Corporate diversification

The object is to have securities that counterbalance one another. So when some of them fall in value others increase or at least remain relatively unchanged. Thus, the overall portfolio value stays as even as possible. Diversification means having different lines of business or products. When one line does poorly, the other line does well, and overall revenues stays the same or grows.
We can distinguish different levels of diversification:

- Low level of diversification: Between 70% and 95% of revenue comes from a single business
- Moderate to high levels of diversification: less than 70% of revenue comes from the dominant business and there are only limited links between businesses.
- Very high levels of diversification: less than 70% of revenue comes from the dominant business and there are no common links between businesses.

Benefits of Diversification

Growth: in the absence of diversification, firms are prisoners of their industry. For firms in declining industries this is a discouraging prospect (perspectiva), especially for top management. The urge to achieve corporate growth that outstrips the one of a firm`s primary industry is an appealing prospect for managers. Companies in low-growth, cash-rich industries such as tobacco and oil have been specially tempted to diversify. For example, during 1980s Exxon diversified into coal mining, electronic motors and computers and office equipment.

Value creation: Michael Porter defines three essential tests which determine whether diversification will truly create shareholder value.

- The attractiveness test: The industries chosen for diversification must be attractive or capable of being made attractive
- The cost of entry test: the cost of entry recognizes that for outsiders the cost of entry may counteract the attractiveness of the industry. For example, pharmaceuticals offer above average profitability precisely because they are protected by barriers to entry.
- The better of test: the new unit must gain competitive advantage from its link with the corporation or vice versa. In other words, combining different businesses must enhance the competitive advantage of the original business and the competitive advantage of the acquired business.

Economies of scope: the most general argument concerning the benefits of diversification focuses on the presence of economies of scope. Economies of scope exist when using a resource across multiple activities uses less of that resource than when the activities are carried out independently.

Parenting advantage: parenting value comes from deploying the resources and general management skills possessed by the partner company. In Virgin´s case they include the brand, Richard Branson`s skills at attracting media coverage and Virgin`s business partnering capabilities. If these skills add value to a new business, then Virgin should think of entering that business.