

RED FROG, INC. - CASE STUDY

Date Deal Closed: September 18, 2007

THE COMPANY

Red Frog, Inc. (www.redfroginc.com), formed in Southern California in 1996, is an advertising agency that is best known for its multi-media / digital work. This creative firm's high quality design of websites, CDs, DVDs, interactive, flash, and other multi-media tools and exceptional customer support have resulted in a strong repeat national client base. It is especially well known for its work with educational book publishing companies such as Prentice Hall, McGraw Hill, Houghton Mifflin, Delmar Learning, Thomson, W.H. Freeman, and Wiley. Other well-known non-publishing clients have included The Independent Film Channel and the biotech company, Amgen.

THE ASSIGNMENT

After ten years of building Red Frog, Inc. into a successful small business the owners decided that they would like to pursue other entrepreneurial dreams. One of the owners desired to start a small chain of high-end women's boutiques, the other owner aspired to start a holistic health and wellness related business.

SELLER'S GOALS

- Get as much cash out of the deal as possible to use to capitalize new entrepreneurial activities, rather than carrying a large contract
- To turn the business over to someone who has the ideas, energy, and drive to take the business to a whole new level
- To possibly continue some involvement with the business, but in a non-management, limited scope, project-only basis to enable focus on new entrepreneurial ventures

THE CHALLENGES

- Being a small creative business, some acquirers would be concerned that continued business would largely be tied to the identity of the seller rather than the business
- Many acquirers may want to have an earn-out or hold-back to ensure that there will not be a loss of clients or employees immediately after the transaction closes
- The changing nature of multi-media and new media may make some acquirers that have more traditional advertising (print, broadcast, etc.) backgrounds less comfortable with doing an acquisition due to their limited knowledge of the more technology-driven focus of the business
- There are few tangible assets to the business – some potential acquirers would argue that they could better use capital necessary to acquire Red Frog, to organically grow an ad agency

- The business is a relatively small business, but has extremely large corporations as clients that give Red Frog very small amounts of business – while this should be an opportunity for an acquirer to obtain more business from the existing client base, it may cause some buyers to be concerned about why Red Frog wasn't already seeing dramatic gains in business from those clients.

PRICING STRATEGY DEVELOPMENT

While the sellers definitely desired to exit the business, there wasn't a time pressure or reason that they needed to exit in a timely manner. After doing a thorough analysis of the business a realistic range of prices was discussed at which it was likely an all-cash deal could be structured, and then the asking price was established at the higher end of that range.

POSITIONING & PACKAGING

There were a few primary ways that Red Frog, Inc. was positioned in a seven-page initial information package and a more comprehensive 98-page confidential package:

- The business was largely operated over the phone and by email, and with a flexible schedule which would allow the business to be relocated to anywhere that a buyer lived, or desired to live, and would allow flexibility for vacation, travel, or splitting time between different residences as long as there was phone and email service available.
- The primary current owner was not only doing well financially with the business, but he was also working very limited hours at the business (10-15 hours a week) and was instead relying on employees/contractors to do most of the work.
- It has a very solid group of large publicly-traded companies as clients which would aid in business development from existing clients (due to budget and project size & quantity), and attracting new clients due to credibility from working with big-name clients.
- The business could be a great opportunity for different types of acquirers: 1, someone who wanted to make a good living but wanted the flexibility that this business would give to lead a life of their choosing with limited working hours; 2, someone who wanted to work hard to significantly ramp up the business by building on an already successful platform; 3, a passive owner who, since the business has very strong margins, could hire someone to run the business and still have a nice return on their investment; or 4, another creative firm, possibly one that is less focused on new media, that wishes to expand through an acquisition.
- It was shown that there is strong future growth in demand for multi-media design work.
- Not only does the company have top notch clients, it had a significant track record of repeat business with a large part of its client base.
- The business has won several creative / advertising awards.
- There were several natural unexploited opportunities for the business to grow.
- It had a strong niche that it served – the publishing industry.

MARKETING METHODS

As with all niche businesses that lend themselves to being acquired by strategic industry acquirers, Codiligent did extensive research up front to identify logical strategic acquirers.

- Sophisticated business web crawler research software licensed from Broadlook Technology along with extensive manual research on the advertising industry was performed to develop targeted mailing lists of the most likely acquirers from the advertising industry throughout the United States.
- A search of Codiligent's database of several thousand people and companies was searched to identify past prospective acquirers of creative firms and/or those whose profile were deemed to make them a possible acquirer.
- Two targeted lists were developed based on the research conducted: an "A" list containing the businesses or individuals who Codiligent believed had the highest probability of being a prospective acquirer (i.e. firms that have a history of doing acquisitions; firms that have indicated an appetite for acquisitions; firms that seemed complementary to this business – i.e. similar size but focus on traditional advertising and were lacking multi-media talent; and firms that appeared that they would benefit from the client mix or geographic location of Red Frog and its clients; etc.) and a "B" list of businesses or individuals who Codiligent believed had a possibility of being an acquirer, but for one reason or another it was deemed that they may not have as much of an interest in doing acquisitions or where Red Frog may not have been as good of a strategic fit.
- Initial Information Packages were sent to the "A" list of about 250 people. These prospects were followed up with by phone and e-mail.
- Oversized postcards with a URL address to a web page with more information on Red Frog were sent to about 400 people on the "B" list.
- Web-based ads were placed on major national and international business sale websites.
- Other brokers and intermediaries throughout the nation were made aware of the business being available and were offered a share of compensation if they were the procuring cause of a buyer.

PROCESS & RESULTS

In June of 2006 Codiligent began analyzing and packaging Red Frog. By August active marketing began. By February 2007 there were over 40 serious inquiries on the business, with 14 acquirers signing confidentiality agreements to learn more. Approximately 58% of the inquiries received up to that point in time were from other creative firms or ad agencies that were targeted. One of the prospective acquirers was an individual who was working as an IT project manager in the print publishing industry and because of Red Frog's high concentration of business in the publishing industry this business seemed to be a good fit. This individual acquirer submitted a Letter of Intent (LOI) to purchase the business on February 9, 2007 for the full asking price. However, the buyer was utilizing an advisor who wanted to proceed in a less traditional way: rather than submitting a LOI that outlined basic terms, followed by a draft of a purchase agreement, the buyer anticipated submitting a very basic LOI that didn't discuss terms, which would be followed by a binding Memorandum of Understanding that would lay out the basic terms, and finally a Purchase Agreement would be drafted that incorporated the terms agreed to in the Memorandum of Understanding. Codiligent challenged this process and suggested it would be more efficient to go with just a two-step process of the LOI and

purchase agreement, but the buyer's advisor insisted on a three-step process and the seller and Codiligent agreed to that approach.

The challenges of this deal were only beginning. The LOI had a formula that resulted in the Memorandum of Understanding being required to be produced by March 21, 2007. The buyer and his advisors did not meet that requirement, and a Memorandum of Understanding was not entered into until April 21, 2007 – a month late. The Memorandum of Understanding called for the Purchase Agreement to be entered into by May 10, 2007 and closing to occur by May 15, 2007. Codiligent understood that the buyer had a “professional acquisition advisor” and was working with an experienced national lender, so it was assumed that the deadlines would be achieved by the buyer. Disappointingly, that was not accurate. The Buyer sought a price reduction on the business. Generally, Codiligent is very reluctant for sellers to agree to price reductions after a LOI has been agreed to, however, the original internal pricing estimates showed a realistic pricing range from 85% - 103% of the asking price. Because of the delays, it was agreed that the price would be reduced by approximately 4% in exchange for a closing in two weeks. Unfortunately, the deal did not close in two weeks. The buyer was having trouble with issues related to his financing and there were issues surrounding language in the purchase agreements. Consequently, a \$10,000 non-refundable earnest money deposit was required. After additional delays, another extension was granted but with an additional \$10,000 in non-refundable earnest money. Even so, Codiligent had to intercede and apply pressure directly to the buyer's advisors and lenders to get the deal successfully closed. The transaction finally closed on September 18, 2007 (about four months later than anticipated). While it is not uncommon for there to be some delays in a business sale transaction, the delays in getting from LOI to closing in this transaction were excessive. In retrospect, there are a few different things Codiligent could have done to create a stronger motivation in the buyer to push the deal through, but hindsight is 20/20. Due to the significant delays in getting this deal closed, in many ways it is one of the least successful deals that Codiligent has closed. Nevertheless, while the sellers had to wait and go through a much longer than normal process the final result was positive: a closing price that was within four percent of the asking price in all cash.

Furthermore, from the time the buyer signed a LOI until closing Codiligent received an additional twelve buyer inquiries. Consequently, had the transaction terminated, not only would the buyer have been entitled to keep the \$20,000 in non-refundable earnest money, but there likely would have been another acquirer who would have moved forward in a short time frame.

All of the seller's goals were realized. The business was sold for near the top of the realistic range of value in all cash. One of the principals has already started her next business, a high-end women's boutique called Happenstance. The other principal is continuing to do some contract work with Red Frog while he pursues setting up a new health and wellness business. The new owner is continuing the successful operation of Red Frog and is pursuing some changes to take the business to the next level.