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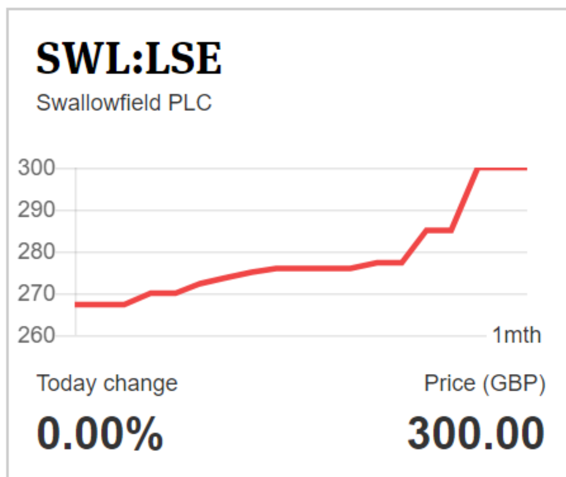
Beauty products group **Swallowfield** (SWL) is attempting to move up the beauty-industry value chain by investing in brands. The hope is this will boost the returns it generates from its know-how in product innovation and manufacturing.



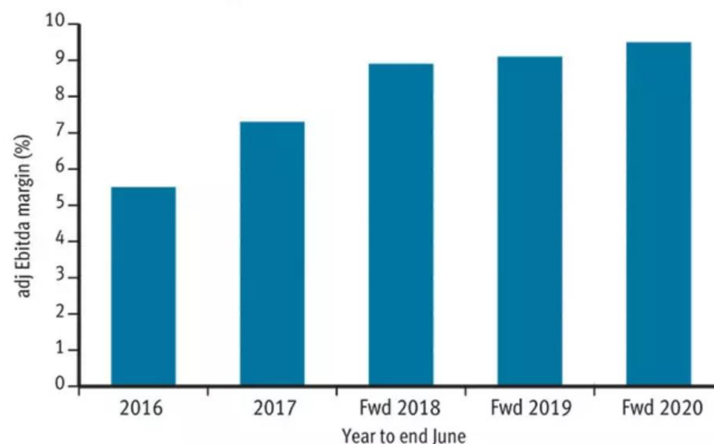
Such strategies do not always progress smoothly, and for Swallowfield, the financial year to the end of June has been a case in point. The share price performance and valuation seem to reflect recent mixed fortunes. However, where it really matters (brands), the recent progress made by the company has been encouraging. Meanwhile, the problems faced by the group's manufacturing business that have been the source of recent woe, may soon abate.They also explain why the company is looking to take more control over its own destiny through the ownership of brands as opposed to its traditional role of supplying owners of top brands.

The financial year before last saw a rash of product launches by key customers, which resulted in bumper trading for the manufacturing division and the 12 months to mid-2018 was always going to pale in comparison. This issue was compounded by two other disappointments that surfaced at the manufacturing business during the second half: the commencement of three major contracts was delayed, and the company was unable to adjust for a sharp increase in raw-material prices quickly enough to protect margins. To add to investor concerns, a jump in working capital will result in a sharp increase in net debt to £11m at the year end; the size of the rise in debt being the cause for concern rather than the actual debt level which represents 1.7 times forecast cash profits. The company also has a £5.7m pension deficit.

The good news is that the delayed contracts are expected to be up and running soon and management has a plan in place to revive margins. Meanwhile, following the year end, working capital is expected to quickly get back down to more normal levels bringing net debt down sharply. Nevertheless, the negative developments, which were revealed in a year-end trading update last month, were enough to make house broker N+1 downgrade cash profit forecasts for the manufacturing division by £1.7m. Given that group cash profit in 2017 was £5.2m, the magnitude of the setback may have been expected to have very painful ramifications for overall profit forecast. However, this was not the case thanks to the much-better-than-expected progress made by Swallowfield's brands. Indeed, the overall impact on N+1 Singer's 2018 and 2019 EPS forecasts were downgrades of just 4 per cent and 5 per cent respectively.

Swallowfield's real potential as a 'quality' play lies in the opportunity to grow the higher-margin brands business. Brands accounted for 31 per cent of first-half sales and 57 per cent of first-half profit, and in the 2017 financial year the division's operating margin before central costs of 16 per cent was almost double that of the manufacturing business. A strong brand gives its owner increased pricing power allowing it to grow and protect its margins. A strong brand also means more reliable sales growth. These factors translate into what investors refer to as high 'earnings quality'. This dynamic is reflected in the rise in margins over recent years and forecasts of more of the same (see graph).

Swallowfield hopes brands will drive margins higher



So arguably the more significant news from last month's trading update was not the manufacturing disappointment but that brand revenue increased by 16 per cent in the 12 months and that the division's profitability "will be significantly above both management's expectations and the prior year as a result of improving margins".

Brand margins are being enhanced by the company bringing the manufacture of recently acquired brands in-house. The most recent brand acquisition was the £3m purchase of men's hair styling brand 'Fish', which will hopefully build on the strong growth Swallowfield has enjoyed from the product category. Meanwhile, the company has been investing in its manufacturing facilities to boost efficiency and is also expanding into international markets. Overseas sales made up 24 per cent of brand sales last year, although challenging conditions in North America have been a drag.

The appointment of Tim Perman as chief executive following a succession period of several months should also keep the group's focus firmly on brand growth given his previous job as PZ Cussons' group brand director and divisional global beauty director.

If, as management expects, the manufacturing business is poised to get back into its stride and net debt moves downwards quickly, investors may start to focus more on the potential for the brands division. There could even be positive news on these fronts in the company's full-year results announcement scheduled for 25 September. The existing sales growth and margin trends suggest scope for a noteworthy re-rating of the shares should the strategic shift be a success.