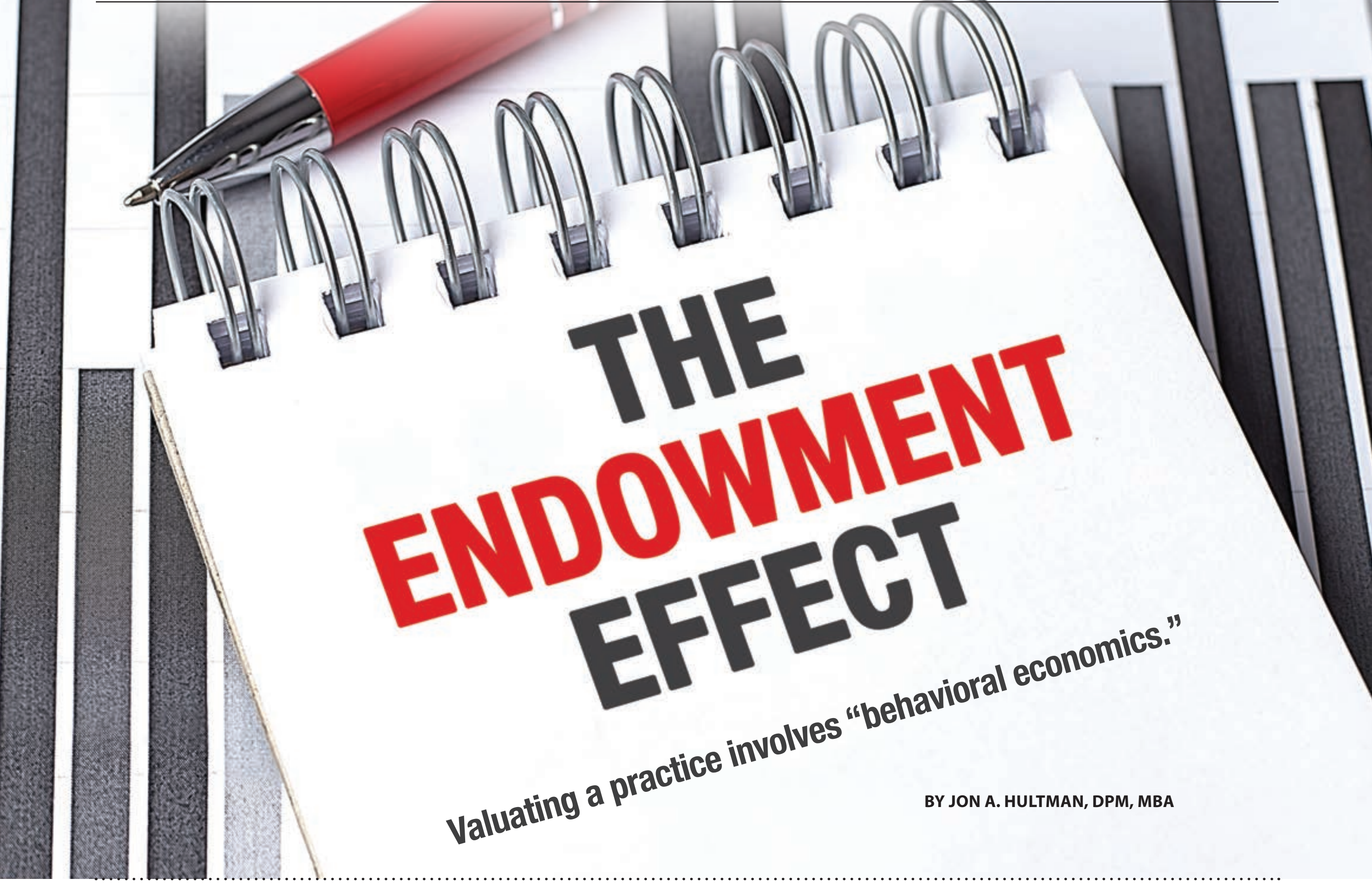

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THE ENDOWMENT EFFECT

Valuating a practice involves "behavioral economics."

BY JON A. HULTMAN, DPM, MBA

Of the numerous practice valuations that I have been involved in over the past thirty years, the least complicated were those for practice owners who wanted to retire and sell their practices on the open market. The more complicated valuations were for practices with existing associates who wanted to buy in or for practices seeking to create groups by merging with others. While the practice valuation process is relatively straightforward and objective, when negotiations for buy-ins or mergers are underway, emotions significantly impact the process.

Navigating the delicate process of medical practice negotiations not only requires a strong grasp of financial and economic matters but also a keen awareness of the psychological forces at play. While spreadsheets and formulas can be used to calculate a range of plausible practice values, the human element exerts a strong pull on the outcome. A valuable tool for negotiations between buyers and sellers is the understanding of behavioral economics.

Most of the time, the emotions that make buy-ins more challenging are (1) those pertaining to owners who believe their practices are worth their weight in gold and (2) those of associates who feel they should be given partnership for free. In a merger scenario, each practice owner typically believes that his/her practice is worth far more than those of the others with whom they are negotiating. A valuation report should make all parties aware of these issues by including a short discussion of the *endowment effect*, which helps to explain just how the value of a practice is influenced by human emotion.

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The following is the *endowment effect* explanation included in valuation reports:

When doctors enter into negotiations in an attempt to agree on the value of a practice, it is important to be knowledgeable of the endowment effect. This term, based on an interesting experiment conducted by Eric Johnson, PhD, Director of the Cen-

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ter for Decision Sciences at Columbia University, gives valuable insight into why buyer's and sellers' perceptions of value can vary so widely. In this experiment, Johnson divided one of his classes into two groups, asking the first group how much they would pay for a specific coffee mug. The typical response he received was $4. He gave the second group the same mug for free and then asked, "How much would I have to pay you to part with it?" What is important to recognize at this point is that Johnson is basically asking the same question of both groups, which is, "How much is this mug worth to you?"

Surprisingly, the average response from the second group was $8. Researchers refer to this phenomenon as the endowment effect, which Johnson explains in the following way: "Simply owning something increases its value."

When negotiating price, it is helpful to understand that such issues of "behavioral economics" are an unspoken factor in the minds of the negotiators.

The results of this experiment can help us to understand why negotiations involving practice buy-ins and buy-outs can be contentious and often defy logic. If two groups can disagree by 200% over the value of a simple commodity such as a mug, is it any wonder that the perception of the value of a much more complex entity—in this case, the medical practice—can differ so much between a buyer and a seller? Each party feels that the other is being unreasonable. When negotiating price, it is helpful to understand that such issues of "behavioral economics" are an unspoken factor in the minds of the negotiators. Ultimately, these issues should not dictate the outcome of the negotiations. Rather, a practice valuation must be approached objectively—in a way that leads both the buyer and the seller to a reasonable agreement as to the practice's fair value. **PM**

Dr. Hultman is the president of Medical Business Advisors, specializing in practice evaluations, practice valuations, and mergers. He is the author of *Reengineering the Medical Practice* and *Medical Practitioner's Survival Handbook.*