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How Big Could Your Business Be?
- *CALCULATING THE TAM* -
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How Big Could Your Business Be? **- CALCULATING THE TAM -**



Let's say that you have just built the next great mousetrap, and a potential investor wants to know how many you could possibly sell...

Or, maybe you just want to know how big your local catering company could grow if you sunk your life savings into advertising.

The answer to both these questions is known as the "Total Addressable Market," or TAM. But finding your TAM is not as easy as you might think, and this difficulty often leads companies to make startlingly bad decisions.

So, what is a TAM?

To be sure that your decisions are grounded in reality, it is important first to understand what TAM is, and what it is not.

TAM is the sum total of all of the possible sales you could make if you had no competition. Said another way, TAM measures the potential market for your product – and your product only – assuming you could reach 100% of your customers.

What TAM is not:

TAM is not the same as your "industry." If you are a caterer, you are part of the trillion-dollar food service industry, but clearly, you could not sell a trillion dollars worth of canapés and finger sandwiches!

And TAM is not the same as your "market share." General Motors may have 30% market share for SUV's in the USA, but their TAM includes all the people who buy Ford Explorers or Honda CRV's.

Finally, TAM differs from your "Target Market" (which tends to mean the descriptive demographics of your ultimate customer) and "Market Segment" (which is a description of a subset of your "industry"), since TAM is generally expressed as a value in dollars.

Put a pencil to it

Let's go back to the auto industry. Imagine a "Muffler Co." that makes specialty mufflers for luxury sedans. They could be classified as a parts supplier (market segment) in the automobile industry. Their target market is defined as auto manufacturers that make luxury cars. Knowing that much is the first step to calculating their TAM.

To calculate Muffler Co.'s Total Addressable Market, we need to know how many manufacturers make luxury sedans, and how many each one makes. We can count up all the BMW's plus all the Cadillacs plus all the Lincolns and Mercedes and so forth. The total number of mufflers needed for ALL those cars is the Muffler Co.'s TAM. Usually, we express this in either units (number of mufflers) or dollars (value of selling all those mufflers).

Note that the muffler company's TAM is not the trillion-dollar automobile market since they only make mufflers. Nor is it market for all mufflers on all cars, since their product is only designed for luxury sedans.

Shortcut pitfalls

If adding up all the luxury sedans made in a year seems like too much work, the company might be tempted to find an industry number for all luxury sedan mufflers sold. Sometimes that's a good shortcut. But beware – if that number includes the mufflers installed on luxury sedans at repair shops then it's not a good representation of the true TAM. Remember, we originally defined our customer as only the auto manufacturers. To include these after-market sales means we would have to redefine our customer... and that will change our whole business plan!

Where's the beef?

Lets try one more example. A company wants to sell prime filet mignon to all the restaurants in Ohio. Sounds like a good idea, right? After all, research shows that there are 10,000 restaurants in Ohio spending over \$100 million a year on beef. That's a sizeable TAM, and a great opportunity, isn't it?

Not so fast. Clearly, by packaging and selling filet mignon, the company is excluding potential customers like McDonalds and Pizza Hut. As it turns out, fast food chains like those represent 60% of the restaurant market. So, much of your \$100 million beef market is for ground chuck and pepperoni sausage, not filet mignon.

Introducing a new source of filet mignon – even the world's best tasting filet mignon – is not likely to make people eat much more of it. So let's take a look at how much is already consumed in restaurants. Perhaps you will find that steaks represent just 30% of the beef market... and filet mignon represents just 10% of the steak market. Suddenly your Total Addressable Market is just 3% ($30\% \times 10\% = 3\%$) of what you thought it was.

So what?

So what does this really mean? As your investor tries to decide whether to buy your stock, or as the caterer decides how much of her life savings to pour into advertising, it is good to know what your TAM really is.

Clearly, it would make very little sense to pour \$10,000 into advertising in a local area that only spends \$5,000 a year on catering. Likewise, an investor in the Ohio Filet Mignon Company will want to know how you plan to repay his \$5 million investment out of your slice of just a \$3 million total market!

Keep an eye on your true TAM, and let that determine the scope and scale of your business. Don't grow out of your TAM until you have your next market already defined!

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