RIA M&A Advice Series

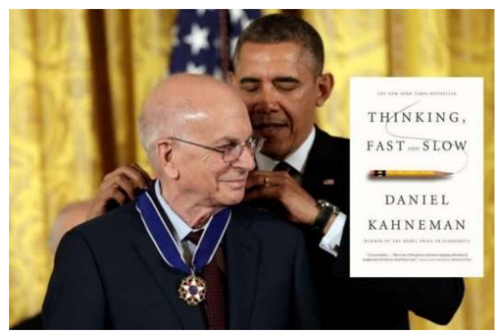
Behavioral Finance in M&A: *Beware of Biases That Cost Millions*

By Tyler D. Nunnally

This is Part 1 of a 2-part RIA M&A Advice Series that examines the role of behavioral finance in mergers and acquisitions. It details how RIA owners forfeit millions due to decisions driven by emotion and bias.

Selling a business brings out a lot of emotions. Most RIA owners have spent years building their firms. Some folks liken the experience to that of raising a child. When it becomes time to sell, it is hard to let go – just like it is watching your kids leave the nest. Over time the team and clients become like extended family. That makes the emotional attachment to the business even stronger.

As an M&A Advisor to RIAs, I see these struggles almost daily. I've encountered countless owners that anguish over the decision to sell. Some can never quite pull the trigger on a deal. I have also witnessed owners that sell their firms because the offer is just too good to pass up, absent due diligence, and irrespective of fit.



What drives these decisions is always of interest to me. Earlier in my career, I was trained in behavioral finance at a spin-off consultancy of Oxford University. Much of the training centered on the research of Kahneman and Tversky, renowned academics who spent their illustrious careers studying biases that cause people to make poor financial decisions. I later joined FinaMetrica which produced the world's most widely used financial risk tolerance assessment.

I entered M&A after FinaMetrica was acquired by Morningstar and it did not take long to realize that behavioral finance and risk tolerance have profound influences on deal making. To be a successful M&A Advisor, you must help your clients temper their emotions. And to help clients reach their goals you need to keep their biases in check. As you already know, that is easier said than done.

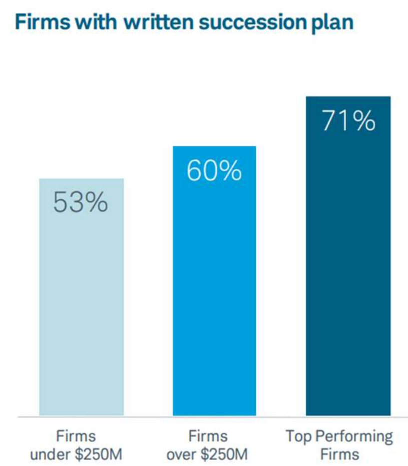
How Emotions and Biases Result in Costly Decisions

Emotions

Fear is one of the primary emotional drivers in M&A, but on opposite sides of the spectrum. The fear of missing out (FOMO) is well known to money managers. FOMO precipitates a strong desire to make a quick decision before an opportunity slips away. It results in half measures in due diligence that can lead to regrets post-sale. One of the biggest mistakes is choosing the wrong partner, which is like a bad marriage, but one you cannot get out of.

On the other side of the spectrum is the fear of change. Many owners that are contemplating a sale have had protracted conversations with multiple suitors over a period of several years. Regardless of how great a fit and how great the offer, they still cannot move forward because they are afraid of what comes next. The failure to act is driven, in part, by low risk tolerance which causes people to be overly cautious. It also gives rise to status quo bias.

Inaction comes with its own risks, to the detriment of both clients and the business. A recent Schwab RIA benchmarking study shows just how few firms have a written succession plan. This is a particularly grave concern for firms that do not have a viable internal succession option. The risks are compounded by the age of the owner(s) and how close they are to retirement. Being overly cautious can also lead to complacency and procrastination, which ultimately impacts business valuation.



Taking a leap of faith requires commitment and confidence. Stepping out of your comfort zone is hard for people that are risk averse. Choosing to work with a seasoned M&A Advisor is often helpful in overcoming this obstacle. Our job is to guide clients through the sale process so that critical decisions are not made in a vacuum.

In addition, we serve as our clients' advocate and act in their best interest during negotiations. That is opposed to "working for the deal" by representing both the buyer and seller. That model entails obvious conflicts of interest. Imagine Partick Mahomes sports agent Leigh Steinberg representing both Mahomes and the Kansas City Chiefs in contract negotiations! There is a reason that would never happen. You don't have to know much about behavioral finance or human nature to understand why.

Biases in Valuation

The hard work starts once a decision is made to act. A goal of almost all sellers is to join a great firm that's willing to pay the highest possible valuation. The process to get there is long and tedious (usually about 6 months). As a result, owners that decide to do a deal on their own take shortcuts. Most are busy enough as it is. This is when biases like anchoring adversely sway decisions.

Owners typically already have a number in mind when they start thinking about selling. One common mistake is that if an offer comes in at - or above - that number, then everything else becomes inconsequential (e.g. deal structure, risks, culture, compatibility…). Time discounting and anchoring biases spawn poor partnership decisions as well as sub-optimal deals that can cost sellers millions.

Fair market value is set by determining what buyers are willing to pay, not what the seller thinks the business is worth. It is established by receiving and comparing multiple offers (around 5) from multiple suitors simultaneously (i.e. apples to apples). This provides benchmarks to narrow the selection to the most qualified prospects and weed-out low bidders. Dialogue and due diligence then continue with the top contenders to determine the best fit and to secure the best deal possible.

Biases in Negotiations

Having comparable offers provides leverage in securing the best deal. This is particularly advantageous given the current state of the market where the number of buyers far exceeds the number of sellers. The fierce competition for deals drives up the price.

The fear of missing out works both ways. Capitalizing on the buyers' own vulnerabilities in negotiations is very beneficial, but it takes a bit of savvy. The trick is to do so in a manner that does not create animosity between the parties.

Being overly aggressive or perceived as a jerk during negotiations can cause an open wound that never quite heals. Not exactly the ideal way to kick-off a long-lasting relationship. An M&A Advisor serves as a buffer between the parties to avoid that scenario by keeping clients at arm's length during the wrangling.

Of course, experience successfully negotiating RIA M&A deals makes a huge difference in arriving at the highest possible valuation with the best possible terms. Overconfidence is probably the most common and costly bias I see. A lot of RIA owners over the years have told me that they don't need the help of an M&A Advisor because they are more than capable of doing a deal on their own.

Many of these same groups took an absolute bath in 2022 by agreeing to restrictive revenue retention provisions that netted zero earnout which represented a substantial part of their overall deal consideration. Overconfidence in their own ability was a humbling experience, no doubt. There are plenty of other examples.

The 3 Fs – Fit, Financials, Future (Part II of II)

While arriving at the best deal is obviously important, the significance of fit cannot be overstated. Culture is perhaps the single most important factor in M&A partnership success. Knowledge of the industry and an understanding of the nuances between firms is vital.

Part II of this series will address this topic in much greater detail. I will explain the 3 Fs – a decision framework which we have developed that utilizes best practices in behavioral finance. It is designed to help clients make rational and deliberate decisions that are void of emotion and bias by focusing on the things that really matters: Fit, Financials and Future

For more information call us at 404.492.2152 or send an email to tnunnally@NunnallyInternational.com

About Nunnally International, Inc.

Nunnally International, Inc. provides strategic M&A services to RIA firms that are looking to buy, sell or merge their business. The company was founded in 2020 by Tyler D. Nunnally.

Prior to entering M&A, Tyler served as a strategist to leading advisor technology providers – including FinaMetrica, which was acquired by Morningstar. He began his wealth management career in England as an executive at Oxford Risk, a spin-off of Oxford University that specializes in behavioral finance.

Tyler has consulted hundreds of RIAs on matters of mergers, acquisitions, and risk as a frequent speaker at industry conferences, host of countless webinars and proficient author of journal articles. He has been a key relationship manager to strategic partners including Schwab, Fidelity, Redtail, Orion, eMoney, Fi360, MoneyGuidePro and SEI.

As an industry thought-leader, Tyler has been interviewed extensively by The Wall Street Journal, Bloomberg, CNBC, Smart Money, Kiplinger and InvestmentNews. He holds a B.A. from the University of Georgia and a Master's in International Business with Distinction from the University of St Andrews in Scotland.

How We Work with Clients

Nunnally International, Inc. works with RIAs in the following ways. You can choose whichever option best suits your unique circumstances.

Option A – Seller Representation

RIA firms that want to sell or merge engage Nunnally International, Inc. through a Sale and Fee Agreement. We lead the M&A process all the way from initial introductions to close. Our fees consist of a success fee based on the closing price. We guide you through the M&A process by:

- Help define your strategic objectives.
- Identify shortlist of prospective M&A partners.
- Market your firm to prospective acquirers.
- Coordinate calls and meeting.
- Facilitate conversations and information flow.
- Solicit initial offers.
- Negotiate terms of sale and maximize valuation.
- Assist in preparation of necessary documentation.
- Conduct due diligence on prospective acquirers.
- Successfully close sale

Option B – Referral Partner Network

Nunnally International, Inc. can introduce your firm to prospective buyers through our referral partner network. Our referral partners pay our fees, so there is no cost to you. We work with around 22 referral partners that are all differentiated in terms of what they bring to the table.

We employ our expertise in investor profiling to find the best fit based on your strategic objectives, partnership criteria and firm culture. Naturally, this is done in consultation with you. If you decide that you would like to pursue a conversation with a group that we recommend, then we make the initial introduction and help facilitate talks.

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