Opportunity Assessment: Different Types of Business Opportunities

(Updated: June 16, 2017)

Every business opportunity depends on a value proposition that creates value. The Network for Teaching Entrepreneurship (NFTE) defines a value proposition as an equation:

Value Proposition = Benefits - Costs

This means that entrepreneurs and small business leaders determine a value proposition that they believe delivers benefits in excess of the costs required to offer their product or service. If they see a positive value - if they believe that there is an opportunity for them to earn a positive return from an enterprise they can envision - they then proceed to develop a business concept and ultimately a business plan for their envisioned venture.

A value proposition can be something that an entrepreneur conjures out of thin air, an inspired concept developed from imagination and hard work.

Or a value proposition can be built into a business packaged and supported by a third party (called a "franchisor") or purchased by acquiring an existing business.

From a practical perspective, there are four different types of commonly available business opportunities:

1) **Start-up** - as we learned in Resource 23-09, a start-up is a business created from scratch. An entrepreneur with a vision, some capital, prospective customers, and talented team members creates a sound business plan to launch a completely new enterprise.

   Start-ups face all manner of challenges. Their basic value proposition must be sound - actual market experience has to prove that the benefits the entrepreneur envisioned are appreciated by customers, and that these customers will then provide revenues at or above projected levels.

   The start-up has to recruit the right team members. The start-up has to operate efficiently, provide great customer service at affordable costs, spend within budgeted levels, collect revenues at or above projections, etc. etc.

   If a start-up can succeed in meeting these and the many other challenges it faces every step of the way, then the start-up's investors and team members can succeed wildly. The wealthiest people in the world are the visionaries whose start-ups have become business giants providing positive value propositions to customers across the globe.

> **Different Types of Business Opportunities**
> 1) Start-Up
> 2) Acquisition
> 3) Franchise
> 4) Joint Venture

2) **Acquisition** - this is an existing business purchased from its owner. The entrepreneur / small business leader is acquiring the business because he / she believes the future potential of the business justifies the purchase price.

   The purchase price for an acquisition reflects four factors: 1) the cash flow generated by the business; 2) the value of assets (including "intangible assets" like patents and other forms of intellectual capital); 3) the growth potential the business; and 4) market conditions.

   An acquisition of a healthy, fast-growing company with modern assets, great growth potential and a healthy market will be very expensive. On the other hand, a "turn-around" - a company with poor (or negative) cash flow, outdated equipment and facilities, operating in a small or declining market will obviously cost less.

   Business acquisitions can be structured in many different ways. The acquirer can pay cash in advance, or make payments over time. The acquirer and seller can make a deal that the new owner will pay part of the purchase price out of future earnings (called an "earnout"). Buyers who use mostly debt to purchase a company in the hope of using future profits to pay down the debt execute a "leveraged buyout" (leverage being another term for debt).

3) **Franchise** - the owners of successful businesses can become "franchisors," offering investor-operators the opportunity to open a copy of their business. The basic franchise value proposition is:

> *The franchisor provides all the elements of a successful business to investor-owners in return for an upfront franchise fee, as well as ongoing "royalties" (usually a percentage of revenues paid by the franchise owner to the franchiser) and marketing fees.*

Franchisors provide a proven business concept, an established brand, and all types of management support (accounting systems, personnel training, marketing campaigns, technology packages, etc.).

Franchisees agree to operate their business according to the guidelines established by the franchisor, in the belief that this business concept will generate a significant return.

Not every franchise opportunity is the same. McDonald's - the most famous franchise operation in history - is clearly a successful franchise opportunity. Consequently, the terms of becoming a McDonald's franchise are extremely demanding. The initial investment is usually millions of dollars. Franchisees must operate *exactly* according to McDonald's standards (most especially their quality standards). And often franchisees must invest additional funds in the future to meet aggressive expansion targets specified in their agreement with McDonald's. But the cost of a McDonald's franchise has historically proved to be a sound investment.

Alternatively, a new franchise opportunity may offer a less-proven business concept at a more affordable level of investment. This would enable a newer entrepreneur / business leader with less capital to launch a new venture, although the value and prospects for success of this less-well-established franchise are far from certain.

There are strict laws governing who can be a franchisor . . . the responsibilities of franchisors . . . and the obligations of a franchisor to franchisees. In the best-case scenario, franchises have enabled many entrepreneurs to capitalize on the vision of others to create successful new businesses.

4) **Joint Venture (or JV)** - a joint venture is a new business launched by two existing businesses. Both businesses contribute something of value to the new venture, and serve as partners in making the joint venture succeed. Typically, a joint venture enables JV partners to pursue business opportunities they couldn't pursue alone.

Examples of joint ventures could include:

- a landlord with many unused properties creates a joint venture with a popular pizzeria owner. The joint venture (or JV) creates a network of small delivery-only pizza locations, enabling customers across the city to receive fresh pizzas delivered within 20 minutes from this popular pizza restaurant. The landlord contributes the location and operating capital. The pizzeria owner contributes intellectual property (the recipes for the pizza), brand value (the popularity of the pizza) and team members to staff each new location. Both JV partners are better off by contributing resources and/or capabilities that they're good out. The JV mitigates risks for both parties - the pizzeria owner doesn't have to come up with expansion capital for new locations, and the landlord doesn't have to operate a restaurant business.

- an app company creates a JV with a consulting company in another company to offer a foreign-language version of the app. The app company contributes its concept, its code and its market reputation. The consulting company provides translation of the app into another language, as well as expertise in gaining customers in this new market. Both JV partners are better off by contributing resources and/or capabilities that they're good at. The JV mitigates risks for both parties.

These are the two features of successful joint ventures: 1) both partners are better off by contributing resources and/or capabilities they're good at; while 2) the JV mitigates risks for both parties.

Opportunity Assessment: Different Types of Business Opportunities

The table below offers a summary of the pros and cons of each type of business opportunity.

Business Opportunity	Pros	Cons
Start-Up	• Biggest financial upside • Opportunity for running the venture exactly how the entrepreneur chooses	• Hardest type of business opportunity to make successful • Challenge of raising sufficient resources • Challenge of finding the right team members • Challenge of cost-effectively securing customers • Challenge of delivering products / services at required cost and quality levels • Challenge of responding to new technologies / new competitors • Challenge of responding to legal / regulatory changes
Start-ups represent a tremendous opportunity to build wealth because of how challenging it is to create a successful start-up!		
Acquisition	• Business can generate cash flow immediately • Business has existing customers and staff • Business has a track record serving its communities / customer segments	• Upfront capital (or the assumption of substantial debt) necessary to pay for the acquisition • No guarantee that customers or staff will stay with the new owners • No guarantee that future results will be as positive as past results • Possibility that the business will require substantial additional investments for marketing, technology and/or new staff
Franchise	• Proven business concept (*usually*) • Established brand (*usually*) • Target customers are already determined, value proposition are already tested and proven (*usually*) • Systems and support (accounting, training, marketing, operations, technology)	• Upfront capital required - often franchise agreements also call for mandatory expansion plans that require additional capital • Ongoing royalty payments and marketing fees • Limited creativity / flexibility, since franchisees must meet franchisor standards • Sole-source purchasing requirements from the franchisor may be expensive • Restrictions on an "exit strategy" - franchisors may prohibit a franchisee from selling out at a profit to a third-party buyer
Joint Venture	• JV partners get to focus on what they're good at • Lower investment for each JV partner	• Hard to find / arrange for JV opportunities • Expensive to create the JV structure • Challenge of creating a new company culture that works for both JV partners

If you've noticed that the "Cons" column has more bullet points in it than the "Pros" column, you've made an important observation. ***Pursuing <u>any</u> type of business opportunity entails risk, because the odds of success are against you.*** That's why entrepreneurs must "embrace" risk - there is risk inherent in every type of new business opportunity.