



Customer Segmentation

From the practice of mass marketing to targeted marketing

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1. Foreword

Despite massive investments during the past decade in operational business systems, business intelligence systems, e-commerce systems, and customer-centered business processes, there has been no commensurate improvement in consumer satisfaction. The experience of most consumers is one of consternation as they grapple with more and more junk mail, SPAM, unsolicited calls, invasions of privacy, and increasingly homogenized product offerings. Customers are targeted more frequently certainly. But they are targeted with less accuracy than ever before. Some businesses are now starting to respond to the urgent need to move away from this ineffective and counter-productive world of the monotone signal of mass marketing. Their response is to embrace genuine two-way communication. An essential tool to complete this transition safely is the customer segmentation system.

2. What is customer segmentation?

The activity of marketing involves numerous decisions concerning what products, services, and support should be offered to which customers, at what price, through which channels, and when. For these decisions to lead to success (measured for example in terms of customer loyalty and customer profitability) requires the marketing professional to develop an understanding of large volumes of complex data. As always when people try to make sense of complex issues, the natural tendency is to break the subject down into smaller pieces. This is done in the belief that each of the smaller pieces will be easier to understand, and that the assemblage of improved knowledge and understanding of all the smaller pieces will result in better-informed decisions across the business enterprise's entire market.

Customer segmentation is the process of breaking down a large group of customers into smaller groups. The idea is to partition a heterogeneous market into separate and distinct homogeneous segments, where a segment comprises a group of consumers that react in a similar way to a given set of marketing stimuli.

Once a market has been segmented, further analysis can reveal interesting patterns within individual segments, and it may then prove profitable to conduct further segmentation processes on the individual segments that resulted from the initial segmentation

process.

3. Segmentation Techniques

Any segmentation application must support the most popular mechanisms that may be used to populate segments:

- ❖ **Scored population**, in which each customer is allocated a score for each segment, and becomes a member of the segment in which they score higher than in any other segment.
- ❖ **Scalar population**, in which each customer is allocated a score for every segment. Each segment has its own scale of values associated with it and the customer is positioned against that scale. Each segment is independent of any others, and may be thought of as a separate dimension of customer analysis.
- ❖ **Selected population**, in which each customer is selected for membership of a segment according to compliance with some logical expression, for example, 'Any customer that is male and under 25 is a member of Segment 2'.

A priori segmentation defines, in advance, a framework that is based on known characteristics of customers or prospects. For example, the SKA LV segmentation model contains 16 segments in a two-dimensional, four-by-four matrix in which one dimension measures the value of customers to the enterprise and the other measures the strength of customer relationships with the enterprise.

Cluster segmentation, in direct contrast to the *a priori* method, seeks to discover naturally occurring clusters of customers that share common characteristics or behave in the same way. The cluster analysis process looks for groupings of customers, and generates new segments rather than taking into consideration boundaries imposed by pre-defined segments.

The complexities of proliferating products, markets, time zones, cost structures, and promotional channels have created an increasingly dense volume of information that must be intelligently analysed and exploited. More sales and marketing information continues to amass with every purchase made, every credit card transaction, every coupon used at checkout, every telephone call made, and every ATM bank transaction. This volume of transactional information is growing relentlessly and is transmitted through many channels en route to the enterprise.

Businesses wishing to use customer transaction histories to define segments will need to source and supply summaries of this data from their source systems (or from a data warehouse or data mart containing this data).

4. The Transition from Mass Marketing to Differentiated Marketing

As competition and fragmentation intensifies in the retail sector, retailers are beginning to examine how to leverage information as a strategic tool. The effect of this increasing focus on customer insight is to rebalance marketing investment away from exclusive above-the-line investment in brand and advertising to include a greater direct marketing component. The exploitation of customer data has resulted in dramatic improvements in profitability by the leading exponents of these techniques and many of those who have recently invested in customer segmentation and profiling capabilities have experienced annual sales and profit growth of 10%. However, the challenge of moving the organisation from an exclusive focus on mass marketing techniques to a technology-driven intelligence-based targeted approach should not be underestimated. For every retailer who is successfully managing this transition there are three who have already abandoned their first attempt to do so. In this Briefing Paper we look at the goal that Body Shop International has set itself, the challenges we believe Body Shop International will encounter and the prize that can be gained by managing this project successfully.

Performed and exploited properly, customer segmentation can yield startling results, bringing the enterprise a wide range of direct benefits, which can include increased sales, profitability, loyalty, retention and satisfaction. The experience retailers who have achieved advanced levels of customer insight suggest that the indirect operational benefits of achieving in-depth customer insight are greater by a factor of five over the direct benefits. With customer insight each individual customer's purchase behaviour is recorded and analyzed. The abundant intelligence collected from the database provides answers to questions like 'what are they worth', 'when they buy', 'what they buy' and 'what motivates them to buy'.

In this environment, the enterprise interested in winning, retaining and deepening customer relationships can no longer do so simply by creating a better product or even by holding down costs. For

many companies, both strategies are essential simply to stay in the game. Faced with highly demanding and fickle customers, executives are increasingly finding that the winning differentiator is no longer the product or the price, but the level of engagement—the degree to which a company succeeds in creating an intimate long-term relationship with the customer or external stakeholder.

Moving away from mass marketing towards individual communications with customers requires a change in the attitudes and strategies of the enterprise. Mass marketing is characterized by businesses whose primary focus is on products, branding, and price. Individual communication is based on re-orienting the enterprise towards multiple internal markets that have different needs and expectations and growing the business in and between these segments.

5. Segmentation categories based on the type of customer information employed

Segmentation activities may be categorized according to the customer information used in deciding the allocation of customers to segments. Segmentation categories include:

- ❖ *Behaviour segmentation*, which groups customers according to attitude, usage, or response to a product or promotion.
- ❖ *Benefits segmentation*, which groups customers according to the different kinds of benefit they seek from the product.
- ❖ *Buyer-readiness segmentation*, which groups customers according to the different stages that consumers normally pass through during the purchase process. These usually comprise awareness, knowledge, preference, and conviction.
- ❖ *Demographic segmentation*, which groups customers according to demographic variables such as age, gender, family size, income, occupation, education, language, religion, race, nationality.
- ❖ *Ethnic segmentation*, which groups customers according to the needs and strengths of ethnic communities or on the basis that they share a common, recognized heritage.
- ❖ *Ethical segmentation*, Which groups customers according to their degree of ethical sensitivity on issues such as social

justice, ecology and the environment

- ❖ *Geographic segmentation*, which groups customers according to geographic factors such as country, region, climate, population density.
- ❖ *Interaction segmentation*, which groups customers according to their preferences regarding channels, payment methods, promotions, and communications.
- ❖ *Life-cycle segmentation*, which groups customers according to their changing needs at different stages of their lives.
- ❖ *Loyalty segmentation*, which groups customers according to different degrees of loyalty to supplier or brand.
- ❖ *Occasion segmentation*, which groups customers according to their consumption of a product or service in certain situations, in response to particular events, or at particular seasonal or cyclical times.
- ❖ *Profitability segmentation*, which groups customers according to the degree of customer value to the enterprise (usually measured in terms of profitability).
- ❖ *Psychographic segmentation*, which groups customers according to different degrees of lifestyle, social behaviour, and personality characteristics.
- ❖ *Usage segmentation*, which groups customers according to different degrees of their level and type of usage of product or service.

6. Using customer segmentation in practice

Business enterprises are under increasing pressures to improve customer loyalty and profitability while controlling, or even reducing, marketing costs. This requires businesses to effect a transition from mass marketing to individual communications with customers.

Both mass markets and the existing customer base of the business need to be broken down into smaller segments at which customized marketing campaigns can be directed. This means that businesses need to be able to predict customer behavior.

7.

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Even businesses that achieve the goal of one-to-one marketing will continue to observe and study the formation of affinity groups among their customers. The power of segmentation is such that its use can extend beyond the planning and implementation of marketing campaigns: it can provide a basis for planning and operating the entire business.

It is conventional wisdom that the greatest positive impact on the business enterprise's bottom line can be made by focusing on two categories of customer:

- ❖ customers that currently provide the most value to the enterprise
- ❖ Customers whose level of business with the enterprise is the easiest to grow.

This can often prove to be a sound assumption. But undoubtedly, for most enterprises, there is a great wealth of additional customer segments that can and should be exploited to provide substantial financial benefits to the enterprise.

Because the segmentation of customers cannot be separated from the market segmentation that has already occurred as a result of the positioning of the company brand, it is necessary to understand how these two interact. This requires that there is ongoing dialogue and co-ordination between the development of customer insight and the ongoing development of the oval brand.

Customer segmentation can also be used to identify the needs of individual customers or groups of customers, including needs that remain unsatisfied. Where it proves possible to define or discover a segment comprising customers with needs that have not been satisfied, the business enterprise may decide to target satisfaction of those customer needs, thereby becoming the first supplier to fulfil customers in the segment. Such a strategy can be used to become the leading player in that market segment in question.

When customer segmentation started to be used by marketing functions, the approach was to define a number of segments, measure the size of each segment (usually expressed as a percentage of the complete market of which the segment was a part), measure the value of business the segment provided the enterprise, and then concentrate marketing efforts on the segment that was yielding the highest value per percentile of customers. For example, if the highest performing segment comprised 25 per

cent of the market and was yielding 65 per cent of the enterprise's sales revenue, then it obviously made sense to concentrate marketing efforts on that segment. But that is by no means the only way of improving the cost-effectiveness of marketing campaigns.

Here are some typical issues that can be addressed in determining the strategy for a segmentation project, or series of projects. To start with, sales revenue for a given period is not the only way of measuring a customer's value to the business. Lifetime value can be a more a useful measure for many campaigns. In other circumstances, the marketing professional might be interested in the likelihood of customer behaving in a particular way in response to a particular campaign for a particular product at a particular time.

Another factor that may be considered in deciding how to use the results of a segmentation analysis are acted upon, is the degree to which the needs of customers in each segment are easily satisfied by the enterprise. A customer may have become a high spender with the enterprise, but the future needs of the customer may not be easy to satisfy within the product-service-delivery strategy of the enterprise. For example, issues such as the following can have a large impact on the success or otherwise of the campaign include:

- ❖ Can the offerings of the business be customized to exploit the potential for profit in the segment at which the campaign is directed (the object segment)?
- ❖ Can the delivery channel for products or services be customized to exploit the potential for profit in the object segment?
- ❖ Is it possible to clearly identify the enterprise's competitive advantages in the object segment

7. Segmentation Model Definitions

Answer weighting: For a segment populated by the scalar population mechanism, this is a numerical weighting given to a customer answer. The result of the weighting is to move the position of the customer against the scale of the segment either up

or down in comparison with the position of the customer that would result from the un-weighted answer.

Bias: The degree to which the questions, answers, and segmentation rules favor placing a customer in one segment over another, assuming that all customers select the mean of the available predefined answers. Bias can be unconscious (where there is no awareness of the favoritism) or conscious (which, while intentional, should be noted). Bias is used only in the scored and scalar segment population mechanisms.

Confidence: The extent to which the dialog questions the customer did not respond to affect the degree of assurance of that customer's scores and placement in segments. A low confidence rating indicates that the segmentation process has determined a result but there is uncertainty about how accurately the customer has been placed in segments. This is used only with the scored and scalar segment population mechanisms.

Separation: The degree to which a customer's score in the segment to which they have allocated exceeds their score in other segments. This calculated value is of use only with the scored population mechanism.

Appendix A – Segmentation Benefits

<i>Benefit</i>	<i>Value ranking</i>
Marketing programs tailored to customer needs	1
Identification of customer segments of high value to the business	2
Identification of customer segments that have been neglected	4
Identification of new market segments of high potential value	1
Identification of previously unrecognized customer needs	3
Identification of unsatisfied customer needs	2
Discovery of customer purchasing patterns	3
Improvement of marketing campaign response rates	2
Marketing programs to increase customer profitability	3
Marketing programs to increase customer loyalty	2
Marketing programs for up-selling and cross-selling	1
Marketing programs for winning and retaining new customers	3
Informing and prioritizing product design	2
Devising new product bundles and enhancements	2
Estimating the future value of market segments	5
Identification of products and services for which demand is likely to increase	3
Identification of products and services for which demand is likely to decline	3
Customizing delivery channels to improve satisfaction of customer needs	4
Informing pricing strategy and decisions	2
Improvement of competitor analysis	5
Gaining insight into market purchasing trends	4
Gaining insight into market affinity shifts	2
Gaining insight into market shifts in key purchasing factors	3