Why Big Opportunities Crush Small Companies

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One topic that isn't discussed very much is how entrepreneurs should go about picking which market to target for their product/idea.

To frame our discussion, let's assume that there is a continuum (or spectrum if you will) of market that you could conceivably target. At one end (the left end) of the continuum is a very "vertical" (or focused) market. At this end, the number of potential customers is relatively small. At the other end of the continuum, which we will call "the horizontal market" the number of potential customers is relatively very large.

One of the most frequent mistakes that entrepreneurs make is to automatically think that a large potential market (i.e. the horizontal strategy) is better. The (flawed) reasoning goes something like this: "If I pick a broad market with millions of possible customers, my likelihood of finding X customers is much higher than if I had a very small potential market". The problem with this reasoning is not always obvious (if it were, fewer entrepreneurs would make this classic mistake).

Here are list of problems with the broad/horizontal (i.e. millions of potential customers) strategy:

1. It is difficult to figure out exactly what you need to build into your product because your potential customers are likely very different, and there are so many of them.

2. Large markets are interesting to a larger number of competitors (because it's a potentially lucrative market). These opportunities are particularly interesting to the really big players (like Microsoft, Google and Yahoo!). They're also tempting to the smaller players, because broad/horizontal markets are more fun and glamorous.

3. In a horizontal market, it is relatively difficult to actually *differentiate* your product from your competitors (i.e. the products that are able to successfully serve the larger market often are very similar). If you try to make your product different in meaningful ways (that are hard to replicate), you end up reducing the size of your market.

Any one of the above points on its own would likely make horizontal markets a somewhat risky approach. All of them *combined* result in a situation whereby picking the horizontal strategy will almost always end in failure. However, the horizontal market is just so *tempting* — (it's glamorous, big and venture-fundable.)

Lets look at an example: Let's say you were going to build a news reader application of some type (yes, I realize this has already been done a thousand times, but it's a good illustration and I can't think of a better example at this particular moment in time). You have two choices: You could build a generic news reader that would be useful to just about any of the billion or so people on the Internet today. Sure, you have some nifty ideas of how using mouse gestures and machine learning to make the product *better* than the existing readers, but effectively, you're building something that could be useful to millions of people. For discussion purposes, lets say you had an *actual* target market of 1,000,000.

Or, you could build an news reader that is very specialized, because it integrates with a large-scale financial services application, takes that data feed (via RSS) and aggregates with another proprietary system in the healthcare industry and provides an end result in RSS that can then be used as a part of yet another enterprise application for data visualization and price/capacity optimization (note: I'm making this all up). In fact, there are only 250 possible customers for this product on the entire planet (primarily because only 500 people even *understand* what the thing does, and only half of them can afford this specialized product).

Now, let's put aside price for a little while. We can assume you can charge much more (on a per customer basis) for the specialized product than you could for the non-specialized product. But, interestingly, I don't even *need* to use price to make my case. Let's say your goal is to get about fifty paying customers at whatever the price is. This is not your *ultimate* goal, just your initial goal. As it turns out, you are much more likely to get 50 customers out of the 250 in the "specialized/vertical" market than you are to get fifty out of the million people in the horizontal market.

So, why is it easier to get 50 out of 250 customers instead of 50 out of a 1,000,000 customers? Because the specialized market has the following benefits:

1. In the specialized market, you can *name* all of your possible customers. In fact, you could pick five of them and have a fair idea of what they would actually need. As such, your product is much easier to define.

2. You can *reach out* to just about all of your target customers. Heck, if you absolutely had to, you could fly out and visit all of them in person.

3. The likelihood of 10 other startups also going after precisely those same 250 customers with the same exact product as you is very low. The likelihood that Microsoft, Google or another large competitor will go after those same 250 customers with a near-identical product is near zero.

So, even though you are trying to capture 20% market share in one case (where you have 250 potential customers) and only 0.005% in the broader market, you're *much* more likely to succeed at the former. Now, the really important part is this:

> "Even though you target just those few potential customers *today* there is no law that says you are limited to those customers for eternity."

If you just so happen to actually get 50 of those customers, you can later explore other markets, broaden the product offering and see what other "pools" of potential customers might be out there.

In fact, the next pool might be even easier than the first pool because now you have credibility, resources, knowledge and customers.

Dharmesh's Rule of Thumb #1: In almost all cases, self-funded entrepreneurs should pursue smaller, addressable markets. The probability of early success is inversely proportional to the size of the initial market.

If you don't have early success, the size of your potential market is irrelevant anyways, because you're out of the game. Do not pass GO, do not collect $200.

Now, if you're determined to raise venture capital as an early, first-time entrepreneur (may the force be with you), then it's a *whole different story* and a completely different game.

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