning business in order to achieve expected future economic benefits, as an alternative to starting a new one from scratch. In either case, whether growing organically or by acquisition, the economic cost to VetPartners is higher than only the cost of buying new assets.

7.3. For example, when a new practice is established, a significant amount of cost is incurred before any revenue is generated. The practice will also take several years before it builds up the reputation necessary to attract the volumes that will allow it to reach an efficient scale. Throughout this time, it will be carrying fixed costs and generating economic losses. Losses incurred in earlier trading periods will not be recognised as assets in the balance sheet. The valuation of intangible assets at the time of acquisition is one way of reflecting the cost of developing these assets. Therefore, excluding intangible assets and goodwill from the profitability analysis would render any conclusions economically meaningless.[17]

7.4. VetPartners does not consider marketing costs as a good proxy for the value of customer relationships. VetPartners' customer acquisition – and it believes those of the industry as a whole – is mainly driven by word-of-mouth, and this reflects its reputation and the quality of the services it provides. This is reflected in the value of the goodwill for practices acquired by VetPartners. Moreover, as VetPartners has grown by acquiring established businesses, marketing costs would reflect the costs to maintain existing relationships rather than build up new ones. As such, using marketing costs as a proxy would result in an underestimate of the value of VetPartners' customer relationships.

8 Approach to calculating WACC

8.1. VetPartners agrees with the CMA that CVS could serve as a comparator for the equity beta in the Capital Asset Pricing Model ("CAPM").[18] The working paper also mentions Pets at Home as a potential comparator. **[✂]**.[19] **[✂]**.

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[15] See VetPartners' response to s.174 Notice RFI 6 of 6 September 2024 (submitted on 27 September 2024), "Comments on the challenges associated with conducting a reliable profitability analysis in the veterinary sector".

[16] See VetPartners' response to s.174 Notice RFI 1 of 23 May 2024 (submitted on 18 June 2024), Question 39.

[17] See VetPartners' response to s.174 Notice RFI 6 of 6 September 2024 (submitted on 27 September 2024), "Comments on the challenges associated with conducting a reliable profitability analysis in the veterinary sector".

[18] Working Paper, para 4.69.

[19] See VetPartners' response to RFI7, Annexes MI-03450 and MI-03451.

8.2. Moreover, VetPartners considers Pets at Home's beta to not be reflective of the risk profile of standalone veterinary services because of Pets at Home's retail operations, which make up a large proportion of its business. As discussed in VetPartners' previous submissions,[20] as a standalone provider of veterinary services, VetPartners is exposed to volume risk in an asymmetric way. Most of VetPartners costs are fixed in nature and, therefore, a decrease in volumes, as has been seen in recent months, would have a material negative impact on the financial performance of the practices. On the other hand, given the limited time available in a day for consultations, practices can only respond to increases in volumes by requiring staff to work overtime, or by using locums or zero-hour contract employees. Requiring employees to work overtime is not sustainable in the long run, while the cost of locums and zero-hour contracts is generally high. This means that unexpected increases in volumes do not necessarily have a significantly positive impact on the financial performance of practices, as the people costs of the practices would also increase as a result.

8.3. In addition, VetPartners disagrees with the CMA's comment in the Working Paper that veterinary services for household pets are generally considered resilient to economic downturns and unlikely to be materially impacted by unusual macro-economic events that influence aggregate pet owners' disposable incomes and willingness to spend.[21] VetPartners has previously provided the CMA with an overview of the risks faced by its practices. This included VetPartners' exposure to macro-economic risks.[22] For example, VetPartners explained that many clients are impacted by the increasing cost of living and more limited household budgets.

9 Liquidity premium

9.1. VetPartners submits that the CMA should also include a liquidity premium when estimating VetPartners' cost of equity ("CoE"). The CoE of a private company is significantly different from that of a listed company. This is because equity investors in a private company do not have the possibility to trade their shares at any point in time. For this reason, private equity investors require higher equity returns. The CMA should reflect this in the calculation of the CoE by including a liquidity premium.

10 Assessment of potential inefficiencies

10.1. The CMA proposes to assess potential inefficiencies through an analysis of costs. It is important that any such analysis that the CMA undertakes controls for factors that drive costs, including factors such as location, size and maturity of practices, and differentiation in the quality of the services offered to clients, as well as an ability to recruit in the local area.

10.2. In addition, controlling for differences in how labour costs may be recognised in large veterinary groups as compared with independent practices is also critical. Specifically, there are several factors that could result in LVGs running at higher costs relative to

[20] See VetPartners' response to s.174 Notice RFI 7 of 23 September 2024 (submitted on 7 October 2024), Question 24.
[21] Working Paper, para 3.10
[22] See VetPartners response to Question 1 of the CMA's MR-RFI 1 of 13 September 2023 (submitted on 11 October 2023), as well as in response to Question 20 of the CMA's MR-RFI-7 of 23 September 2024 (submitted 14 October 2024)

independents and that are unrelated to inefficiencies. VetPartners explains this in more detail in section 11 below.

11 Approach to profitability analysis for independent vet businesses

11.1. When assessing profitability for independent vet businesses, the CMA should consider the different conditions in which these businesses operate compared to the LVGs. As discussed in previous submissions, VetPartners often has to make investments upon acquiring practices in order to improve IT security, H&S and environmental standards, and to ensure regulatory compliance.[23] In particular, VetPartners has had to put in place a dedicated central IT security and H&S teams, **[✂]**.[24] This results in VetPartners incurring higher staff costs and overheads than those incurred by the independent practices, **[✂]**.[25] **[✂]**.[26]

11.2. Furthermore, whilst the CMA has identified challenges in relation to data gathering from independents, VetPartners believes that many of these will be surmountable. For example, **[✂]**,[27] **[✂]**,[28] **[✂]**.[29] Furthermore, for data representativeness, the CMA could also request data from mid-sized groups, **[✂]**,[30] **[✂]**,[31] **[✂]**,[32] **[✂]**[33] and **[✂]**.[34]

12 Additional analysis of LVGs

12.1. The CMA proposed to assess the internal rate of return ("IRR") reported in investment appraisal documents to inform its view on the sector profitability.[35] As VetPartners mentioned in its recent submission,[36] **[✂]**.

12.2. **[✂]**.[37]

12.3. As a matter of principle, VetPartners does not believe that the investment appraisals in board documents should be used to inform any measure of profitability, as the actual performance of the acquired practices may differ from the forecast. In particular, as these are established businesses, upside opportunities are limited while downside risks are material. For example, the retention of key personnel is a material risk. As such, financial forecasts are contingent on these risks not materialising.

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[23] See MR-RFI 1 of 13 September 2023 (submitted 11 October 2023), Q1 and s.174 Notice (RFI 7) of 23 September 2024 (submitted 22 October 2024), Q20
[24] See VetPartners' response to MR-RFI 1 of 13 September 2023 (submitted 11 October 2023), Q1
[25] See for example annexes to VetPartners' response to RFI 3, Q10.
[26] See VetPartners' response to RFI 3, Q10, Annex MI-00075.
[27] **[✂]**
[28] **[✂]**
[29] **[✂]**
[30] **[✂]**
[31] **[✂]**
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[34] **[✂]**
[35] Working Paper, para 4.102.
[36] See VetPartners' response to s.174 Notice RFI 7 of 23 September 2024 (submitted on 7 October 2024), paras 6.1.
[37] Ibid, paras 6.2–6.3.

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