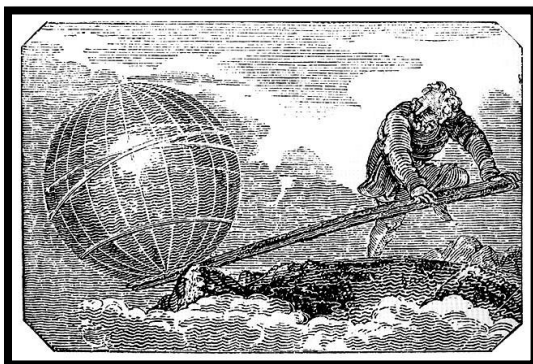




Customer Segmentation: A Powerful Tool for Business Growth

Archimedes said, “Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.”

The commercial equivalent might be, “Give me a good customer segmentation analysis and the flexibility to adjust offerings, and I shall grow the business to great success.”



Archimedes moving the world

What is Customer Segmentation?

Surprisingly, some marketing text books have limited information on either customer or market segmentation. Similarly, Wikipedia

redirects queries about “customer segmentation” to “market segment”, which is defined as “a group of people or organizations sharing one or more characteristics that cause them to have similar product and/or service needs.” Wikipedia further defines “industrial market segmentation” as “a scheme for categorizing industrial and business customers to guide strategic and tactical decision-making, especially in sales and marketing.”

While both of these definitions are good, I prefer the term “customer segmentation” to “market segmentation” because **people make buying decisions**; not everything is a statistic or a commodity. Whether customers are companies (B2B) or individuals (B2C), **people decide the merits of a seller’s value proposition** and whether to purchase the seller’s offerings.



People make buying decisions

The word “customer” keeps sellers focused on their customers’ needs and buying processes. The word “market” can draw sellers into excessively thinking about statistics, which are important, but are not always the drivers of success with customers. The word “market” has also drawn some sellers into thinking that their products and services are undifferentiated commodities that are selected chiefly based on price. This kind of thinking causes sellers to

discount the other value enhancers that they bring to customers, such as brand image (e.g., reliable, safe, high quality, responsive, financially sound, green, etc.), innovation capabilities, and the seller's relevance to customers' future needs.

Think Customer Segmentation instead of Market Segmentation to remain focused on customers' needs and buying processes and, the seller's value enhancers.

Why use Customer Segmentation?

Customer segmentation makes money for sellers by helping sellers define better value propositions, allocate resources, identify and effectively pursue opportunities, anticipate problems and find solutions, and think through situations.

For example, a seller may decide to enter a fast growing market. But if the seller doesn't understand customer needs and buying processes, doesn't have a compelling value proposition that answers "**Why should I pick you over another supplier**", and doesn't know how to pitch its offerings to the different customer influencers and decision makers, then the seller will likely either make a commodity sale or fail altogether.

If conducted on an ongoing basis, at least annually, **customer segmentation can be an important driver of continuous commercial improvement**. Customer segmentation will help the business stay current and focused on the best actions to generate profitable business, minimize and mitigate downsides, and find and exploit upsides.

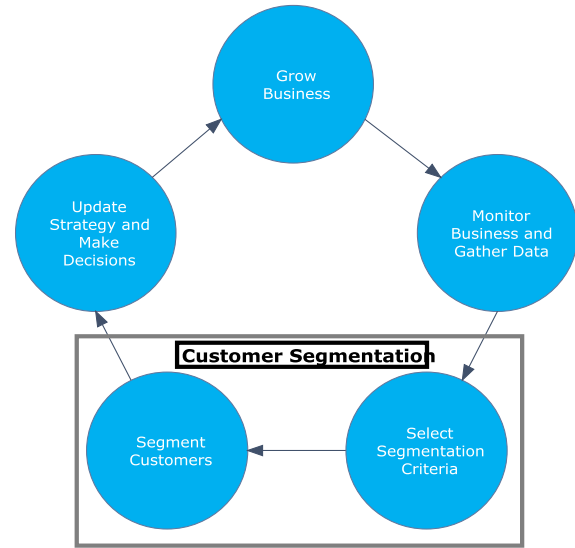


Figure 1: Continuous Commercial Improvement

Below are five typical commercial situations where thoughtful customer segmentation can produce dramatically improved business results. These situations are interrelated and can often be addressed simultaneously.

- Value Proposition Definition
- Resource Prioritization and Channel Management
- Threat Board Analysis
- Marketing & Sales Training
- Special Situations

In **Value Proposition Definition (VPD)**, customers are grouped into segments with similar needs, dynamics, and buying processes such that **compelling value propositions** can be constructed for each segment that the seller chooses to participate in.

A compelling value proposition persuades customers to (a) select the seller and (b) consider several factors, not just price. Importantly, a compelling value proposition should also be compelling for the seller too

– that is, profitable on an absolute or relative basis.

A compelling value proposition is economically attractive for both seller and customers, creates one or more differentiating advantages for the seller, can be efficiently delivered to customers, and positively positions the seller’s brand image and relevance in the minds of customers, partners, investors, employees, suppliers, and other stakeholders.

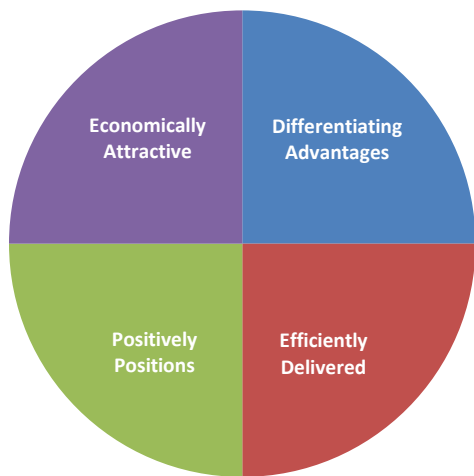


Figure 2: Elements of a Compelling Value Proposition

Key steps of VPD include drilling down into customer segments to (a) define customers’ unmet needs, headaches, and problems; (b) understand issues, trends, and drivers facing customers and the customers’ customers; (c) drive the seller’s team to think about what the seller needs to do to maintain and increase its relevance to customers in the near, mid, and long term; (d) define compelling value propositions; (e) identify key customer audiences (decision makers, influencers, gatekeepers) and develop messages for each audience; and finally, (f) observe, predict, and develop counter-measures to competitive threats.

Positioning is a very important, differentiating component in the buyer’s decision making process. The seller’s value propositions, messages, and value proposition delivery processes (e.g., sales, marketing, customer service, supply chain, technical service, etc.) should position and reinforce the seller’s desired brand image.

For example, in the B2C world, a cosmetic manufacturer that needs to position its anti-aging product as effective, safe, reliable, and worth the money, would hire a beautiful and classy celebrity of a “certain age” to appear in commercials. In the B2B world, a supplier of pharmaceutical fine chemicals looking for success with US and EU drug company customers would position itself as reliable, responsive, possessing an exemplary FDA inspection record, discreet, technically very capable, and reasonably priced.

Resource Prioritization and Channel Management (RPCM)

RPCM uses customer segmentation to help sellers decide which customers to invest behind, which customers to focus retention strategies on, which customers to discourage or avoid, how to approach customers, and everything in between. From a marketing and sales perspective, sellers classify customer segments by priority and method of customer relationship management. This typically results in four segment priority classifications: priority, opportunistic, discourage, and avoid.



Figure 3: Segment Priority Classifications

Priority customer segments are those that the seller wants to invest in and/or retain for a variety of reasons, including current and

expected future profitability, customer loyalty, volume, growth potential, degree of innovation, and prestige. Sellers typically service priority segments directly with the seller's personnel. However, there are instances, chiefly due to economies of scale and scope or the difficulty of building relationships, where sellers will service priority segments indirectly via channel partners (agents, distributors) or marketing alliances and JVs.

A priority designation is not a license to over-invest; investments should only be made when and where attractive returns exist.

Once the priority segments have been identified, a further sub-prioritization of these segments is advisable to resolve resource constraints and to satisfy financial goals (e.g., EPS, ROI, NPV, cash flow), growth goals (e.g., mix of projects meeting near, mid, and long term growth objectives), diversification goals (e.g., reduce dependence on a single customer or application by growing in other areas), and other goals.

Opportunistic customer segments are sources of surprise profits where sellers can sell excess capacity or off-grade product, receive Requests-for-Proposals due to supply shortages, or occasionally participate in for other reasons. Sellers typically approach an opportunistic segment in one of three ways: direct passive (e.g., customers find the seller via the internet), direct mainly passive (seller maintains some contact with larger potential customers who might buy excess capacity or off-grade product), and indirect via channel partners.

Discourage customer segments are those that are difficult and expensive to serve relative to their current and expected future value. They

tend to be high maintenance, low volume, low price customers. The key here is to raise price and reduce offerings (e.g., packaging choices, service levels, etc.) until the segment is attractive (a priority) or disappears. The caution is to not "burn too many bridges" so as to avoid reputational damage that would hinder a return to this segment should conditions change.

Avoid or Do Not Participate customer segments are easy to find. They are too small to serve (e.g., global demand from all customers for all sellers is \$100K/year), obviously flawed (e.g., nursery schools don't need narcotics and hydrazine), illegal (e.g., countries under trade sanctions), or exhibit some other factor that makes it impossible to construct a compelling value proposition.

A **maintain** segment is not mentioned above. The maintain designation is sometimes the corporate equivalent of "death by a thousand cuts." Service levels (and management attention!) in a maintain segment have the potential to fall to discourage segment levels. This in turn causes the segment to lose its profitability as customers leave. What kind of leaders are energized about giving 110% towards a maintain segment or regularly fighting against the "it's in maintenance mode, we can cut resources" perceptions for a significant career stint? **If a segment is worth retaining, then it's a priority segment.** If a segment isn't worth retaining, then it's an opportunistic or discourage segment that should be managed appropriately as a conscious decision and not due to inattention.

A final note on RPCM analysis: effective customer segmentation yields a strategic map that guides marketing, sales, R&D, and supply chain & manufacturing decision making. As

such, it is important to also involve R&D, supply chain & manufacturing, and perhaps other functions in the analysis. These functions can provide insights that will impact the prioritization (e.g., “our technology can solve that customer headache” or “we need those customers to take our byproducts”). Good management practices and common sense dictate that successful organizations are aligned behind shared priorities.



One side missed a threat...checkmate!

In **Threat Board Analysis (TBA)**, customer segmentation provides a “map” that displays current and potential threats and opportunities. A segmentation analysis that is periodically updated to account for changes in industry structure, issues, trends, drivers, channel consolidation, and other factors is most useful. Using the updated map, sellers can identify and understand the impact of competitors’ moves (e.g., purchasing the major compounders supplying consumer packaged goods companies in a region or, the seller’s supplier is becoming a competitor by moving downstream); find segments that are rising or falling in importance (for RPCM); and observe changes in customers’ power and behavior that may impact suppliers.

Customer segmentation can be a powerful tool for **Marketing and Sales Training (MST)**. Good marketing and sales professionals with a deep understanding of both their customers’ needs and their employer’s capabilities will find ways to (a) synthesize needs and capabilities into win-win offerings and (b) successfully pitch these offerings to the various customer audiences.

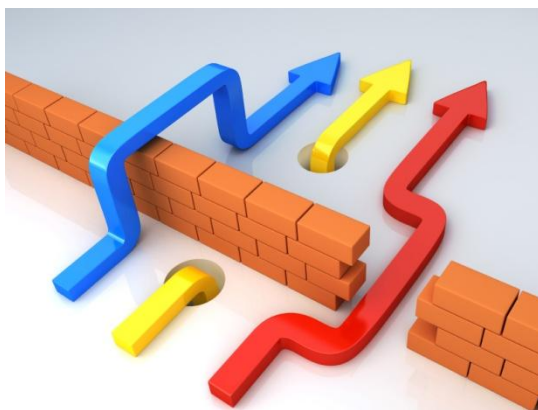
*The best sales people have a crucial advantage. In addition to presentation, people, listening, some financial, and other skills, **they think fast on their feet**. They are able to do the latter because they live, breathe, sleep, and think about their customers’ needs, their employer’s capabilities, and the ways to (a) synthesize needs and capabilities into win-win offerings and (b) successfully pitch these offerings. Customer segmentation can help sales people develop and maintain this crucial advantage.*



Customer segmentation = preparation for success!

Having the seller's marketing and sales team work through customer segmentation on an annual basis is a great way to make sure all team members, including new ones, have the deep understanding of needs and capabilities that they need in order to be successful. In this customer segmentation activity, the seller's team will identify and address opportunities and threats; understand what is and isn't working with customers; revisit and improve value propositions and messages; and build alignment across the organization behind the value propositions and messages. This is especially true if people from customer service, technical service, core R&D, and supply chain & manufacturing participate in customer segmentation activities.

Finally, customer segmentation is useful when analyzing **Special Situations**, such as the impact of external game changing events. For example, segmenting customers according to who will be most positively or negatively impacted by a recession, oil embargo, or government policy initiative, such as health care reform, can identify potential receivables problems and other unwanted exposures, new customers and areas to invest behind, and new offerings and value propositions to roll out.



Special situations demand new approaches

In a similar vein, customers can segment their suppliers to understand the potential for supply interruptions due to an uncertain economy, difficult weather, or political turmoil.

Customer segmentation has its uses in strategic planning and corporate development; it is a powerful tool for estimating pre-acquisition synergies or achieving post-acquisition integration. Customer segmentation can be used to identify, quantify, and validate synergies, as well as to determine the value propositions and organization of the new combined company.

For example, a commercial bank contemplating the acquisition of a high net worth wealth management organization might use customer segmentation to understand high net worth customers and their buying processes, determine opportunities for cross-selling (as well as how to customize the cross-selling approach to each segment), identify growth synergies from new value propositions, and either confirm or refute estimates of cost reduction synergies.

A fine chemicals firm contemplating acquisitions across the pharmaceutical value chain might use customer segmentation to identify emerging growth areas driven by government policy (and relevant acquisition targets before they are discovered!); find leveragable relationships with customers' decision makers that could create valuable cross-selling and cost reduction synergies; and define compelling value propositions that could be delivered if the seller acquired an adjacent business.

A customer segmentation analysis should be performed at least yearly to ensure that value propositions are compelling, resources

are appropriately allocated, and that threats and opportunities are identified and addressed.

Who should be involved in customer segmentation?

A customer segmentation analysis should involve all functions that impact the customer. This will improve the quality of the segmentation, the effectiveness of the value propositions created, and the organizational alignment behind delivering the value propositions. The functions typically involved include marketing, sales, customer service, technical service, and supply chain & manufacturing.

Sometimes it is appropriate to include additional functions. For example, if the seller's value propositions include significant innovation, especially joint development initiatives with customers, then core R&D must be involved. Legal should be involved for value propositions involving 3rd party distributors and agents and, joint development initiatives with customers.

Finally, there is the very common situation of a global business with suppliers, manufacturing plants, customers, competitors, government incentives and disincentives, and corporate entity structures around the globe. Having the legal and financial functions involved in international customer segmentation can be key to both understanding customer issues and, crafting compelling value propositions that enable success by fully utilizing the seller's capabilities.



Global businesses face extra challenges

In addition to functional involvement, another “who” question is what “rank” of person should be included in a customer segmentation analysis? The answer is to include people who know your company, know and interact with your customers, and are necessary to achieve the segmentation objective. In other words, there is not a “rank” requirement. Customer segmentation analysis is about solving problems and growing the business. It is not about exclusivity or egalitarianism.

Customer segmentation is about solving problems and growing the business.

What criteria should be used to segment customers?

There are four general rules to follow in selecting segmentation criteria:

- 1) Keep criteria as simple as possible, but no simpler than necessary
- 2) Use criteria that allow customers to be grouped based on the similarity of their response to given stimuli
- 3) Use criteria that allow you to understand the situation and learn what you need to learn to solve your

problem; creativity and flexibility are fine here

- 4) Don't overlook the customer's buying process – the buying process can be both a segmentation criteria and a variable to change with a better value proposition

In short, **keep it simple, look for sameness, use whatever method works for you, and pay attention to the customer.** Conceptually simple and easy to do, right?

The customer's buying process is very important to customer segmentation and making the sale. Buying process means the variables, constraints, criteria, and processes by which the customer makes a purchase decision. **Buying process** encompasses **how customers buy** (e.g., long term contract vs. 3 months contract, single decision maker vs. multi-level/multi-function decision making process); the **buying cycle** (e.g., 3 months from initial contact to commercial scale sales vs. 10 years, many regulatory hurdles, and multiple competitive bidding stages to achieve commercial scale sales); **where customers buy** (e.g., local feed distributor, plastics compounder, direct from manufacturer, bricks-and-mortar retail outlet vs. internet retailer, etc.); **what customers buy** (e.g., individual ingredients as inputs to be consumed, manipulated, or processed in the manufacture of another product, such as oil used to make gasoline or xanthan gum used to make salad dressing; final "actives" or goods to be used "as is" in another product, such as a battery in a car; products shipped in a certain package type or size, such as those shipped in bottles via truck vs. tank cars via rail; etc.); and **why customers buy** from one seller vs. another (e.g., reliability, purity, price, family relationship,

reputation, greentech/cleantech attributes, etc.).

I would like to say that there is a standard set of customer segmentation criteria to use. But frankly, over many years and many segmentation problems across many industries, a wide range of criteria have been necessary for successful segmentation. I have occasionally used 3-dimensional segmentation and multiple 2-dimensional slices to appropriately segment customers. Figure 4 contains some ideas on segmentation criteria.

Criteria	Description	Examples
Application	Use of seller's products by customers or customers' customers	Aircraft, automotive, medical device, energy, food & beverage, semiconductor, software
Buying Process	How, how long, where, what, and why customers buy	Single decision maker vs. multi-level/multi-function decision making process
External Impact	Impact of external trends, drivers, and issues on customers	Government subsidies for alternative energy, carbon emission limits, use of social media
Loyalty	Customer loyalty to a seller based on technical service, relationship, reliability, price insensitivity, brand image, etc; competitive intensity between sellers	Japanese Keiretsu; multi-generation family loyalty to a brand of truck or car; rewards programs at airlines, grocery stores, and hotels
Service	Cost to serve, technical service needs, etc.	Customer segments requiring considerable seller infrastructure
Statistics	Size, growth rate, # of customers	80/20 rule: 20% of the customers make 80% of the purchases
Technology	Customers with different technology and/or degrees of innovation	Semiconductor line width, biotech vs. small molecule drugs
Value	Current and/or future segment value to seller	\$1MM/yr profit (to seller) segment with ~10%/yr growth vs. \$5MM/yr profit segment with ~20%/yr growth

Figure 4: Categories of Customer Segmentation Criteria (see Appendix)

Lastly, in many B2B situations it is important to remember that a **distributor, blender, compounder, or other intermediary is the seller's channel to reach the customer and not the end customer itself.** Or, put another way, if the seller wants its pixie dust in P&G's Olay cosmetic family, then the seller had better be thinking about P&G's needs and buying process. It is not enough to just think about the distributor who represents the seller's products to P&G.

What information should be known for customer segmentation to work well?

Given that businesses operate in the real world, the answer is as much information as practical given the timeframe in which the seller has to make decisions, the value at stake in these decisions, and the resources that the seller can apply. Translated – if the reward and time are there for a detailed customer segmentation analysis with a significant amount of supporting data, then do that. If business conditions necessitate a one day workshop next week, then make that work. Either way, the seller is better off.

It is, however, important to remember that the results of a customer segmentation analysis should guide everything from profit growth to R&D direction to manufacturing output. Hence, a more detailed approach is preferred.

For best results, the segmentation analysis should include information about (a) trends, drivers, issues, unmet needs, problems, and headaches facing customers; (b) buying processes; (c) strategic moves made by customers, competitors, and suppliers in that order; (d) segment statistics regarding customer size (revenue, profits), growth rate, number of customers, current and likely future segment spend on seller's type of offerings; and (e) competitive dynamics. The latter should include the seller's segment share, competitive intensity with respect to seller's offerings, and information on competitors' value propositions.

Conclusion

Customer segmentation is an incredibly powerful tool to help businesses grow.

Customer segmentation helps sellers define compelling value propositions, find opportunities, allocate resources, understand threats, build internal alignment, and enhance individual skills and performance.

Customer segmentation is a powerful tool for achieving business results!

About the Author



Hal Craig is the founder of Trout Creek Consulting (TCC), a management consulting firm that combines “real world” experience, judgment, and industry knowledge with sophisticated strategy and valuation tools to **help clients create value through improved decision**

making. Mr. Craig's industry knowledge includes the agriculture, biomaterial, biopharmaceutical, cosmetic/cosmeceutical, energy/cleantech, fine chemical, food ingredient, medical device, nutraceutical, oral care, petrochemical, pharmaceutical, semiconductor, and specialty chemical industries. TCC's offerings encompass strategy definition, valuation, and scenario planning engagements in addition to immediate impact problem solving workshops focused on customer segmentation and management, competitive gaming, development portfolio management, and sales force design and effectiveness.

To discuss customer segmentation further or other areas of interest to your firm, please contact Mr. Craig at 610-296-2370 or hcraig@troutcreekconsulting.com.

Please visit our website, www.troutcreekconsulting.com.

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Appendix: Categories of Customer Segmentation Criteria

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