Does your company want to satisfy a niche or gain a foothold in the market?

Market segmentation is among the most powerful weapons in the marketing arsenal. Competitors leave themselves open to crippling attack when their products or services lump together groups of customers with different needs that are better met by different value propositions. Identifying segments where others see an undifferentiated mass market creates opportunities for innovations based on meeting specific customers' needs more precisely.

Fulfilling any particular segment's needs is optional, based on your business strategy. Indeed, to many, choosing which segments to serve and which to avoid is the essence of business strategy: Are you a high-end differentiator or do you serve the price-sensitive consumer with a low-cost approach? We call these segments "niches" because serving one well seems to preclude serving the others. There are inevitable trade-offs between providing the kind of service demanded by, for instance, more affluent segments and being able to keep prices within reach of less wealthy customer groups.

The needs of other segments should not be ignored no matter what your strategy. The reason is that, under particular circumstances, it's possible to launch a structurally superior business model in one segment, then march "up market" to compete for a bigger slice of the market from a position of almost unbeatable advantage. We call these segments "footholds" because they provide the starting point of an assault on the pinnacle of an industry's profitability.

Strategies based on either a niche or a foothold can be spectacularly successful. But experience shows that it's only too easy to mistake each for the other, and the results either way can be disastrous. If you have a niche and think it's a foothold, you not only fail to grow, but also might destabilize a perfectly good business. And settling for a niche when you've found a foothold means forgoing the kind of growth and profitability most business people never experience firsthand.

Niche Limitations

In the summer of 1951, Kemmons Wilson, his wife, and five children set out from their home in Memphis for the family's summer vacation in Washington, D.C. Surprisingly, it wasn't his kids' backseat antics that drove Wilson to distraction; it was the lack of suitable, moderately priced accommodations for his traveling family. Outside of center city hotels, which were beyond his budget, there was an unpredictable range of mom-and-pop motels, guest houses, and small town hotels where the standards of cleanliness, facilities, and pricing ranged from excellent to awful. Wilson saw the opportunity to provide a clean, friendly, moderately priced hotel/motel to serve the growing segment of post-war families who were traveling together by automobile. Thanks to Wilson's efforts, Holiday Inn was born in 1952. Prices were kept low by keeping the facilities
clean and comfortable but basic, with no indoor parking, no bellman, no room service, no concierge, and no special requests.

In 1960, as Wilson was hitting his stride with the Holiday Inn franchise, Isadore Sharpe launched the Four Seasons hotel chain. He had experienced the same variability and attendant frustration as Wilson, but at the opposite end of the market—with business executives and well-off individuals and families who wanted the best that a hotel could offer. So his Four Seasons hotels innovated by supplying guests with thick Turkish towels and dressing gowns, Belgian chocolates placed on the high thread count cotton pillow cases at night, fine dining, and health clubs and spas as his clientele became more health-conscious.

Holiday Inn and Four Seasons were successful because each identified specific customer groups with specific needs that demanded trade-offs in order to serve them economically. At Holiday Inn, it takes tremendous courage to stick with "just the basics" when there are bigger margins and an opportunity to improve margins by adding frills. Similarly, it can be just as challenging at Four Seasons to stick with its "pillow menu" (buckwheat filled, hypo-allergenic, natural down, and a host of shapes and sizes) when a dip in business seems to demand cutting such extravagances. Competitors either weren't able or weren't willing to make these trade-offs, and so weren't able to compete as effectively for the business of customers in those segments. And it almost goes without saying that Holiday Inn and Four Seasons don't compete with each other.

But success in one segment can beguile even the savviest strategist. Wilson retired as chairman of Holiday Inn in 1979, when the chain was still struggling to recover from the slump in long-haul auto travel due to the oil embargo of the early 1970s. Those who were traveling were increasingly price-sensitive, and new competitors cropped up with an even lower cost structure. Days Inn and Motel 6 offered even more Spartan services for less money—a classic segmentation attack on Holiday Inn's niche. With limited incentive (and too expensive a business model) to challenge Motel 6 and Days Inn, the new management at Holiday Inn looked up market to higher margin segments. They seemed to feel that they could compete by leveraging their "core competencies" in hotel operations and attacking high-end hotels from below, just as they were being attacked from below themselves.

What Holiday Inn discovered was that the luxury segment had needs that could only be met by increasing their costs, such as superior furnishings and linens, more well-trained staff, round-the-clock fine food service, and so forth. Needless to say, Four Seasons and its peers in the luxury segment were much more experienced at efficiently providing these services than Holiday Inn.

In our parlance, Holiday Inn's traditional segment was a niche. That is, the initial success and significant growth the chain enjoyed was a function of exploiting the trade-offs inherent in providing hotel services. The attempt to drive up market has not been the success management likely hoped it would be because in serving the "traveling family" segment, Holiday Inn did not discover a way to break the trade-offs between cost and service quality that define the industry.

**Footholds and Breaking Trade-Offs**

The growth potential of innovations based on exploiting trade-offs can be significant, but they are limited by the size and profitability of the segmentation schemes on which they're based.
Attempting to carry a business model designed for one segment into another with very different demands can be disastrous if it violates the economic principles that made the initial business successful.

Many companies recognize this fact, but they negate their insight by accepting it. When the economic principles of the business model can be preserved, a company can successfully compete for larger, more lucrative segments from a position of structural advantage. In this way, it's possible to break defining trade-offs, and the fruits of doing this are sweet indeed.

Consider credit unions. Historically, credit unions have been based on the notion that members pool their money and lend it to each other. Only members who have contributed to the capitalization of the credit union can borrow.

Typically based around membership pools that have other bonds, such as a common employer or close-knit communities, credit unions have prospered for decades. That's because they can exploit a seeming trade-off in the financial services market where large, national-scale players have built the scale required to offer a broad range of sophisticated services but have consequently sacrificed their ability to profitably offer "high touch" services. Credit unions have, historically at least, forgone these same sophisticated services in favor of a high-touch approach. On the face of it, we have a perfect financial services analogue to the Holiday Inn/Four Seasons segmentation of the hospitality market.

But there is potentially a difference of enormous importance. Some credit unions are finding ways to deliver an increasing range of ever more sophisticated services without sacrificing their traditional advantages. For example, CUSO Financial Services (CFS), a California-based organization founded in 1992, provides brokerage services to dozens of individual credit unions. While all major financial services competitors--Citigroup, Charles Schwab, Bank of America--provide their own brokerage capability, CFS pools the volume of its credit union clientele, creating an increasingly competitive scale that none of the credit unions could match on their own.

The result is that some credit unions are beginning to break a defining trade-off of the financial services industry--an increased breadth of sophisticated services within a high-touch service environment.

If we're right in this analysis, then what the credit unions have done is turned their niche into a foothold. That is, they have found a way to build a business model within their own segment that can compete for other segments from a position of structural advantage.

We certainly don't expect credit unions to put Citigroup out of business anytime soon, but we see these tentative first steps as a harbinger of something truly remarkable: a genuinely disruptive innovation.

**Footholds and Up-Market March**

The opportunity that some credit unions see is the chance to disrupt incumbent providers of financial services. We use the term "disruption" in its technical sense: a very specific kind of
innovation that, in our view, has been at the root of the greatest successes in American business. Disruptive innovations typically find their start—their foothold—by serving customers that established, successful, dominant firms have little interest in serving because those customers are economically unattractive compared to other segments.

Consider the evolution of the airline industry. From the inception of commercial air travel in the post-World War II era through the late 1980s, established airlines introduced a stream of innovations that allowed them to better serve their most attractive customer, the relatively price-insensitive business traveler who wanted predictable levels of service to as many destinations as possible. Sophisticated reservation systems, frequent flyer programs, hub-and-spoke route structures, and various classes of service were all crucial to success. And, since all the airlines had the same generic strategy, execution was the name of the game: Do it better and faster than the competition because the competition is sure to copy you.

Some low-cost airlines tried to get in on the game, attempting to exploit trade-offs in the cost structure required to serve less demanding segments of the market. People's Express, for example, enjoyed a spectacular run in the early 1980s. But the airline faltered and eventually slid into bankruptcy when, upon saturating its "natural" niche, it tried to grow beyond those boundaries without having figured out how to break the trade-offs on which its initial success depended. It mistook its niche for a foothold.

Southwest Airlines, the Dallas-based carrier that took to the skies for the first time in 1971, was founded much earlier than People's Express. With a low-cost structure that presaged the strategy that People's Express would employ, Southwest bumped along for 25 years in what appeared to be a niche market by bringing low-cost air travel to people for whom the alternative wasn't another air carrier, but the bus or car.

By the early 1990s, however, Southwest was beginning to eat into the markets of the established air carriers. By May 2003, Southwest had more passenger boardings than any other U.S. airline. Michael E. Porter's 1996 Harvard Business Review article "What Is Strategy?" attributed Southwest's success to its unique combination of assets and capabilities: a point-to-point route structure, a single type of airplane, and stripped-down service (compared to the erstwhile industry leaders) that was nevertheless "good enough" for most passengers. This analysis is, in our view, correct but incomplete. Seeing Southwest's success as a consequence of disruption completes the picture. Southwest was pursuing, in one fashion or another, essentially the same strategy since its inception in 1971. Why did it take more than 30 years for Southwest to become the dominant airline carrier in the United States? The reason is that it was unable to march up market, or translate its niche into a foothold, until the established carriers had overshot the segments that Southwest hoped to compete for.

Disruption depends on incumbent players "overshooting" the needs of the markets they depend on in the pursuit of ever-higher margins from more demanding customers. So, as established air carriers (e.g., Delta, United, American) fought for higher margins by catering to price-insensitive business travelers, they effectively left behind an increasingly large number of customers. As their cost structures crept up to meet the needs of the most profitable few, they left themselves unable to respond to a lower-cost challenge from Southwest. (See Exhibit 1.)
As the incumbents were on the path to "overshooting" the needs of more and more of the market, Southwest was catching up with needs of those same customers. Southwest in 2002 was not the same airline it was in 1971, but the company strategy was unchanged. What it had done was figure out how to break the trade-offs that defined one aspect of the industry (e.g., route coverage and flight frequency) while getting "good enough" on other aspects of competition (e.g., in-flight service) that established carriers were providing "too much" of. The combination of Southwest's improvements and the overshoot by incumbents allowed Southwest to move from a niche in the low end to a foothold providing the purchase necessary to ascend to the summit of its industry.

Exhibit 1 illustrates how Southwest disrupted the airline industry. It might seem odd to illustrate airlines as appealing to the "least demanding" segments of the market in 1950, and Southwest appealing to the same least demanding segments in 1970. In fact, over time, what constituted the least demanding tier of the market changed dramatically. The first airline services were enormously inconvenient (e.g., they had very limited schedules and slow and noisy planes) and were very expensive compared to what's available today. Only those customers who were comparatively undemanding but absolutely had to travel came into the market. Early airline carriers saw that they could grow by "catching up" with more demanding segments but, as they captured the mass market, they continued to improve in ways that increased their share of still more demanding segments, such as people who wanted plush seats, better wines, and airport lounges.

When Southwest entered the market in 1971, it was appealing to a very different "least demanding" segment: air travelers who were willing to forgo all the amenities that had become de rigeur on the established airlines in exchange for low prices. Southwest has since improved its service in many important ways, without sacrificing the cost advantages that allowed it to be profitable in segments incumbents typically shun.

**Deliberate Disruption**

Market segmentation is the cornerstone of finding profitable niches and viable footholds. Both can fuel powerful growth strategies, but spectacular disruptive growth can only be achieved by using segments as footholds. Can companies achieve disruptive results deliberately and make their choices regarding which segments to target with disruptive end games in mind? Perhaps. The secret lies in understanding that foothold segments provide opportunities to explore improvements that break the trade-offs that define competition in more demanding segments. In contrast, niche segments depend on those trade-offs to keep competitors at bay.

In the 1980s, Indian software services companies such as Tata Computer Systems sold basic programming services to the least demanding segments of the U.S. software services market. Among its most successful projects were conversions--the translation of programs from an older computer system to a more modern replacement. Conversions were relatively simple for customers to specify and required limited customer interaction. In addition, they required little understanding of the business issues involved, with conversions being largely a technical challenge.

Established IT services firms didn't feel much heat from the Indian providers for quite some time. The complex problems they focused on required sophisticated consulting teams with
advanced degrees, substantial experience in the industry, and training in program management. But the Indian firms saw the size of the market available if they could figure out how to break those trade-offs, increasing the quality of their services without proportionate increases in their costs.

They tackled this challenge using the same sort of process analysis that the incumbent consultants applied to their clients' problems: They broke down the complex business systems problem into its components, with spectacular results. By 2002, the Indian software industry had more development centers certified at CMM Level 5 (the highest level of quality) than any other country.

Executing these up-market marches is not easy, and not every company that finds a foothold successfully disrupts the dominant competitors that lie above it in more demanding segments. Consider the well-documented disruption of integrated steel mills by mini-mill technology.

In the late 1970s, mini mills began their disruption of the integrated steel producers. That market disruption has long been completed as once famous Fortune 100 names such as Bethlehem Steel and U.S. Steel were one by one forced into bankruptcy in the 1990s. However, not every mini-mill company succeeded equally spectacularly. Nucor Corp. was the most conspicuous success: By 1989 its market capitalization was equal to all the integrated producers combined. But just a few years earlier, Chapparal Steel was the name on everyone's lips. Chapparal was a mini-mill operator with a business model so admired that it was the subject of Harvard Business School case studies. What happened?

In the 1980s, the mini-mill operators had begun their successful up-market march and by 1982 they dominated the rebar and the bar and rod market, approximately 12% of total steel tonnage in the United States. At that point, Chapparal became distracted by its marketing segmentation studies. The data clearly defined the differing needs of customer groups in the markets for rebar and bar and rods, and Chapparal invested mightily in what we would now call a Six Sigma program. The program was instilled to exploit the trade-offs to serve the segments of those markets better and at lower cost than any other supplier, including Nucor. But Nucor did not respond. Instead, it stayed focused on their upmarket march to break the trade-offs that kept them from producing the higher quality required by structural steel customers--a market segment almost twice the size and much more profitable than the rebar and bar and rod markets combined. The result was a huge payoff in market share and profits for Nucor and the "stalling out" of a previously high growth rate for Chapparal.

The trick, then, is to find a foothold segment that provides the appropriate incentives to improve product performance in ways that break the trade-offs that define competition in more lucrative segments. The strategic challenge is to target comparatively undemanding segments and accept the challenge of building a business model that meets their requirements. The opportunity is then to improve product or service performance without sacrificing the advantages that made it possible to serve the foothold segment in the first place. This is how trade-offs are broken and how the market pays disruptive innovators to do it.

This is the strategic path being taken by the automatic external defibrillator (AED) makers. Based on highly sophisticated technology, AEDs cost a fraction of the typical "crash cart," and
have already become standard fixtures in airport concourses and convention centers. Although
not up to the performance standards of hospital-based equipment operated by medical
professionals, AEDs make it possible for well-intentioned but untrained bystanders to save a
person's life.

AED technology is sure to improve, and we envision a day when AEDs dot the walls of hospitals
around the world, obviating expensive crash carts and their expensive operators. By pursuing a
disruptive strategy, AED makers will have broken the trade-offs between performance, cost, and
ease of use by appealing first to much less demanding segments of the market.

Contrast this with the typical failure of frontal assaults on the trade-offs that define certain
markets. In mobile telephony, for example, "3G" (third generation--after analogue and digital)
was supposed to provide mobility and bandwidth, two characteristics that typically have been
antithetical. Based on this belief, European wireless operators spent more than $150 billion on
licenses for a new spectrum allocated to the 3G standard for high-speed mobile communications.

A typical example was BT Group, a telecommunications services group that by 2000 had spent
more than $15 billion on 3G licenses with the goal of transforming mobile telephones into
wideband, multimedia devices on which voice telephony would be only one of the applications.
However, by 2001, BT was telling shareholders: "The size of the [3G] market is as yet unknown
and may fall short of expectations. BT cannot be certain that the demand for such services will
justify the related costs." Under increasing financial pressure, BT later spun out its mobile
business.

In our niche vs. foothold language, we would say that not only was BT unable to find a profitable
foothold from which to develop a disruptive growth opportunity but, for the price paid for the
spectrum, they were unable to find a profitable niche. As a result, compared to other technology,
3G didn't offer "more for more," instead of "less for less." Multimedia mobile phone services
have yet to find enough customers who will put down their iPods or portable DVD players to
enjoy multimedia experiences on their mobile phones.

Fortunately, 3G's segmentation story is not over. 3G capacity can be used to provide demanding
segments of the mobile voice market with two benefits that they will pay for. Those benefits are
(1) voice quality that rivals a wired telephone for important conversations, such as conference
calls with clients and (2) the ability to avoid network congestion in high-traffic locations, such as
airports, highways at rush hour, sports arenas at half-time, or other places where the first-come-
first-served nature of mobile telephony makes it a gamble as to whether you can make a call.
Customers will pay a premium for premium voice services, segment by segment. For mobile
communications, voice is still the "killer app."

**Only the First Step**

Like every tool, market segmentation is most powerful when used as intended. And, as a way to
distinguish between the common needs of different groups of customers, it remains
indispensable. Our caution is that segmentation is only the first step. For organizations seeking to
build blockbuster new growth businesses, the real power lies in determining whether the
segments so identified constitute niches or footholds.
Niches can be very profitable. But it's crucial to understand that their growth potential is defined by the size of the niche, and their profitability depends on how well you can exploit the trade-offs that prevent powerful incumbents from competing.

Footholds, on the other hand, provide a profitable initial market, but hold the promise of much greater growth and profitability because they create opportunities to break the very trade-offs that niches hope to exploit. A successful upmarket march from a viable foothold market allows smaller, seemingly under-resourced organizations to compete for the most valuable segments of a market from a position of nearly irresistible competitive advantage.

Segmentation is a great way to look for the seedbed of tomorrow's growth business. Understanding the difference between niches and footholds allows you to recognize what you've found. In other words, realizing the growth potential of new markets demands that we go beyond segmentation.

EXECUTIVE briefing

Segmentation is a great way to uncover growth markets, but current segmentation practices often blind companies to market disruption--the most valuable kind of innovation. To realize the growth potential of new markets, it's important to understand the difference between niches and footholds. A niche exploits the trade-offs that allow companies to serve different customers differently. A foothold, on the other hand, provides a chance to break those trade-offs--in the process disrupting a market and planting the seeds for future growth.

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