

## **J. Michael Locke**

### **Musings**

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#### **#47: The Benefit of Diversification**

##### **May 8, 2020**

Financial advisors will always speak to you about having a diversified portfolio. It is widely accepted that you should spread your investments across “asset classes” (stocks, bonds, alternatives) so as to not be overly exposed to one asset class.

The same basic construct applies to your revenue line. It is best to have diversification: by client, by channel, by product/service, by geography. Note that I did not say to diversify what business you are in. I am not a fan of the conglomerate model – Tyco, old ITT, GE. To me, you should focus in one business area and drive value. This also lets investors choose what business they want to be in when providing capital.

With respect to diversification by client, the value of your enterprise will be directly affected by revenue concentration. Professional investors will calculate value using a discounting cash flow (DCF) model or comparable transactions (“comps”) but then discount it if you have too much of your revenue coming from one client. There is not a black line on the amount but I would say anything over 25% reduces value. You want big customers, so you just have to sell more to others to keep the percentage manageable. Also, get the big client on a multi-year contract with long notices of cancellation or nonrenewal so you have time to adjust if they decide they are going to end the relationship.

On channel, watch “playing with the big boys.” Certainly, it seems exciting if Walmart decided to pick up your product line or Amazon ranked it high in their recommendation engine. However, those entities are so big and influential that they could end up driving a majority of your business and inflict major damage if they ever went away. In this respect, I consider Google a channel. I was on the board of a business that lost more than 25% of its volume due to a change in the Google search algorithm. We were over 90% reliant on SEO and Google made an algorithm change and off of page 1 we went. Results plummeted. Shame on us for not mitigating the risk ahead of time and being diversified in our customer acquisition approach!

With respect to product or service, think about Disney. If it was only a theme park and cruise line company right now, it would be dead. Bob Iger’s good leadership had them launch a streaming service last year that was wildly successful. Still a hard time at the Mouse but can you imagine it without the media services. Below is their revenue by segment reported earlier this week (per the musing on watching public company filings):

- Media Networks: \$7.26 billion, up 28%
- Parks, Experiences and Products: \$5.54 billion, down 10%
- Studio Entertainment: \$2.54 billion, up 18%
- Direct-to-Consumer and International: \$4.12 billion, up more than 100%

Finally, if you are in a site-based business, think about geography. One Northeastern university president once told me, "I am trying to live off a double-digit declining group of high school graduates in upstate New York. I have to open up elsewhere" and down to Florida he went.

Be safe.

Jml

### *Second Thoughts*

In a previously musing, I referenced starting with the balance sheet when you are looking at the health of a business. Vince Blume properly pointed out to me that you have to also look at what liabilities are not on the balance sheet. The \$22 trillion in U.S. federal debt does not include the underfunding of social security or pensions. Some have estimated that IOU to be another \$50 trillion. Need to bring it on the balance sheet at the federal and state level.

Meanwhile, Jeff Dobosh hit it on the head. "I've long believed that possibly the biggest problem in our country was the gerrymandering combined with 2-party duopoly. The 10% fringes control almost everything - there is just no incentive to come together and find middle ground. All of the incentives are to be disruptors. While China works on a 50-year plan, we've regressed to 18th century Ireland"