Prism / 1 / 2010

Overcoming the real barriers to entry into adjacent markets

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Moving into adjacent markets is a common step among companies that have grown as much as they can in their home markets and wish to sustain high growth rates. However, many companies underestimate the difficulties involved, and the historical record is littered with cases of otherwise successful companies failing in adjacent markets. We explore the questions that companies considering adjacent entry need to ask and show what they should do to ensure success in making this promising but difficult step.

Within a few years of the development of his infant formula, Henri Nestlé embarked on an expansion strategy outside his home market of Switzerland and into a myriad of new product markets that would eventually make Nestlé S.A. the largest food company in the world. Today such diversification into adjacent geographic or product markets rather than pursuing further expansion on familiar turf is still a favorite vehicle of market leaders that wish to sustain high growth rates.

This makes perfect sense. For one thing, attempting further growth in the home market may prove futile because of the finite size of the market combined with the inevitable, often margin-destroying battle for market share that results. For another, the very nature of market leadership implies that a company has established some core competences, which provide the company with a competitive advantage in that market. The logical next step to accelerate growth is to identify adjacent markets where these very competences may be successfully applied. The term "adjacent" (as opposed to "new") refers to the similarity to the home market either in geographic or product terms.

One should not, however, underestimate the complexity of making reliable business plans for entering into adjacent markets. And for good reasons. The historical record of otherwise successful companies in their home markets entering into adjacent markets is littered with numerous and often spectacular failures. Some examples:

- US retail giant Wal-Mart entered South Korea in 1998 only to be forced to exit eight years later. Two months after that, the company withdrew from Germany with a US$1 billion loss following the sale of all its German stores.

- Egg, the world's largest online bank, now owned by Citi, launched La Carte Egg in France in mid-2002, capitalizing on its initial success in the UK. However, despite

investing heavily in the French market, Egg decided to close its loss-making French operations in 2004.

- McDonald's wanted to get a slice of the pizza business but failed to convince consumers of its credibility in this new category, even though there seemed to be no reason to fault McDonald's executives for pursuing the strategy on the basis that they were not in hamburgers but in fast food.

The ability to leverage core competences and to identify attractive adjacent markets is alone no guarantee of success. Experience reveals that companies considering adjacent entry need to address a number of critical questions first. This article explores what those questions are and what companies should do to address them in order to ensure success.

Answering these questions correctly will be even more important in the "new normal", where home markets are expected to grow more slowly, increasing the pressure to tap into other markets, and where tolerance of failure will diminish with the increasing cost of capital.

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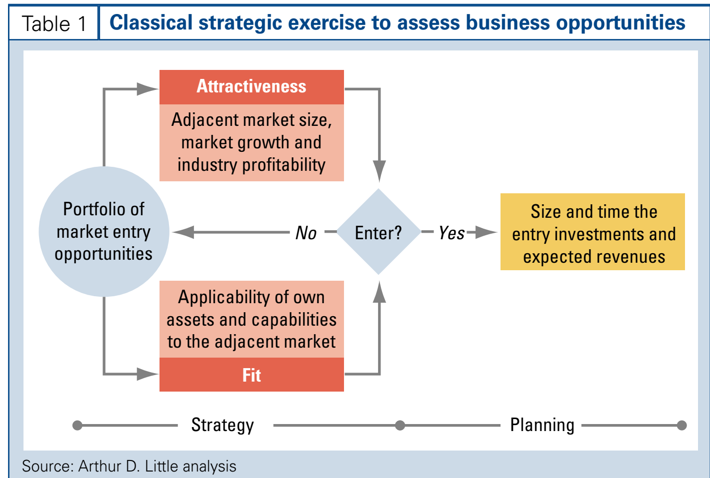
The shortcomings of an overall market assessment

A company's decision to enter an adjacent market is often the result of a classical strategic exercise in which it assesses alternative business opportunities in terms of attractiveness and fit (see Table 1). "Attractiveness" is measured by factors such as market size, market growth and profitability of the incumbents. "Fit" is related to the applicability of the company's home market assets and capabilities to the adjacent market. The opportunity that scores high on both criteria is awarded a "Go". The next step is to convert the decision into a business plan with more accurate estimates of investments and revenues.

It sounds straightforward, but time and again we find that companies fail in their efforts to make reliable business plan estimates for entry into adjacent markets. The business plan typically grossly overestimates both the attainable market share and the speed with which they can win

Table 1 **Classical strategic exercise to assess business opportunities**



Source: Arthur D. Little analysis

it. The reason is that companies with strong capabilities in one market tend to make overly optimistic assumptions about the transferability of their unique assets and capabilities to other, "similar" markets. This leads to unmet expectations and wasted investments, not to mention failed careers.

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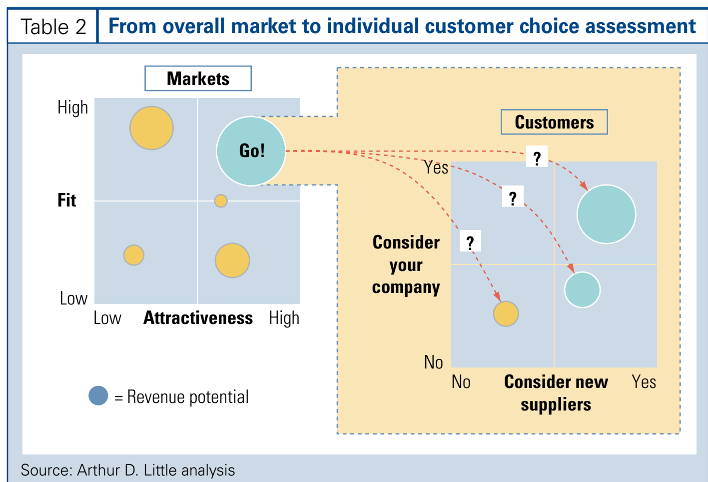
In our experience there are two primary reasons for such failures. First, many companies simply do not allow enough time and effort for objective assessment of the volume and share that they can expect to attain in the adjacent market. Companies tend to identify a target market and then focus their attention on what is often an exaggerated vision of their place in it, including their desired market share. There's nothing wrong with visions and the like, but the reality of the market place reveals that it is not what a company wants to achieve that will drive its revenue stream but what it can achieve. And what it can achieve is ultimately driven by customer choices. These customer choices may be influenced by sales and marketing efforts, but it is the customer who ultimately makes the choice whether to buy or not to buy and hence determines the total revenue potential of a company.

A second reason for failure stems from the tendency to overlook or underestimate the real barriers to entering a particular market. Companies tend to look at the standard list of barriers to entry, such as lack of scale economies,

financial capabilities or technological advantage, to name a few. Yet the barriers that are frequently overlooked and, in our experience, the most important ones, are those associated with customer choices: how to convince an individual customer firstly to abandon a current supplier and secondly to buy your products?

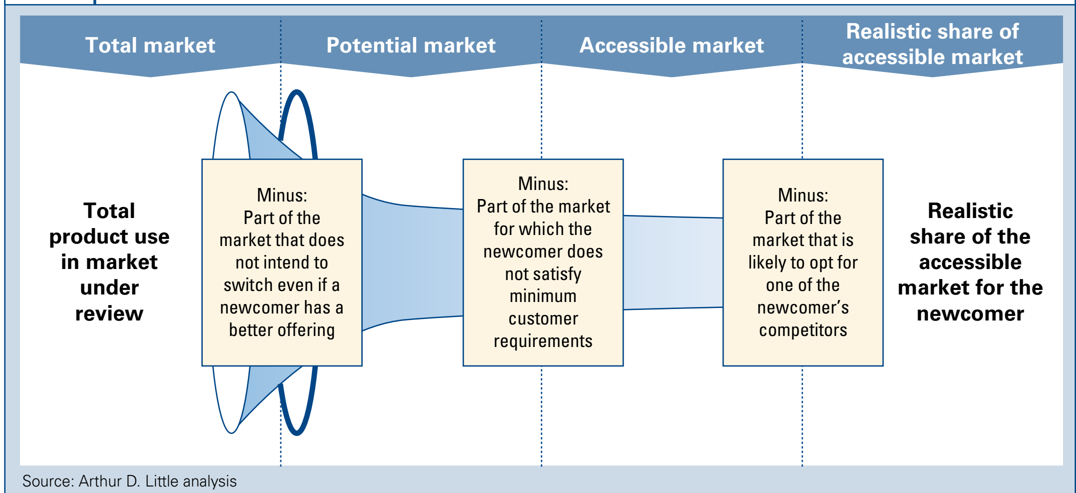
As Table 2 shows, once a company has made an accurate assessment of individual customer choices, it may find that the opportunity that received a compelling "Go" in the strategic exercise ultimately has a much reduced revenue potential, even to the point that the initial "Go" decision may have to be reversed.

Table 2 | **From overall market to individual customer choice assessment**



Source: Arthur D. Little analysis

Table 3 **Steps to estimate a newcomer's attainable share of an existing market**



Source: Arthur D. Little analysis

Four steps to a reliable business plan

Ignoring those customer choices and convincing yourself that you will be able to generate an acceptable market share is, of course, not enough. What is critical is to understand how your target customers will behave. The question is not whether you have a good product or service to offer to a new market. Without that, there is not even a chance of success. Instead, the question that must be answered is why customers would want to buy or switch to your product or service. Once you have answered that satisfactorily, the next step is to identify cost-effective ways to increase the number of customers who want to do so.
An adjacent market can be very sizeable and offer a potentially strong strategic fit. Yet the realistic share that a newcomer can expect to obtain may still be minimal. Table 3 shows the steps that a newcomer needs to take to estimate accurately its expected share from the total market, which can be used as a foundation for the top-line estimation in its business plan.

1. Total market: Identify the number of customers

The total market is the total number of customers that will buy specific goods or services in the foreseeable future (i.e., the selected planning horizon for measuring the success of the entry strategy). For instance, this could be the

total number of customers that will buy a certain type of industrial machinery over the next three years. The total market size roughly equals the current market size times the expected growth rate of the market.

Estimating the total market size is typically the domain of market research, where large samples are used to understand both the size and the growth rate. For a major adjacent market entry decision, companies may be tempted to spend time and money on improving the accuracy of these total market size or growth rate estimates. However, such an effort will provide only marginally useful additional information, which is not nearly as beneficial as spending effort on the critical steps below.

2. From total to potential market: Identify who actually considers new suppliers

What is critical is to understand how your target customers will behave. The question is not whether you have a good product or service to offer to a new market. Without that, there is not even a chance of success. Instead, the question that must be answered is why customers would want to buy or switch to your product or service.

Of all customers in the total market, only a fraction (the potential market) would consider switching to a new supplier in the planning horizon, even where the alternative supplier claims to have a superior offering. Typical reasons for being unreceptive to new suppliers include being either locked in or sufficiently satisfied with their current supplier, or that the value at stake is relatively small in comparison to other purchases and therefore does not merit the consideration of alternatives.

For example, we recently worked for a large European B2B services provider, which found that the potential market amounted to only a small share of the total market; in fact, it was estimated to be less than one-third. The main reason was the high switching costs for their potential clients, because changing supplier would imply the replacement of the client's IT system and the cancellation of existing contracts, incurring exit fees.

Likewise, another company we worked for, a supplier of superior small hospital accessories, discovered that most hospitals showed little interest in even considering switching from their existing suppliers, let alone actually completing the switch. Why would a hospital consider switching to an alternative supplier of low-budget accessories when the total cost of these accessories is only a

fraction of the cost of a big-ticket item such as a new CT scanner?

Understanding the size of the potential market is critically important as a first filter to a company's ambitions. For instance, if the potential market is about 30 % of the total market in a given year and that total market is not growing phenomenally, then an ambition of 10 % market share roughly boils down to believing that the company would be able to capture one third of the market that is receptive to switching from incumbent suppliers. This is clearly a daunting figure, particularly when the newcomer has little reputation in the new market.

3. From potential to accessible market: Identify customer-specific entry barriers

Suppose for a moment that the potential market is deemed sufficiently large to merit continuing the investigation of your company's share and revenue potential. The key question now is whether your company will be considered as a possible supplier by customers in the potential market.

The answer to this hinges on a number of criteria. First, your company's offer must be able to satisfy all the customer's technical requirements. At first sight, this does not appear to be an issue. If your company is the market leader at home, in all likelihood it possesses a number of unique assets and capabilities that provide more value to your customers than your competitors do. However, evidence from a wide variety of service and product industries reveals that this does not guarantee that customers in the adjacent market will be willing to consider you as a viable supplier. The critical reason for this is that in many cases entry barriers exist at the individual customer level.

These barriers often have nothing to do with traditional barriers such as learning curve, economies of scale or financial capabilities. Rather, they are related to very specific requirements at the individual customer level that established firms can provide and newcomers frequently cannot. Understanding these barriers is critical, as the following examples illustrate.

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The aforementioned B2B services provider had a home market share of around 40 %. It found that it could easily satisfy all the technical requirements of customers in a neighboring market. However, customers in the new market demanded additional reassurance of its capabilities before they would consider the company as a potential supplier. Having reference clients in the adjacent market would provide that reassurance, but this condition could obviously not be met. The solution to this challenge could be to target customers that do not require such reference clients.

This is more easily said than done. Intelligent market research showed that there was no single customer in the potential market willing to consider the newcomer as a provider without reference clients. In other words, whereas traditional barriers were minimal, at least for an entrant of this caliber, customer-specific entry barriers were 100 %, effectively closing the market to the newcomer.

Furthermore, even if the newcomer had obtained one reference client, the research revealed that only 9 % of the potential market would have even considered the company. In total market terms, this is 9 % of 30 %, or less than 3 % of the total market. All in all, to bring the accessible market to 90 % of the potential market, the company would have to obtain 10 reference clients with more than 1,000 employees each. It's a Catch-22: to have a chance to be considered by customers, you must first have a number of reference customers, which you can only get if you have a number of customers to begin with.

Statistics like these appear again and again, not only when preparing an entry strategy into adjacent geographical markets but also in entry strategies into related product markets within the same geographic area. For example, we worked for an established and well-known player in industrial machinery that wanted to enter the market for a related product line sold primarily to customers working with different types of fluids, such as corrosive or dangerous liquids. Again, it turned out that the lack of experience with clients using the same fluid was a formidable customer-specific barrier. The potential newcomer did not have that experience.

First, before planning to enter such markets, invest in understanding customer behavior and likelihood of switching to your company. Second, use the information on customer entry barriers as key inputs for strategic investment decisions.

The above examples illustrate two critical points. First, before planning to enter such markets, invest in understanding customer behavior and likelihood of switching to your company. An accurate understanding of the associated volume and (later) revenue stream should inform the resource investments needed to enter the market place. Compare this to the approach in any of the examples above, where one would have started with "reasonable revenue and share forecasts" (e.g. 10 or 20 % market share within three years). Such an approach would have resulted in significant overinvestment in human and physical resources that, at least in the first few years, would have remained largely idle.

Second, use the information on customer entry barriers as key inputs for strategic investment decisions. The B2B service company mentioned above, for example, made investment decisions intended to attract reference clients. It offered the product for free initially, attracting a number of clients willing to try it out and serve as reference clients later.

4. From accessible market to realistic market share: Evaluate the revenue potential of various product options

Once identified, some customer-specific entry barriers can be overcome by means of tailored investments. The critical question is to determine what to offer in order to attract a customer in this accessible market. Receptive customers will typically experience some form of "switching cost". To attract these customers it will be necessary to provide an offer that delivers higher perceived value than they currently obtain or that their best alternative can generate, plus switching costs. Switching costs can be substantial, even when the products of the current and the alternative supplier are the same. For instance, at a service provider of private networks we found that switching from one private network supplier to another entailed significant switching costs to a number of customers, comprising two components: (1) the monetary costs of running two systems in parallel for a few months, which could be avoided by remaining with the current supplier; (2) the time, effort

and potential associated with making an internal case for switching to an alternative supplier.

It is, therefore, essential to understand what features or different combinations of features (including price) would make a customer switch. For some customers, a slight improvement in a product feature is sufficient. For others, it may be a particular combination of service improvements. For some customers of the above private network service provider, it could, for instance, be a broadening of the service window from, say, 8 am to 8 pm (offered by the competitor) to 24 hours for the entrant. Importantly, what is needed to make a customer switch differs from cus-

Holland Bikes takes on France

Holland Bikes is a leading distributor of city bikes from Holland. In 2000 it identified the French market as being very attractive and having a potentially good fit with its assets and capabilities. It studied the market for more than two years, talking to more than 200 independent French dealers, and then devoted three years to preparing the ground. It created local awareness and experience. It developed understanding of how customers approach the product and adapted the product and promotional language accordingly. It trained the entire chain of people within the company so that they would be familiar with the new local culture and working habits, overcome customer-related entry barriers and convince the first dealers to switch to Holland Bikes. Today, Holland Bikes is one of the leading distributors of city bikes in France, sold through more than 300 dealers and 12 of its own shops. As Bart Vos, CEO, explains: "Even though this move seemed straightforward and easy in the eyes of many - we had the right product and the right market - entering the French market is more than just getting the classical 4Ps right. Two additional Ps tend to be overlooked when entering a new market: "People" and "Patience", which are key elements in overcoming customer-related entry barriers. The best evidence of that are the many other city bike manufacturers and distributors from Holland who tried entering the French market without success."

tomer to customer, particularly when the market consists of a number of customer segments. This generally results in the identification of several feasible offers that would convince some customers to switch suppliers.

Using in-depth indifference analysis to understand customer switching

The process described above allows companies to move away from internal wish-driven and typically hockey-stick-shaped revenue forecasts to reliable revenue forecasts that are based upon customer choices. Using good customer data and a representative sample of customers, understanding the revenue potential ultimately requires companies to do the following:

- Derive the percentage of customers in the sample that would switch to each of the feasible offers (including price) and extrapolate this in a statistically correct way to the total market, taking into consideration the possible under- or over-representation of certain segments.
- Estimate competitor incentives, capabilities and speed of imitation for each of the proposed offerings and refine the above forecasts accordingly. Competitor imitation may prevent switching from taking place.
- Derive the selected offering from those offerings that can be forecast to generate the highest commercial return over the planning horizon. Also derive the correct entry price points.
- Identify an appropriate USP and design the most effective communication plan aimed at the customer at all levels of the organization.

The information required to do the above must be gathered through in-depth interactive interviews with economic buyers. At the core of these interviews is an accurate and systematic approach to identify what or which combination of factors precisely drives different customers to switch (see insert).

CAMM is a method of making accurate quantitative estimates of customers' switching behavior and, ultimately, willingness to pay, particularly in a B2B environment.

The CAMM approach

To understand customer switching and ultimately which products and services to bring to the market in line with the entrant's capabilities, Arthur D. Little uses its proprietary CAMM approach (the Customer Attribute Management Method). CAMM is a method of making accurate quantitative estimates of customers' switching behavior and, ultimately, willingness to pay, particularly in a B2B environment. The method is of particular value where the benefits of the product or service features to the customer are not necessarily measurable by the entrant. It also gives accurate forecasts of customers' and segments' buying behavior.

The method relies on putting a sample of customers into situations where they must make a choice between two options, and making these choices increasingly difficult until the customer can no longer choose. Forcing customers to such indifference has two important benefits. Firstly, it allows them to discover and express their own, often unknown preferences. Secondly, unlike any other method (choice-based or not), the CAMM method generates the exact point at which a customer will switch from one option to another and provides the information critical to understanding what it takes to attract customers.

Ultimately, the method allows the entrant to estimate demand for any feasible combination of its product and service offering, within the entrant's immediate or stretched capabilities. Product and service packages and prices can then be determined on the basis of the tradeoff between the revenues forecast by CAMM and costs.

Insights for the executive

Leadership and commercial success in one's home market are in no way guarantees that the same success can be replicated in adjacent product or geographic markets. Market share performance in the first few years after entry may only be a tiny fraction of the envisioned performance, and outright failure is also possible. Such major setbacks are not unusual, even in situations where a company's core assets and capabilities are transferable to the adjacent market or traditional entry barriers into the market could be overcome. There are three main reasons for this:

- The potential market size is much smaller than predicted, as many customers in the adjacent market will not consider switching suppliers.
- Often formidable non-traditional entry barriers exist at the customer level that exclude new entrants.
- A number of prospective customers have significant switching costs that are difficult to offset by offering superior value in a way that cannot be emulated by their current suppliers.

To radically improve the reliability of your business plan for market entry and increase your chances of success, or, conversely, to minimize the effect of chance in adjacent market entry, it is critical to:

- Gather hard evidence-based customer choice information to form the basis for market share forecasts.
- Devote the time and effort necessary to accurately assess the share of the market that is not voluntarily or involuntarily bound by existing supplier agreements.
- Identify the different entry barriers at the individual customer level.
- Take action based upon the customer-specific evidence to overcome identified barriers before undertaking the definition of any general USPs.

- Understand and analyze the various options within your capabilities that could persuade a meaningful portion of customers to switch to your company and, again, do so in an evidence-based manner.

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