

How to calculate your total addressable market and make a great TAM slide for investors

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I've seen hundreds of startup pitch decks in my time at Matrix, and have found total addressable market (TAM) slides to be among the most frequently mis-executed. I get the sense they are often included as a formality in an attempt to get VCs to check a mental box and continue on hearing about other important things: the product, the team, the progress, the go-to-market, etc.

In this piece, I'm going to walk through the importance of thinking through TAM in a structured way, and present some ideas on how a more thoughtful TAM analysis and slide can improve a startup's pitch as well as its business decisions.

What is TAM in the first place?

To answer this question, we need to start with what a TAM analysis is for. Simply put, investors (and smart management teams) use TAM analyses in an attempt to identify gating factors on the growth of a startup over time. At Matrix, we're transparently looking to invest in companies that can one day become billion dollar businesses, and we see many pitches where the founder simply isn't targeting a market big enough to get there and doesn't have a plan to do so. A TAM slide's role in a pitch deck is to convince investors that the company is chasing an opportunity big enough to achieve venture-scale returns with the right execution.

In the very best pitches, founders use their TAM slides to show insights into how they think about the market they are serving, the extent of their product-market-fit and their product roadmap. The goal of this piece is to help build a slide that accomplishes these goals and elevates the TAM conversation from a throwaway slide to a positive contributor to the pitch and discussions that follow.

Three ways to calculate TAM

There are three distinct ways to calculate TAM:

1. Top-down, using industry research and reports.
2. Bottom-up, using data from early selling efforts.
3. Value theory, using conjecture about buyer willingness to pay.

Let's discuss each in turn, using examples to help keep things relatable.

1) Top down, which takes the form of "according to Gartner, this is a \$Xbn market by 2022" or "we serve potato farmers, a \$40bn industry." This is by far my least favorite way to frame a TAM discussion. It contains remarkably little information, and relies on my faith in the analysts at Gartner. They're smart people, but market sizing is hard and often reliant on self-reported data or difficult-to-make estimates about the revenue of private companies. In cases where there are mixed pricing models (consider a software segment transitioning from license to SaaS pricing), the analysis can be confounded further. When a founder presents a number taken from a Gartner report, the default presumption is that they did some Googling in the midst of the deck-building process and found a number big enough to get the job done.

There is another major pitfall here: it assumes that the company's disruptive product won't change the size of the TAM meaningfully. Too many pitches use industry TAM numbers, then boast about undercutting the pricing of incumbents by 50% or more. Consider if you saw a pitch for an online encyclopedia in 1999, and sales of physical encyclopedias were used to frame the TAM. In reality, online encyclopedias shrunk that TAM meaningfully.

Or on the flip side, consider the case of Uber. Cabs and car services were the incumbents: assuming that this captured the extent of the TAM (a mistake Uber's founders made, ironically) would miss the fact that a superior product could dramatically increase usage and revenue for the whole "chauffeured rides" category.

2) Bottom-up, which takes the form of "here's how we price and how many units of that price we can sell." This is a much better option than #1, because it involves tangible, relatable data on current pricing/usage of the product and imagines a larger customer base. A software startup successfully selling human capital management software at \$20 per employee per month might reasonably take the number of employees in its target market and multiply that by pricing to estimate its TAM.

You can probably see where this is going: in the ideal case, the company is able to carefully explain why certain categories of companies will use its solution, excluding those that aren't likely to. For example, a mid-market provider might use employment statistics to find how many employees work at firms between 100-5,000 employees, and then adjust for blue/white collar mix if it predominately sells to white-collar firms.

This turns the TAM discussion from a simple statement of industry size into a much more interesting discussion: *breadth of potential product market fit*. Instead of an irrefutable statistic, the TAM number is built up with assumptions about which types of customers the company can serve and win. For example, a company might describe the breadth of its current customer base in terms of industries and geographies as evidence that the product works broadly, and then cite how the product roadmap will gradually take it up-market or into new verticals, each with a corresponding TAM estimate.

In Uber's case, the company might have used early data from San Francisco to show how diverse its ridership was and estimated total long term potential ridership and rides/user based on early usage rates. Assumptions on top of assumptions, but nonetheless valuable things to think through as the company expands. For example, if Uber could show with some survey work that its early customers were using the product more than they had ever used cabs, it would have a credible argument that its eventual TAM could be larger than that of the incumbents.

3) Value-theory, which takes the form of "here's how much value we can add, and why we'll be able to capture it." This is where things become more of a dark art, but are nonetheless useful. A value-theory TAM relies on an estimate of the value provided to a set of users by the product, as well as a guess at how much of that value creation can be captured through pricing.

Here's how we might estimate Uber's TAM using value. We'd consider the use case, transportation, in which users choose between alternatives including staying put, walking, public transportation, biking, taking a taxi or driving themselves. Notice that Uber has the potential to draw from ALL of these buckets, and indeed it seems to. We might look at transportation data and ask the theoretical question: "how much would a user pay to be driven instead of X?" and solve for a number. Next, we need an argument for how much of that value unlock we can capture with price. If a startup sells a soon-to-be-commoditized product that adds a ton of economic value, it may struggle to capture that value and see the benefits accrue to customers.

This approach often comes to the fore when companies are considering expanding their core product and cross-selling into existing customers as part of a long term strategy. Many pitches include some version of this, implicitly or otherwise, because big parts of the product are yet to be built. What is helpful is that this approach helps management teams show that they are thoughtful about *what customers find valuable and are willing to pay for*.

In the pitch

Unsurprisingly, I strongly recommend founders use frameworks #2 or #3 and turn their TAM slide from a set of meaningless numbers into a structured model for the potential future scale of the business. Even if the VC you're pitching waves past it, convinced the TAM is large enough, you'll look better for having done the work, and you'll be able to talk more intelligently about the product roadmap (feature ABC will help us sell to these customers, features X, Y & Z open up a new vertical, and so on).

Of course, we know that over time TAMs and plans change and that startup decks are often an almost silly attempt to predict the future, which is why we place so much emphasis on backing great teams. Demonstrating an intelligent approach to thinking about the potential future size of the business is a great way to provide proof-points that a team has what it takes to guide a company to epic scale: ambition, smarts and the ability to identify markets where there is customer willingness to pay for a better solution.

Read on

As part of research for this post, I put together a set of TAM slides from the pitches successful early stage companies including Facebook, Airbnb, Uber and YouTube. Most of them didn't follow the advice in this piece, but they are still great perspectives on how future giants saw themselves in their earliest days. Check them out here:

<https://www.sleeperthoughts.com/single-post/TAMSlides>

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