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Heartland sophisticates

A closer look at Thompson Street Capital Partners finds this Midwest middle-market shop addressing many of the same challenges as their mega-fund brethren. By Rob Kotecki

Way back in the 1990s, the middle market promised refuge from sharp elbows at the big boys' auctions. Proprietary deal flow cost a few handshakes, as CEOs of these barely known businesses jumped at the chance for growth capital and an operational upgrade. These upgrades need not revolutionize an industry, as the purchase prices were reasonable enough that modest productivity gains could fetch an attractive exit from a strategic buyer. Make a few phone calls. Knock on a door. Sign the deal. Fix that supply chain. Sell that business. Repeat. In the middle market, it was simpler. Little wonder it didn't stay that way for long.

The field got so crowded that these players earned their own snide acronym, JAMBOG ("just another middle-market buyout group"). Many fled to lower tiers of the middle market, hoping to find a patch of virgin territory by pursuing increasingly modest assets. What they found was an increasingly small patch worth exploring.

But treasures were found, and while the middle market isn't as green as it once was, neither are its private equity practitioners. Much as the first wave of middle market pioneers brought more sophisticated processes to their portfolio companies, the next wave is busy applying greater savvy to their own operations.

St. Louis, Missouri-based Thompson Street Capital Partners is a case in point. Launched during private equity's last downturn, the firm has successfully steered its debut portfolio through the lean years that followed to close its second fund in a kinder climate, at nearly twice the size of its first. That was accomplished by addressing the fact that competing in the middle market demands no less rigor than deal-making further up the food chain and, in some cases more, given the more meager resources at hand.

Staying relevant from the sidelines

Thompson Street Capital was founded by two veterans of the Harbour Group, a Midwest management buyout group that started back in the mid-70s. Peter Finley and Jim Cooper left the firm back in 1998 within months of each other, but not to pursue a venture together. While they both sought to build their own independent firm, those ambitions would have to wait; the non-association agreement they signed required them to wait three years before creating a firm together.

Finley remained on the board of Omniquip, a construction equipment company from his Harbour Group days that went public under his watch. There he also served as Omniquip's VP of corporate development, in some ways, continuing to source and close deals within the confines of that company. Cooper stayed in the industry, moving to New York to work with Greenwich Street Capital (now GSC Capital).

A few years later Capital Z Investment Partners approached Finley and Cooper. The firm was looking to serve as an anchor investor for first time funds with experienced founders, and the executives' strong track records fit the bill. Timing played no small part in the founding. "Capital Z approached us in 2000, just as the non-association period was drawing to a close," recalls Finley. More than ready for the next step, both jumped at the chance and Thompson Street Capital Partners began.

Timing, unfortunately, can cut both ways. The tech bubble burst shortly afterwards, and coupled with the fallout from 9/11, fundraising slowed to a crawl. Capital Z's anchor investment proved a mixed blessing as well. "The preferred economics that came with their large, upfront commitment scared several potential investors away, as did the fact that we remained a first time fund in the market's eyes," says Cooper. The fund finally closed in 2002 at $145 million, largely filled out from investors from Copper and Finley's past.

Small cities

They based Thompson Street Capital in St. Louis, with its focus on smaller middle market companies, not niche playsers within larger industries, such as retail or natural resources, but industry leaders in niche markets. They sought companies that already enjoyed major market share in a segment poised for growth.

Cooper and Finley narrowed their focus even further by devoting sourcing capabilities to a few smaller American cities such as Memphis, Tennessee; Greenville, South Carolina; and Dayton, Ohio. They visited them frequently, cultivating relationships with intermediaries such as accountants, lawyers and brokers. They didn't expect these visits to pay off immediately, but viewed them as an investment towards getting that prized "first call" when a local business is considering its options.

Even if they are the first to learn of a new opportunity, they're well aware other bidders will probably arrive. "True proprietary deal flow is difficult to find, but there are other factors that can work to your advantage besides raising the price," explains Cooper. Crowded auctions may bring higher prices, but they also require sellers to open their books to that crowd.

Cooper: rapport matters

Thompson Street Capital Partners

Founded: 2002
Head Office: St. Louis, Missouri
Types of investments: Privately held manufacturing, distribution and service companies with sales of $20 - 200 million
Target geographies: Across the US
Sectors: Manufacturing, distribution and service
Number of investment professionals: 13
Total assets under management: $445 million
Number of completed acquisitions: 13
Senior management team:
James A. Cooper - Managing Principal
Peter S. Finley - Managing Principal
Peter S. Villhard - Managing Director
Thomas D'Ovidio - Managing Director
Website: www.thompsonstreet.net
- Classic buyout
- Growth opportunities
- Corporate and family partnerships

"Sellers of this size do get nervous about sharing their information with too many bidders," says Cooper. As a result, Thompson Street Capital wears its Main Street credentials on its sleeve. "Our base in St. Louis allows our approach to remain low key. Larger funds from a larger city will, right or wrong, spark questions in terms of how many people will be viewing the innermost workings of their company."

No matter the number of players in the field these days, the middle market remains a place where rapport between seller and owner is key. "With larger deals, you're spending far more time with the investment banks than the company's management. But at this level, the negotiations are often with the owners themselves. These CEOs have a connection to their enterprises that go well beyond any financial ties. They may be ready to move on, but they want to protect what they've built. Given their deep ties to the business, it's crucial to win their support for the sale to influence remaining managers to buy in," says Cooper.

Like most of their peers, Thompson Street Capital relies on operational reforms to drive returns, which makes winning over the in-house talent all the more crucial to the changing ownership. They will often maintain a relationship with the previous CEO to tap his expertise in grooming a leader they've sourced elsewhere. All of which relies on a friendly sourcing process, hardly an easy task in today's market.

Making every bid count

"You don't have ninety days to close deals anymore," says Cooper. That shrinking window to properly vet an opportunity is particularly challenging with these smaller businesses given the often ad hoc accounting practices in place. "From the get go you've got to make certain you're speaking the same language with the company. They may share the same definition of EBITDA, but what do they consider adjusted EBITDA?," Cooper asks.

The rough hewn numbers on these balance sheets can offer nasty surprises later in the process, or worse, after the offer has been made. "There are few things a seller enjoys less than revisions to an offer," says Cooper. "We pride ourselves on frequently closing on our offer price, mainly because we make certain the numbers substantiate that offer."

That's not always possible with the number of auctions taking place, but Thompson Street Capital will walk away before increasing an offer in response to additional bidders. "In some cases, we've been a week or two into our due diligence and a second bidder arrives, offer in hand, and we'll excuse ourselves rather than enter an uneducated bidding war," Cooper explains. They avoid auctions already underway, preferring to address them if they arise in a situation where they started as the initial interested party.

Their debut deal actually grew out of Cooper's previous experience at Greenwich Street: Waddington North America, one of the top manufacturers of plastic disposable tableware for use by restaurants, caterers and consumers, based in Covington, Kentucky. Eight acquisitions followed from their first vehicle, with an exit from one, Broadcast Electronics proving their model was working.

Broadcast Electronics (BE), based in Quincy, Illinois, provides equipment for over-the-air and Internet radio, essentially the components that transmit signals out to listeners. The deal was referred to them by a lender of the company that knew of them from their Harbour Group days, and after a period of due diligence, they met with management on a Friday, and by the following Sunday had secured the tacit approval of the management team for the sale.

BE had a lion's share of the market for analog broadcasts, which was the traditional means for transmitting radio signals, and were poised to take the lead in introducing HD Radio equipment. HD is the digital alternative to analog broadcasts, taking up a fraction of the bandwidth that an analog signal does, delivering higher quality audio to listeners as a result.

The analog business supplied stable cash flow, while the HD offering could produce growth that substantially swells the bottom line. Finley didn't view BE as a technology play, but as a leader in a niche market, in this case, radio equipment. "The technology was stable and proven, and BE simply had a superior means to deliver it," says Finley.

Thompson Street managed to also exit the business from an unprofitable product line that consisted of providing equipment to pump HD muzak into retail outlets. Soon enough, radio stations began to switch to HD broadcasts and the firm exited the investment at an attractive price to the Audax Group, though terms were not disclosed.

Sequel secrets

One of the strongest testaments to a firm's health is the raising of a new fund, and the sequel to their debut vehicle which closed this year showed how far the firm has come. "We didn't use a placement agent for our first fund, and subsequently learned our lesson. For this fund, we used the Monument Group, set a target of $250 million and then finally capped the fund at $300 million at the behest of one of our major investors. No doubt the market's friendlier these days, but our track record as an independent team goes a long way to convince LPs," says Cooper.

They plan to acquire twelve businesses over the next four years, with expectations to make one to two add-on acquisitions to each. The new fund will also continue to make sourcing solutions a priority, creating an infrastructure within the firm that will assist the portfolio companies in tapping international possibilities.

Digging to China

While exploring China as a sourcing solution is verging on the cliché for larger corporations, smaller middle market companies in the US rarely consider it a possibility and when they do, it's with trepidation. Thompson Street felt that sourcing would be one of the low hanging fruit in producing operational gains within targets, and hired an executive dedicated solely to addressing sourcing issues with the portfolio.

"A big part of my job is educating management, and not necessarily CEOs, as they tend to be more aware of the trend. It's middle management that needs to be convinced. Local suppliers are the folks these procurement executives go to ball games with, have lunch with, and those relationships mean something" says Brad Strahorn, director of operations, who is responsible for delivering sourcing solutions to the portfolio.

Finley: auctions happen

Strahorn: educator first

He cites the necessity of such moves to remain competitive. In some instances he may begin outsourcing a few commodities to allow the executives the chance to grow comfortable with the process. Sometimes the solution involves choosing suppliers in different regions of the US, but more often than not, that means an overseas option, specifically in China. "My travel schedule involves three two-week trips to the country this year," says Strahorn.

Thompson Street is planning to establish a permanent liaison office in China, with staff dedicated to specific portfolio companies. When the portfolio company is sold, the designated staff within the Chinese office would remain with the company, beyond the exit. In this way, the staff serves as an existing Chinese infrastructure, no small selling point for potential buyers.

These types of innovations are the moves that will allow the firm to differentiate itself from the JAMBOGs flooding the market. Crowded auctions and the influence of global economies used to be what firms sought refuge from in the middle market. Now, these deals offer challenges on par with the mega-funds, albeit requiring solutions that respect the differences in resources and targets that exist on this side of the field. Thompson Street Capital Partners may be on track with a model to do just that. ■

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