Market Sizing Using TAM, SAM And SOM

Idea In Short

When doing market sizing, consultants often refer to TAM, SAM, and SOM. But what do these acronyms mean and why are they useful in assessing investment opportunities? One of the most important evaluation criteria for a business idea is the size of its market. If it is too small, the investment is not worthwhile and the idea cannot be realized. For this reason, an estimate of the market size is a mandatory part of every business case or business plan that must be presented in a company or by a startup in order to receive funding for the development of the idea.

TAM, SAM and SOM are acronyms that represents different subsets of a market.

- TAM - Total Addressable Market / Total Available Market. This is the total market demand for a product and / or services.
- SAM - Serviceable Addressable Market or Served Available Market. This is the segment of the TAM within your geographical reach that you can target with your products and / or services.
- SOM - Serviceable Obtainable Market or Share of Market. This is the portion of SAM that you can realistically capture.

TAM

The Corporate Finance Institute defines it as:

> The Total Addressable Market (TAM), also referred to as total available market, is the overall revenue opportunity that is available to a product or service if 100% market share was achieved.

The Total Addressable Market (TAM) is important for startups and existing businesses because the estimates of effort and funding required allow them to prioritize specific products, customer segments, and business opportunities. TAM provides a viable value proposition and helps answer the question about who could (theoretically) buy the product? In other words, it describes the total revenues that a company could theoretically make, if it had an all-encompassing monopoly with its product or service. In calculating the TAM, discard any factors that could prevent the company from achieving this state. Specifically, ignore constraints, such as competition, production and logistical capacity limits, language barriers, geographical distances, etc. when calculating the total addressable market. The TAM shows a prospective investor what is potentially possible, if the company could grow into all segments of the market through appropriate additions to the product portfolio and business model.

Defining the industry

When defining the total addressable market, make sure that you clearly define the industry segment you operate in. In one of the most influential articles ever published in the Harvard Business Review, titled, Marketing Myopia, Theodore Levitt famously asked in 1960:

> What business are you in?

He concluded that many of the railroads were on the verge of going bankrupt because they mistakenly thought they were in the railroad business instead of in the transportation business. Similarly, for decades before the Internet disrupted newspapers, news magazines, radio, and television, journalists mistakenly thought they were in news business, instead of the information business. Then came the Internet and democratized information, thereby disrupting the news business. Journalists learned the hard way that, in reality, they were in the information business of advertising and information delivery, not in the news business. Hence, it is crucial to clearly define the industry your business operates in to reliably estimate the total addressable market.

TAM example

> Let's assume that you are in the fast-food restaurant business. Your TAM would be the worldwide fast food restaurant market. Potentially, if you were present in every country and had no competition you would generate TAM as revenues.

SAM

The SAM answers the question, "for which part of the TAM is our product appropriate?" The SAM describes the market that you can address with the current business model. It answers the question, what portion of the market participants will realistically buy the products or services, either from us or from someone else? In other words, which part of the TAM would realistically buy our products / services? It's important to understand that TAM is not a number of customers but rather dollars per year. SAM covers the willingness to pay - a key estimation metric. The SAM is important for investors because it shows the potential of the business idea in the medium term. The SAM is important for startup founders because it represents the target group for the product. The more precisely you define the SAM, the more efficient and effective will your sales and marketing efforts be. Unless you have a monopoly or unlimited financial resources (deep wallets), capturing 100% of the TAM is almost impossible.

Eliminate irrelevant market segments

The SAM is derived from the TAM by eliminating the market segments that the company cannot serve with the current product / service portfolio. Such exclusion may arise from a product-market misfit for some market segments, geographical delivery constraints, the company does not belong to the target market or because it does not have the ability to serve some market segments, etc. SOM is a good reminder that we need consider:

- Competition
- Geography
- Culture
- Regulations
- Financial limitations
- Willingness to pay
- Market cannibalization
- Resources

SAM example

> Reverting to the fast-food business example, assume that you want to start your restaurant in two cities. You estimate the demand for fast food based on population, food habits and the revenues generated by fast food restaurants in other cities

having similar demographics. That is your Serviceable Available Market: the demand for you type of products within your reach. In other words if you were the only fast food in town you would generate revenues of SAM.

SOM

The Servicable Obtainable Market or Share of Market is the part of the SAM that the business can realistically serve. The SOM answers the question, "What part of the SAM is realistic for our business model?" It also helps answer the question, "Who will buy the service from us?" In other words, SOM helps identify the part of the SAM that is most appropriate for our business model. Thus, the SOM shows which sales can be achieved by the business. The SOM is a subset of the SAM that is restricted by:

- Natural barriers such as distance or language
- Limited capacity, for example production capacity or marketing reach
- Loss of market share to competitors

Additional considerations

The following factors must be taken into account when calculating the SOM:

- The market segment that you can serve with the value proposition
- The market segment that you can reach with the marketing and distribution
- The current competitive situation
- The current production capacity

SOM example

Coming back to the fast-food restaurant example, you are probably not the only fast-food restaurant in town. Realistically you can hope to capture only a fraction of your SAM. You will most likely attract fast-food aficionados living or working close to your restaurants and a fraction of the people located further away that are willing to give your chain a try for the sake of fast-food diversity. This is your SOM.

Common errors

The SAM can also be staggered in phases. For example, a hardware rental business might plan to expand state by state. The more clearly you can differentiate TAM, SAM and SOM, the better. There are two common mistakes in estimating TAM, SAM and SOM. The first mistake is to simply define the SAM or SOM as a fraction of a very large TAM. It is commonly known as the 1% of all Chinese error because it begins as follows:

> If we could only get 1% of all Chinese to buy our product...

What is overlooked is that it is almost impossible to reach 1% of all Chinese with one offer. Jay Samit describes this mistake in the Wall Street Journal as follows:

> If every American only ate a hamburger made from rabbit meat (instead of beef) once a week, we could sell 12 billion rabbits every year.

The second mistake is a misunderstanding of the TAM. If a business makes women's hats, the TAM is not the three billion women on earth who have a head, but rather a significantly smaller percentage of women that wear hats.

Summary

Market sizing is indispensible for both, established businesses and startups. Especially, for startups, investors prefer an established model for estimating the market size, namely the TAM, SAM and SOM. Such standardization reduces the risk of misunderstanding, provides the data baseline for investors to evaluate a business opportunity, and articulates the short, mid and long-term growth potential. The SOM shows what can be achieved with the business idea in the short term. The SOM / SAM ratio describes the market share initially aimed for. Finally, the TAM shows the greatest possible market potential.