BY JOHN KINGHAM

DIVIDEND HUNTER

IS KCOM GROUP A YIELD TRAP?

Over the last two of month's I've outlined a series of ten questions which I use to help me avoid yield traps. This month I'm going to interrogate a company using those questions so that you can see them being used in a practical setting. The company in question is KCOM Group (LON:KCOM), a FTSE 250-listed telecoms and IT services provider. KCOM's yield is currently almost 7%, which puts it squarely in yield trap territory.

The company was created at the start of the 20th century as the council-run Hull Telephone Department, providing telephone services to the people of Hull and East Yorkshire. In more recent years (now as a publically listed company), KCOM has been trying hard to move away from its fixed-line business towards the world of internet services, but the results have been mixed. So are investors right to be wary?

A quick tour of the numbers

Before I dive into the yield trap questions, I want to run through KCOM's financial performance and share price valuation. This should explain why I think KCOM is a company worth looking at in some detail.

Starting with KCOM's dividend, its track record is not brilliant. The company only started regular dividend payments in 2005 and then announced a dividend cut just a few years later in the financial crisis. In terms of growth, KCOM's revenues declined over the last decade, but when earnings and dividends are taken into account it grew an average of 7% per year over the last ten years, which is well above the FTSE All-Share average. Growth consistency was mediocre, with revenues, earnings and dividends only increasing about 50% of the time over the last decade, which is below average. Profitability was good though, with return on capital employed (ROCE) increasing from mid-single digits to more than 20% in the last few years (the average company manages about 10%). Debts have recently fallen to almost zero, and while the company does have a fairly large defined benefit pension scheme which is in deficit, I don't think it's a serious risk.

KCOM

In terms of valuation, KCOM's share price of 88p gives the company a dividend yield of 6.7%, which is obviously very attractive. The share price is also attractive based on my preferred valuation metrics of PE10 and PD10 (price to ten-year average earnings and dividends respectively), with both those ratios currently well below average.

In summary then, KCOM is a company with a reasonably good track record of dividend payments and growth, combined with above average profitability and very low debts. Its valuation is below average, so at first glance it seems that KCOM could be the mythical above average company trading at a below average price. But is that true? Is it really a good company or is it a yield trap? Let's try to find out, using those ten yield trap questions.

1. Does the company have an obvious and dominant core business?

NO. In the 20th century, KCOM's core business was to provide telecoms services to Hull and East Yorkshire. However, fixed-line telephone

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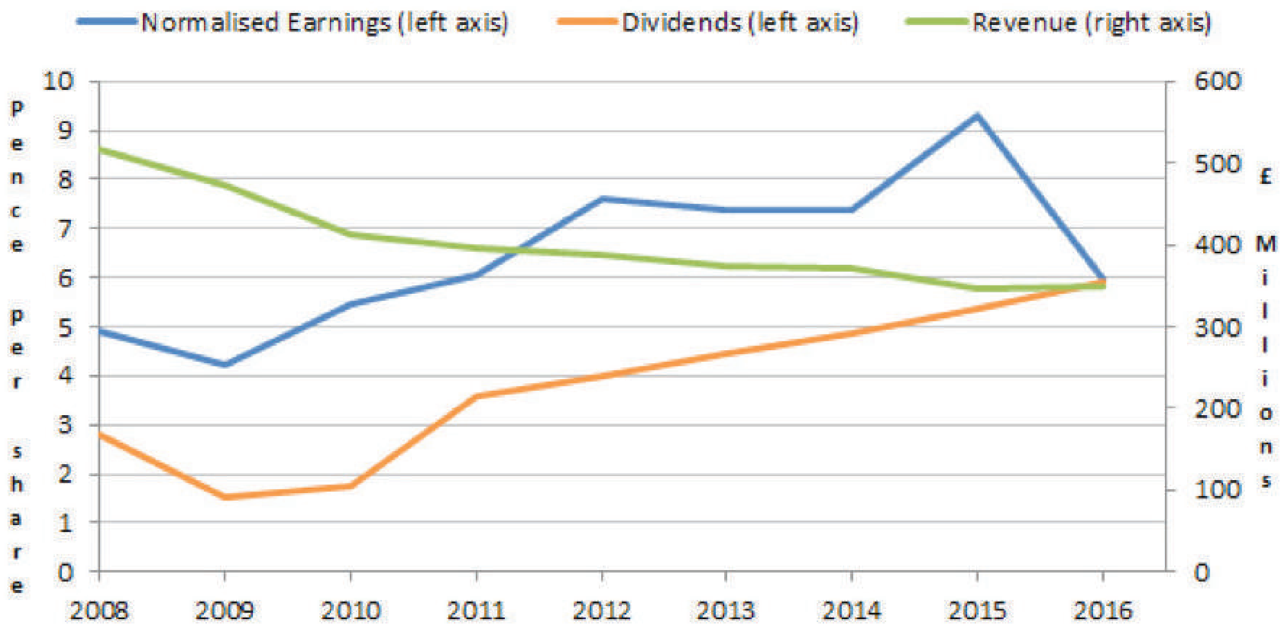

services have long been a declining business, thanks to the now ubiquitous mobile phone. To avoid a long and slow death, KCOM has been developing alternative sources of revenues for many years, both internally and through acquisition.

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Today the company is split into three main businesses: Hull and East Yorkshire (providing fixed-line voice and broadband services), Enterprise (providing complex IT solutions for large organisations) and SMB National (providing simpler telephone and internet-related services for smaller businesses across the UK).

The fixed-line business is seen as a core but constrained by its limited geographic reach. The SMB business is seen as a non-core legacy business because the market is too commoditised to make further expansion worthwhile. That leaves the Enterprise business, which is seen as the company's best hope for a higher growth future.

Given this spread of different business, I would say that KCOM does not have an obvious and dominant core business. Perhaps in the future the enterprise business will grow to be the dominant core, but that is not true today.

2. Does the company have a clear and consistent goal and strategy?

YES. Given KCOM's two core businesses (fixed-line and enterprise) it has two sets of goals and two strategies, both of which have been fairly consistent over the years.

In the fixed-line business its goal is to grow revenues and profits for as long as possible in what is likely to be a market in long-term decline. To achieve this, the strategy is to stay one step ahead of ever faster wireless networks (5G is aiming at speeds of tens to hundreds of megabytes per second) by rolling out superfast fibre broadband to its customers. Fibre also has the added benefit of needing very little maintenance over its multi-decade lifetime, especially when compared to copper wires.

As for the enterprise business, in the somewhat jargon-filled words of the CEO (from a recent interview with Proactive Investor):

"Our vision is to create an asset-light, IP [Internet Protocol] cloud-based company that will be a new world disruptive challenger to the big IT and systems integration companies. And the market is just waking up to us as an organisation to watch."

In other words, the digital revolution is creating a lot of threats and opportunities for large organisations and many

of them are looking for a highly skilled and trusted partner to help them cope. KCOM's strategy is to go after larger, more complicated and longer-term "annuity" contracts, where revenues are recurring for long periods of time due to the need for a stable and deep relationship between consultant (KCOM) and client.

In summary then, KCOM's goal is to keep the fixed-line business breathing long enough so that the enterprise business can eventually take over as the main breadwinner.

3. Is the company one of the largest players in its markets?

NO. The fixed-line business is almost a monopoly, so it definitely has scale. However, KCOM's future is supposed to be its enterprise business, so for me that business is more important and here I think scale is lacking. Nowhere does KCOM describe its enterprise business as a market leader, and in fact the CEO describes the business as a "disruptive challenger to the big IT and systems integration companies", which suggests that the enterprise business is still a relative minnow.

4. Has the company been operating in its current markets for many years?

YES. The fixed-line business has been in place for over a century, while the enterprise business only really got going with the acquisition of Omnetica in 2004 and Smart421 in 2007. However, that's still ten years ago, which is a reasonable period of time, and both acquired companies have histories going back to the start of the millennium or earlier.

5. Is the company free of bet-the-company projects which could push it into a crisis if they failed?

YES. KCOM is in the middle of a transformational project to turn itself from an old-world fixed-line telephone company into a new-world internet consultancy. However, I don't consider that a bet-the-company project as it doesn't put the old fixed-line core business at risk. At the level of its two main businesses, there is nothing currently going on that I would class as a big, high risk project.

6. Are revenues generated from selling many small-ticket items rather than a few big-ticket items?

NO. The fixed-line business generates revenues from many thousands of individuals and businesses who make relatively small but regular payments for their phone and broadband services.

The enterprise business generates revenues from contracts, some of which are very large. Those contracts typically have a fixed life and will eventually come to an end. When a contract ends, KCOM will lose those revenues unless it can either renew the contract or find a new client (or clients) willing to sign a contract of similar scale. If KCOM fails to replace lapsed contracts then its revenues and profits will suffer. This is precisely what happened during the financial crisis when Lehman Brothers, KCOM's largest customer at the time, went bust.

Given that the enterprise business is the future I've given that business more weight, which is why I've answered this question with a no.

7. Has the company avoided large acquisitions which have little to do with its core business?

YES. Over the last decade KCOM has been largely acquisition-free. Before that it was highly acquisitive in an attempt to move away from its fixed-line business. For example, in 2004/5 KCOM spent over £100m buying Omnetica and over £25m buying Smart421 in 2007/8. Both were large acquisitions that were outside the company's core fixed-line business, so they were definitely risky, but also probably necessary. However, in general I consider acquisitions more than ten years old to be ancient history and not worth worrying about.

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8. Does the company operate primarily in defensive markets?

NO. KCOM's fixed-line business is very defensive as it's based on phone and broadband subscriptions, which people and businesses will usually pay regardless of the economic environment. The enterprise business is definitely not defensive, as the financial crisis showed. Its enterprise customers are large public and private organisations, both of which are more than willing to cut their IT budgets if the economy takes a turn for the worse. As a result, additional IT consultancy work will be reduced and contracts with KCOM may not be renewed, or may be renewed on less profitable terms.

9. Is the company relatively immune to commodity price movements?

YES. Other than exposure to clients who may operate in the commodity sector, KCOM is largely unaffected by commodity prices.

10. Is demand for the company's core products or services expected to grow over the next decade?

YES. The voice side of the fixed-line business is in terminal decline thanks to the ubiquity of mobile phones. The broadband side of that business still has some legs though, thanks to its superfast fibre broadband rollout. That rollout is enough to keep fixed-line data speeds ahead of wireless, at least for now. Once fully deployed, the fibre network should allow additional services which can only be delivered through superfast broadband, which could be another source of revenue for KCOM. However, the pessimist in me thinks the fixed-line broadband market is also not a growth market.

For the enterprise business things are different. Computers and network technology are becoming ever more important for business, and for most businesses these are non-core skills. As the scale and complexity of these projects continues to grow for large businesses, so does the need for outside consultants who can design, build, deploy and maintain these systems. And that's where KCOM comes in. This is of course a much less dependable and stable market than the old fixed-line telecoms market, but at least it's likely to be a growth market.

Is KCOM a yield trap?

Having worked through all ten questions, the final score is six yeses and four noes. Remember that yeses are good and noes are bad, so while the good answers outnumber the bad, it's still a very mediocre score.

KCOM has several main problems: 1) Management's focus is split across two very different businesses (three if you include the legacy SMB business); 2) The enterprise business lacks scale; 3) The enterprise business depends on consistently winning large contracts; 4) The enterprise internet systems and services market is cyclical.

These are all negative factors, but they are not necessarily a reason to avoid KCOM. After all, there is no obvious crisis within the company, no obvious sign that its markets are about to suffer a downturn, and I think no obvious reason why the dividend should be cut anytime soon. But those negative factors are still there, so there is a realistic chance that the dividend could be cut if, for example, there is a downturn in the economy or if KCOM fails to replace several major contracts.

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On balance though, I think I would invest in KCOM at its current price, should the opportunity arise. If the dividend is sustained then there is a good chance the share price could double, or better, although I would probably hedge my bets by keeping the investment to just a few percent of my portfolio.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

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