"I notice increasing reluctance on the part of marketing executives to use judgment; they are coming to rely too much on research, and they use it as a drunkard uses a lamp post for support, rather than for illumination."

David Ogilvy (1911-1999)

MARKETS AND PRODUCTS

As we mentioned in our previous newsletter, a good business plan details several elements, including the management team, value proposition, market, product or service. That newsletter focused on the team and the value proposition. This letter focuses on understanding the market and different aspects of the product, or service, including differentiation and barriers to market entry.

Many business propositions fail to excite investors because of communication gaps concerning markets and products. These failures are sometimes caused by simple deficiencies, such as not using standard business definitions, not comprehensively outlining differentiation arguments or barriers to entry. A much more serious issue is a lack of detailed market understanding. This newsletter will provide definitions of a few market metrics, and then provide our take on what defines good, and not so good, marketing and product strategies.

DETAILS WITHIN THE TEXTURE

Market Share

One truism often discussed in business comes from GE business thinking: that to be successful a business must be the #1 or #2 player in the market in which it competes. This rule was adopted and formalized within GE because the top players in a market generally have substantially better financial results than other players in the market. However, if a market is very crowded, even the #1 and #2 players can struggle to produce healthy financial results.

Companies in markets with too many players are driven by pricing pressures to the point that even the largest players cannot achieve attractive levels of profitability. This is super easy to see in the business world: look at the disk drive industry prior to consolidation, or the overall poor profitability of the telecom industry. Being the #1 player in a market with too many competitors, such that no player has sufficient scale to "rule" sizable market segments, is a very, very pyrrhic victory. (Wow, that was a cool word to use!)

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Key Points:

Only enter markets where you can be #1 or #2.

***Look for markets where >80% share is captured by less than four players*.**

A bit of reflection on these rules leads to a couple of practical thoughts concerning the upper and lower bounds for market share. If you assume that a couple of players have 80% market share, then a reasonable market share for a company aspiring to be a solid #2 player would be around 25%.

Key Point: ***Target, at minimum, 25% market share.***

Monopolies, where virtually the entire market share goes to one player, are not all that common and are often not stable unless there is an unusual characteristic of the market, such as regulation or structure that would maintain the monopoly's stability. In a market that does not have the structure to artificially support a monopoly, trying to sustainably obtain market share above some natural "leader level" drives companies to unnatural behavior and decreased profitability. In most markets, it is rational to aim for approximately 75% market share as a market leader.

Key Point: ***Target, at maximum, 75% market share, unless the market structure can truly sustain a monopoly.***

Market Size

One of the most common things we see in business proposals is a mismatch between the funds requested and the market size. The first case is where a business plan will request a tiny amount of money to pursue a very large market already packed with substantial competitors. That conversation goes along the lines of . . .

Q: "Can you give me $50K?"

A: "Why?"

Q: "So I can have a company that gets $5M a year in revenue"

A: "Well, that seems interesting. How big is your market?"

Q: "It is big, $3B a year! No one will even notice me!"

A: "How big is the biggest player in this market?"

Q: "Don't know, maybe $2B a year. Why do you ask?"

A: "Well, they spend, oh, like $200M a year on R&D. If your product is profitable and attractive, how will you protect yourself?"

This is obviously a bit cheeky, but it is actually not too far from what actually happens in many early stage discussions with start-ups. Simply stated they are trying to participate in

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very large markets with very little capital. While it is possible to discount some of this as simple optimism, the disconnect is often so big that it results in the staff looking naive and careless.

Key point: ***Don't pursue a huge market without coming to the game with real cash and differentiation.***

The flip side of the above example is the business plan that asks for a ton of capital to fund fabs and factories for a $20M/yr market. In reality, we don't see this very often in early stage companies. From our perspective, many of the tech companies around the valley have fixed cost structures too large and too expensive for the markets they intend to serve.

In a previous newsletter, Venturing Into Reality, we discussed the corporate growth/size/profitability implications of taking investment money. We leave it to the reader to do the math, but here is the circle of life business statement for the day . . .

Key point: ***Make sure that the market you are pursuing is appropriately sized for the company you wish to build; such that it supports the investment you are seeking.***

Segmentation

The reality of many large markets is that they can be viewed as many different markets, each of which is characterized by different buying behaviors and preferences. If you aim to create a company within a larger market, a very good thought exercise is to work through the different types of segments within the overall space to find segments that are better suited, both in size and characteristic, to the strengths of a young company.

Segmentation is a huge topic, well beyond the scope of this short newsletter. However, there are a couple of points worth stressing. The first is to seek segmentation that actually provides protection from competitors. By this we mean to look for segments where participation would require competitors to actively change part of their business model.

The strategy taken by Southwest is the classic example. They segmented travel by type and sought to serve those passengers that would have traveled by car or bus instead of by plane. In serving this segment Southwest employed a different route configuration, point-to-point, than was being used by the other major carriers of the time. This segmentation is real, and Southwest was able to put in place structural barriers that other airlines seeking to compete in these segments would have a hard time replicating.

Key point: ***Look for segments that allow or help create barriers to entry for competitors.***

The second point is really just the flip side of the first. Some segmentation is so narrowly defined as to offer little to no protection or opportunity for sustained differentiation. To get a feeling for what narrow market segments look like, just visit your local supermarket and count the number of toothpaste offerings: gritty, extra-gritty, germ-killing, gum massaging, sensitive teeth loving, whitening, extra-whitening. The choices are, to say the least, dazzling!

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In a highly fragmented market such as this, a company like Colgate would have little problems entering a segment; in sharp contrast to the difficulties that would be faced by United in trying to re-jigger routes to compete with Southwest. Because of this, young companies are very vulnerable in these kinds of markets.

Key point: *Avoid segments where large competitors can easily enter.*

People

The "market" is really people. Any business plan worth a good listen starts with a lot of discussion with current customers. Just ask a huge number of questions: about the market, the segments, the products, price points, features, how orders will be placed, integration with computer systems, and on and on and on . . .

A few practical suggestions…

- Do your homework before you take a customer's time. Plan, plan, plan!
- Have specific objectives for the discussions. Have two or three specific questions that you're going to try to get answered within the discussion.
- Recognize that the customer's time is valuable. Keep the conversations fairly brief, an hour at the most, unless you are comfortable that the customer also values the meeting.

Assumptions

We constantly make assumptions. Without them, many decisions simply could never be made. Many, if not most, of our assumptions turn out to be reasonable. However, a fairly significant number of our business beliefs are simply wrong.

Furthermore, most people don't start out thinking very much about the assumptions that undergird their thinking. Because of this, we spend a great deal of time trying to help teams figure out biases and assumptions that are built into their thinking. Following that, we strongly encourage teams to go back out into the world of products, services and customers and actually test these assumptions.

GOTTA BE DIFFERENT!

To have a business succeed, it is critical to cleanly articulate how your product or service is better, or serves a unique or new market need, and how you will protect and continue that lead into the future. Otherwise, it is unlikely that your business will get funded. The first concept, of being better or of essentially defining a market, is called differentiation. The second concept, of protecting this lead, is in essence what is captured by the term "barrier to entry". A barrier to entry is basically a challenge that a competitor would have to overcome in order to compete with you.

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The Investor Isn't the Expert

The common myth about pitching a business proposal is that you get this incredibly brief moment of time, like in an elevator ride, where instead of complying with the non-spoken elevator rule of staring forward you turn to the person in the elevator next to you, who is a sage and wise venture capitalist, and quickly tell them about your value proposition, market, differentiation, and . . . Wow! You're funded! Alas, we're here to tell you this is rarely ever true.

While we're just huge fans of being concise, the truth is that most investors have good, broad market understanding but nowhere near the technical depth that a strong start-up team will have. Because of this, they often can quickly understand how a concept fits into the market and how it is unique. However, the technology at the core of the concept, how hard the technology is, and how difficult it would be to replicate may be very challenging for the investor to quickly understand. Expect a lot of questions, and truthfully be prepared to spend some time educating a potential investor. This isn't a place where a simple rule works; rather it is dialog about just exactly how a company intends to be different and why that differentiation would be very hard for a competitor to replicate.

Key Point: ***It will take time to explain the technology behind the company; be prepared to answer a ton of questions.***

Only Be Best At What Matters

Being different is only interesting for a business if that differentiation will lead a customer to pay more for the product or service. Period. It doesn't matter if the product or service is hard to do, or smart, or elegant, if customers aren't willing to pay for it. This is a place where the investors by and large are way more sophisticated than the technologists. All that matters is that a sizable number of people will pay extra for this difference. Yep. End of discussion!

Key point: ***Only differences that customers value, with their wallets, matter.***

KEEPING YOUR LEAD

The subject of maintaining an advantage is sometimes difficult. All technological achievements can be replicated with time and money, so ignoring the topic doesn't seem to make a lot of sense. From our viewpoint, there are a few ways of maintaining this advantage that make sense.

Investment

Continue investing at a level higher than the competitors. This practical approach looks at what other companies might be expected to economically invest and plans to continually invest at a level above the competition. The primary risk here is that the product/market landscape may change in the future and decrease the economic value of the differentiation.

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IP Barriers

Use intellectual property to create a barrier to competitors entering the field of play. This strategy relies on using engineering and legal resources to develop a portfolio of patents as a barrier. Before we comment here, it has to be made clear that we're not lawyers, and this little newsletter is in no way, shape or form to be confused with an erudite opinion on patent law. Whew! With the disclaimer out of the way, we'll go ahead and comment. There are big risks with this strategy. First, big companies have big patent portfolios, with the ability to rapidly, and strategically, develop a patent portfolio specific to a targeted market. Stated differently, you can invest a lot of time and effort and lose.

The second risk is that the development of a strong IP portfolio takes considerable corporate resources. To develop a good IP portfolio takes strategic thinking, substantial effort from technical resources and last, but never least, a big investment in patent attorneys.

The third risk is stark. In many places around the world, intellectual property is simply not respected and is therefore not a substantial barrier to entry. If the patented idea is fairly easy to duplicate, it will be.

To be fair, we do believe that all technology companies should work to build a reasonable patent portfolio to protect certain bits of intellectual property. If the technological innovation can be reverse-engineered, or stated differently, if it is easy to figure out if a competitor is infringing on a patent, then patent the idea. If it is difficult or impossible to reverse engineer the product, the technologies and the construction of the product should be kept secret within the company. We advise the gentle reader to tread carefully and thoughtfully in architecting a barrier strategy using a patent portfolio as the centerpiece.

Structural

The structure required to produce a technology can also be a barrier to entry for other companies. The best example of this is in the duopoly of Intel and AMD. These companies invest huge amounts of money to participate in a very large, high margin market. The amount of money required to participate in this market makes it unlikely that a third company would try and enter that particular market. Indeed the world of fab-less semiconductor design was largely due to the extraordinarily high cost of owning the high fixed cost of a wafer fab. Unfortunately, most of the companies using high fixed costs as a barrier to entry are in markets that have suffered a severe downturn, making the construction of a new high fixed-cost asset, well, a bit stupid.

USE YOUR JUDGEMENT

Understanding markets and products involves a lot of work, thinking, and questioning. Reach out to people in the industry, pick their brains and test your ideas with them. Spend time understanding how your market truly functions, what features customers will actually pay money for. Put a lot of time and effort into understanding your market landscape, creating your market share goals, and crafting and defending your differentiation and your investment prospects, whether boot-strapping, angel or venture-based, will be much, much brighter.

Cheers,

The InSite Team

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