Understanding Bottom Up Market Sizing

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There are several factors that we at Armory Square Ventures (ASV) cover in the first initial meetings with an entrepreneur, but one that often seems to lead to confusion is the discussion of market sizing. Market sizing is significant not only from the perspective of how much revenue could you potentially generate, but also in consideration of an exit. If your company is generating $10 million in revenue and is operating within a Total Addressable Market (TAM) of $40 million, this is not a compelling case to indicate there is much further room for growth. Most venture-backed companies that are acquired are not bought on revenue but on growth, meaning that the company has been growing significantly year-over-year, and there is substantial room for continued growth for an acquirer. So how does one approach market sizing?

ASV typically looks to see a TAM of approx. $500 million. This does not mean that we expect to see revenues of this size but simply that if you were to sell your product or service to every potential customer, how big would that market be? Many entrepreneurs propose billion dollar market sizes, citing the latest annual industry spending information however, this can be misleading if the entrepreneur is unable to dissect what portion of that spend would actually potentially apply to their product or service. This top-down approach is certainly used but we instead ask every entrepreneur to apply a bottom-up approach, where they take their pricing methodology and, looking at the order of magnitude of their potential customers, complete a simple Price * Quantity to get their market size (note: this is often much easier for a B2B customer versus B2C, but not impossible for either one). Seems easy enough so long as you have figures which support the number of customers within your target market. So let's complete a quick example. (Note: none of the figures presented represent actual figures or industry pricing)

Let's consider a B2B SaaS solution providing electronic medical records services. Assuming the technology is targeted at private medical practices and the pricing structure is tiered as follows:

	Tier I (Large)	Tier II (Medium)	Tier III (Small)
Implementation Fee:	$50,000	$25,000	$10,000
Monthly Maintenance:	$5,000	$1,500	$500
Seats Included	50	25	10
Additional Per Seat Fee:	$50	$60	$75

Now let's assume there are approximately 30,000 offices in the United States broken out as follows:

- Large – 2,000 offices requiring on average 75 seats
- Medium – 8,000 offices requiring on average 35 seats
- Small – 20,000 offices requiring on average 15 seats

The basic market size calculation would be as follows:

- Annual Maintenance Fee Revenue:
    - Large: 2,000 * $5,000 * 12 = $120 million
    - Medium: 8,000 * $1,500 * 12 = $144 million
    - Small: 20,000 * $500 * 12 = $120 million

  Total $384 million
- Annual Per Seat Revenue:
    - Large: 2,000 * (75-50) * $50 * 12 = $30 million
    - Medium: 8,000 * (35-25) * $60 * 12 = $57.6 million
    - Small: 20,000 * (15-10) * $75 * 12 = $90 million

  Total $177.6 million

This business would have a TAM of $561.6 million.

ASV would ask an entrepreneur to undergo this exercise for several reasons. The first, as mentioned above is to highlight whether the opportunity is large enough to become a potential acquisition target. Second, an entrepreneur should know their target industry and customers at least as well as a potential investor and therefore, should be able to quickly provide and validate this number. It is important to note that an investor will conduct their own analysis of the market as well which leads to the third point, that the exercise provides insight to potential investors on how the management team thinks. If an entrepreneur is unable complete the exercise, it may signal to the investor that they need to more carefully examine the sales pipeline or that the founding management team needs to better define their sales strategy. Conversely, if the target customers include companies or organizations that would likely not use the product or service, then it may indicate the management team needs to spend more time understanding their target market.

In the end, understanding a company's true market potential from a bottom-up perspective is helpful for both an entrepreneur and a potential investor. It not only highlights the key revenue drivers of the business but also emphasizes opportunities to further expand the market as well as areas where a potential investor can add value through their own network and expertise.