Understanding Markets

Introduction

This part of the BUSS1 course requires you to focus on the place where a start-up business must compete; the place where buyers and sellers come together.□ We□re talking about the **market.**

Quite simply, a new business is bound to fail unless it has a reasonable understanding of its **target market.**□ What does the new business need to understand?□

? The needs and wants of customers, and how these differ

? The **buying behaviour** of customers □ why, what and how they buy

? The ways in which a market is split up into different parts to serve different customer needs □ these are known as **market segments**

? The nature of demand in the market □ how are prices set & the factors that influence the quantity of demand

? The size and growth rate of the overall market and its segments

? The proportion of market demand that is already taken by competitors □ an important concept known as **market share**

As you can see, there is a lot to understand! However, this is a really important area in BUSS1, so take time to work through each part of this section.

Defining a market

Let□s start with a definition:

A market is anywhere where buyers and sellers come together to transact with each other.

The traditional image of a market is a **physical place** where buyers and sellers come together in one place. This still happens, of course.□ Take a drive along any main road on a Sunday and you will come across car boot sales □ the classic example of a physical market in action.□ The UK has many towns that are referred to as □market towns□, so-called because they host a town-centre market on regular dates throughout the year.

However, the term market has a much wider relevance when it comes to business studies.□ A market exists whenever buyers and sellers come together.□ So you should appreciate that the buyer and seller don□t have to be in the same place in order to conduct transactions with each other.

Do you sell or buy items on EBay?□ Have you bought products from Amazon.co.uk, bought tracks from iTunes?□ Have you bought something from a catalogue by making a phone call?□ In all these examples, you have participated in a market, although you were not physically with the other party to the transaction!

So, there are many different kinds of market.□ The BUSS1 specification requires that you understand how the variety of market types can be categorised.□ Here is a summary of the main market categories:

Geographical markets

The two main categories of geographical markets (from the point of view of a start-up) are:

Local markets ***Definition:*** Where customers are a short distance from suppliers	Common for the sale of fresh and locally-sourced products and the delivery of locally-supplied services. The car boot sale is a great example of a local product market.□ The use of local services (e.g. franchise operations, hairdressers) is another good example.□ Your local high street or retail park is another example, where consumer goods are sold to people who tend to live pretty close. Businesses operating in local markets enjoy several advantages. They are physically closer to their customers, so are better placed to understand local cultural issues and traditions.□ It is also easier to develop relationships with local customers, to engage in market research and to respond quickly to changes in the market. The main downside to operating in local markets is that the market size may be relatively small.
National markets ***Definition:*** A market where customers are spread throughout the country or over a large area	National markets are very common in the UK. Here, the same product or service is offered to customers who are spread around the country. A business may have several (or many) locations in the country in order to reach those customers. One way to illustrate this is to think of businesses that seem to be everywhere as you travel round the UK.□ For example, you□ll see BT phone vans, BSkyB satellite dishes, Tescos, McDonalds and Subway branches in just about every town and city in the UK.□ These businesses are operating in national markets □ e.g. the markets for telephones, television, groceries and fast food. However, you will notice from the examples given that businesses which are national in terms of the scope of their operations are definitely not small businesses!□ Your BUSS1 case study business in the exam is very unlikely to be so large or complex. Another way to think of a national market is in terms of the total sales of a product or service across the country.□ For example, the total demand for greetings cards, jams or loft conversions.□ A start-up or small business can be focused on a national market, although it is likely that it will have a very small share of the market.

Physical and electronic markets

We have touched on these two categories already.

A physical market brings buyers and sellers together in the same location. We've already mentioned car boot sales and markets in town centres. Farmers' markets are another good example.

A much larger number of markets are now electronic. Businesses find their customers using a variety of electronic media, including the Internet, mobile telephony, digital television and via email. Transactions are completed electronically with the delivery method depending on the nature of the product sold.

Both physical and electronic markets are important to start-ups and small businesses. For example, Fraser Doherty started his Superjam business by selling his homemade jams at farmers markets and then promoting them in the aisles of supermarkets. By contrast, Nick Jenkins' specialist greetings card business Moonpig has always relied on using electronic markets, building sales by running a specialist website.

The key points to remember about electronic markets are that:

They provide an easier way for start-ups to enter a national market, particularly if the business has identified a small niche segment of that market

Electronic markets tend to be highly **price-competitive** since it is quite easy for customers to search for products from a variety of suppliers and to compare the best prices available (just about every consumer goods market has one or more price comparison website).

Setting up a new business in an electronic market tends to have lower start-up costs than entering a physical market.

Factors affecting demand

As we mentioned in the introduction, it is important that a start-up business understands the nature of demand for its products, and how demand can be affected by certain factors.

Many of the concepts covered in this section are drawn from the world of economics. However, don't worry if you are not studying economics. We can keep the theory quite simple!

The main factors that affect demand can be summarised as follows:

Price

The most important factor, particularly in any market when customers are **price-sensitive**. As the price of a product increases, the demand for it will usually fall. The extent to which this happens is known as the **price elasticity of demand** (which you will study in more detail in BUSS2). If the product has no close competitors or consumers find it hard to substitute it for other products, then an increase in price will have relatively little effect on demand.

Like all businesses, a start-up needs to remember that the price of a product or service is often seen as a signal of value for money or quality by customers. A higher price might put some customers off who don't perceive it as good value for money compared with cheaper alternatives. Conversely, a product priced too cheaply might deter customers who associate low prices with poor quality!

Setting prices is, therefore, a tough task for any start-up. There is no magic formula, although market research can quickly tell the business whether its prices are out of line with the competition.

Incomes

Demand for most products and services is closely related to the disposable incomes of customers.□ The more that households and businesses have to spend, the more they are likely to demand!

A key measure of incomes in the economy is Gross Domestic Product (GDP) which is the main measure of economic growth.□ As an economy grows (an increase in GDP), consumers have higher incomes and translate this into greater demand for products and services.□ In contrast, a weaker economy where GDP is falling, should lead to lower demand.

However, the link between GDP and demand is not quite as clear-cut as you might think. If consumer incomes are rising, they may decide to demand more luxury or higher-priced goods at the expense of basic or lower-priced goods.□ Alternatively, as the economy weakens, consumers may switch demand towards goods which have low or □value for money□ prices, at the expense of more expensive products.□ We have seen this happening in the UK recently as consumers have moved spent more in the discount grocery chains such as Aldi and Lidl, as a result of the □credit crunch□.

Tastes and fashions

As a consumer, what you buy is often influenced by your tastes and interests and by what is fashionable. Consumer product markets are particularly influenced by changes in fashion.

The main issue for a start-up business is to consider whether demand in the target market is likely to be strong enough, for long enough!□ The danger is that investment in starting a new business in a fashionable market segment may be completed at a time when demand starts to fall as consumers move onto a different market.□□ Fashionable products quickly attract new entrants which reduces the available sales and profits.

A good example would be the coffee bar market in the UK.□ Ten years ago there were relatively few coffee shops and a start-up would have a good chance of establishing itself in the market (either locally or nationally).□ However, the market is now saturated with competitors, making it very difficult for a start-up entering the industry now.

Competitor actions

It is rare that a business has a market all to itself!□ The demand for a product or service will be directly affected by the actions of competitors in the market.□ This is all part of the game of capturing market share.

A start-up entering a market should expect a hostile response from existing competitors.□ They may decide to lower their prices or offer other promotions in order to retain their customers.□ They may launch new and improved versions of their products to counter the new entrant.□ Alternatively, a competitor may copy the approach taken by the start-up, particularly if it is innovative and popular with customers.

The opposite is also true.□ A competitor may decide to leave a market segment in order to concentrate on other activities.□ This will increase the share of demand available to businesses that remain in the market.

Social and demographic factors

Social and demographic factors related to the changes that take place in society and the population which influence demand.□ Some examples will help make the point.□ In the UK recently we□ve seen:

? An increase in single-person households

? Growth in the number of affluent, retired people

? Increased awareness of, and interest in the environment

? Higher immigration into the UK, particularly from the enlarged European Union

? Greater consumer demand for organic products and for businesses based around social enterprise

There are many more social changes. The point is that each affects what and how much is demanded by customers.

Seasonal factors

In some markets, demand changes depending the time of the year.

Some markets traditionally experience peaks in demand during the summer - for example tour operators focusing on family holidays, ice-cream manufacturers and visitor attractions. Others see peak demand in the autumn and winter – e.g. distributors of heating supplies, retailers that rely on the Christmas trade.

The key point about seasonal factors is that the start-up or small business needs to understand which seasonal factors are relevant to the market they are in. There is little they can do to avoid seasonal peaks and troughs in demand, but knowledge of them certainly helps business planning (e.g. allowing for them in any monthly cash flow forecasts).

Government action

Changes in legislation and government regulation can certainly affect demand.

Some legislative changes have the effect of reducing demand in certain markets. A great example is the introduction of the ban on smoking in public places. This has reduced demand (spending) in traditional pubs, although it was expected to result in increased demand for eating out at pubs and restaurants. Actually, the evidence to-date is that there hasn't been an increase in customers visiting smoke-free pubs for a meal!

Some legislative changes are designed to de-regulate a market, which should have the effect of increasing demand. For example, the de-regulation of certain betting and gaming laws in the UK initially had the effect of increasing visitors to bingo clubs. However, the growth in online bingo has had an opposite effect, reducing demand (the number of people who come to the club and the average amount that they spend there).

A key point to remember about changes to demand caused by government action is that there is nothing a business can do about it! It is outside the control of the entrepreneur. The trick is for the entrepreneur to be aware of recent or pending changes and to have taken account of them in business planning.

Introduction to market segmentation

Market segmentation was mentioned in our section on how entrepreneurs conduct market research. We pointed out how important it is for a start-up to have a clear sense of its target market and how, ideally, the start-up should aim to establish the business in a **niche market segment.**

So what is segmentation all about?

Markets consist of customers with similar needs. For example, consider the wide variety of markets that exist to meet the need to:

- Eat (e.g. restaurants, fast food)
- Drink (e.g. coffee bars, pubs & clubs)
- Travel (for business and leisure, near or far)
- Socialise (as couples, with family, with friends)
- Be educated (as a child, adult, for work or other reasons)

As you can imagine, such markets (if they were not further divided) would be very broad.

The great news for any business is that **customers in any broad market are not the same.** For example, within the market to provide meals, customers differ in the:

- Benefits they want
- Amount they are able to or willing to pay
- Media (e.g. television, newspapers, and magazines) they see
- Quantities they buy
- Time and place that they buy

It therefore makes sense for businesses to divide (or segment) the overall market and to target specific segments of a market so that they can design and deliver more relevant products and services

A market segment can be defined as follows:

A part of a market which exists to serve a group of customers with specific needs and wants.

The process of segmentation involves subdividing markets, channels or customers into groups with different needs, to deliver tailored propositions which meet these needs as precisely as possible.

Why use market segmentation?

There are several important reasons why businesses should attempt to segment their markets carefully. These are:

Better matching of customer needs	Customer needs differ. Creating separate products for each segment makes sense and provides customers with a better solution
Enhanced profits for business	Customers have different disposable incomes. They are, therefore, different in how sensitive they are to price. By segmenting markets, businesses can raise average prices and subsequently enhance profits
Better opportunities for growth	Market segmentation can build sales. For example, customers can be encouraged to "trade-up" after being introduced to a particular product with an introductory, lower-priced product
Retain more customers	Customer circumstances change, for example they grow older, form families, change jobs or get promoted, change their buying patterns. By marketing products that appeal to customers at different stages of their life ("life-cycle"), a business can retain customers who might otherwise switch to competing products and brands.
Target marketing	Businesses need to deliver their marketing message to a relevant

communications	customer audience. If the target market is too broad, there is a strong risk that (1) the key customers are missed and (2) the cost of communicating to customers becomes too high / unprofitable. By segmenting markets, the target customer can be reached more often and at lower cost
Gain share of the market segment	Unless a business has a strong or leading share of a market, it is unlikely to be maximising its profitability. Minor brands suffer from lack of scale economies in production and marketing, pressures from distributors and limited space on the shelves. Through careful segmentation and targeting, businesses can often achieve competitive production and marketing costs and become the preferred choice of customers and distributors. In other words, segmentation offers the opportunity for smaller firms to compete with bigger ones.

Types of market segmentation

Whilst there are many ways to segment a market, the BUSS1 course only requires you to have an understanding of two of the main methods: **demographic and geographical** segmentation. We'll cover these two in some detail below, and then provide you with a quick insight into the other methods.

When looking at these two methods, please remember that segmentation is an art, not a science. There are no precise rules or formulae that help the entrepreneur split the market up. Market research can help, but much segmentation is done using gut instinct and experience of a market gained over time.

Demographic segmentation

Demographic segmentation consists of dividing the market into groups based on variables such as age, gender family size, income, occupation, education, religion, race and nationality.

As you might expect, demographic segmentation variables are amongst the most popular bases for segmenting customer groups.

This is partly because customer wants are closely linked to variables such as income and age. Also, for practical reasons, there is usually a lot more market research data available to help with the demographic segmentation process.

The main demographic segmentation variables are summarised below:

Age	Consumer needs and wants change with age although they may still wish to consumer the same types of product. So marketers design, package and promote products differently to meet the wants of different age groups. Good examples include the marketing of toothpaste (contrast the branding of toothpaste for children and adults) and toys (e.g. pre-school, 5-9, 10-12, teen, family).
Life-cycle stage	A consumer stage in the life-cycle is an important variable - particularly in markets such as leisure and tourism. For example, contrast the product and promotional approach of Club 18-30 holidays with the slightly more refined and sedate approach adopted by Saga Holidays!
Gender	Gender segmentation (that's men and women to you and me) is widely used in consumer marketing. Great examples include the clothing, hairdressing, magazine, toiletries and cosmetics markets.

Income	Many companies target affluent consumers with luxury goods and convenience services. Good examples include Lexus cars & Moet & Chandon champagne. By contrast, many companies focus on marketing products that appeal directly to consumers with relatively low incomes. Examples include Aldi and Lidl (discounted groceries) and fast-fashion clothing retailers such as TK Maxx.
Social class	Many marketers believe that a consumers "perceived" social class influences their preferences for cars, clothes, home furnishings, leisure activities and other products & services. There is a clear link here with income-based segmentation.
Lifestyle	Marketers are increasingly interested in the effect of consumer "lifestyles" on demand. Unfortunately, there are many different lifestyle categorisation systems, many of them designed by advertising and marketing agencies as a way of winning new marketing clients and campaigns!

Geographic segmentation

Geographic segmentation tries to divide markets into different geographical units: these units include:

? **Regions**: e.g. in the UK these might be England, Scotland, Wales Northern Ireland or (at a more detailed level) counties or major metropolitan areas

? **Countries**: perhaps categorised by size, development or membership of geographic region

? **City / town size**: e.g. population within ranges or above a certain level

? **Population density**: e.g. urban, suburban, rural, semi-rural

Geographic segmentation is an important process - particularly for multi-national and global businesses and brands. Many such companies have regional and national marketing programmes which alter their products, advertising and promotion to meet the individual needs of geographic units. However, it is less relevant for the start-up or smaller business.

Limitations of market segmentation

It would be nice to think that market segmentation is the answer to a lot of the entrepreneur□s problems. By spotting a clear niche market using segmentation, the start-up business can focus all its efforts on reaching the target customer base.

If only business life was that simple.□ It isn□t.□ Here are some key limitations with market segmentation:

Lack of information and data: some markets are poorly researched with little information about different customer needs and wants

Difficulty in measuring and predicting consumer behaviour: humans don□t all behave in the same way all of the time. The way that they behave also changes over time!□ A good example is the □grey generation□ (i.e. people aged over 50).□ The attitudes and lifestyles of the grey generation have changed dramatically in recent years.

Hard to reach customer segments once identified: it is one thing spotting a segment; it is another finding the right way to reach target customers with the right kind of marketing message

Analysing market data

Markets need to be measured in order to assess the size, growth and competitive shares of the market. Such data is key information for any business large or small. It is important to know what the potential sales are from competing in a market and which competitors are winning the battle for the available customers.

This is an area of BUSS1 where you may be asked to perform calculations the same kind of calculations that an entrepreneur may make. The key areas we ll cover are:

? Market size (volume and value measures)

? Market growth (percentage growth)

? Market shares (percentage of the market owned by each competitor)

A worked example

The market size is a measure of the total sales in a market. Total sales can be measured in terms of

Volume i.e. the quantity of products sold

Value i.e. the sales value of products sold. Remember that sales value = quantity x price

To take an example: imagine that Derek is planning to open a car valeting business in his home town of Worcester. His market research has provided the following data:

? Approximately 25,000 cars are valeted in the Worcester area each year

? The average price of a car valet service is 10

? Last year there were about 22,000 car valets performed

? Whilst there are many small car valeting businesses in the Worcester area, the three largest competitors currently achieve the following annual sales:

	Sales ( )
Cleanstyle	65,000
WorcesterValet	45,000
AutoFresh	30,000

What analysis can be performed using this data?

Firstly, we can calculate **market size**, since we have a volume measure and an average price.

So the total value of valeting sales = number of valets per year (25,000) x average price (10) = 250,000.

Secondly, we can also work out **market shares**. This is because we know the overall market size and the sales of the three largest competitors. The table below shows how this data can be calculated:

	Sales ( )	Share (%)
Cleanstyle	65,000	26.0%

WorcesterValet	□45,000	18.0%
AutoFresh	□30,000	12.0%
Others	□110,000	44.0%
Total	□250,000	100.0%

You can see from the above table how market share is calculated. Take the example of Cleanstyle, which is the market leader with sales of □65,000.□ That means that Cleanstyle□s share of the market size (□250,000) = □65,000 / □250,000.□

Market share is calculated as a percentage, so the number is 26% (i.e. (65/250) x 100)

After calculating the individual market shares for the three largest competitors, you can see that the balance of all the other car valeting businesses must equal 44%.□ This is because the total market shares of a market = 100%.

From the information given, we can also calculate market growth.□ We are told that last year the total volume of car valets was 22,000.□ This year it is 25,000, which is an increase of 3,000 valets.

To calculate market growth, we express the change (3,000) as a percentage of the previous figure (22,000).□ So market growth is 3,000 / 22,000 = 13.6%

Exam tips

There is lots of opportunity to analyse a market in a way that helps a start-up: segments, growth, size, trends, customers etc.□ A start-up that is focused on really understanding its market has the best chance of success. Look out for evidence of this in your BUSS1 case study.

In the exam you will be expected to be able to calculate market share, market size and market growth, and to be able to interpret the calculations.□ Make sure you practice these calculations - don't shy away from them!

You should also appreciate that there are several factors that affect demand for a product, not just price. Some factors will be more important than others - it depends on the product and market!

Guided revision questions

Revision questions for Understanding Markets

(1) Define the term □market□ (2 marks)

(2) Explain the meaning of the word □demand□ (2 marks)

(3) Using an example of each, describe what is meant by geographic and demographic segmentation (4 marks)

(4) Define the term □market segment□ (2 marks)

(5) Explain why segmentation is so important for a start-up wanting to target a niche market (4 marks)

(6) Why is age such a popular method of demographic segmentation?□ Support your answer with two real-life examples (6 marks)

(7) List three consumer markets in which gender is used as a way to segment the market (3 marks)

(8) Why might market segmentation be unhelpful to a start-up business? (4 marks)

(9) How might a grocery supermarket use socio-economic groups for market segmentation? (6 marks)

(10) Define the terms □market size□, □market growth□ and □market share□ (6 marks)

(11) Explain why a market growth might be slowing even though the overall size of the market is rising (3 marks)

(12) List two reasons why the sales value of a market rise even if the size of the market in volume terms has fallen? (3 marks)

(13) What is the market share of a business that sells □12 million in a market whose size if □60 million (2 marks)

(14) A market was worth □150 million in 2006 and □165 million in 2007.□ What was the market growth rate in 2007?□