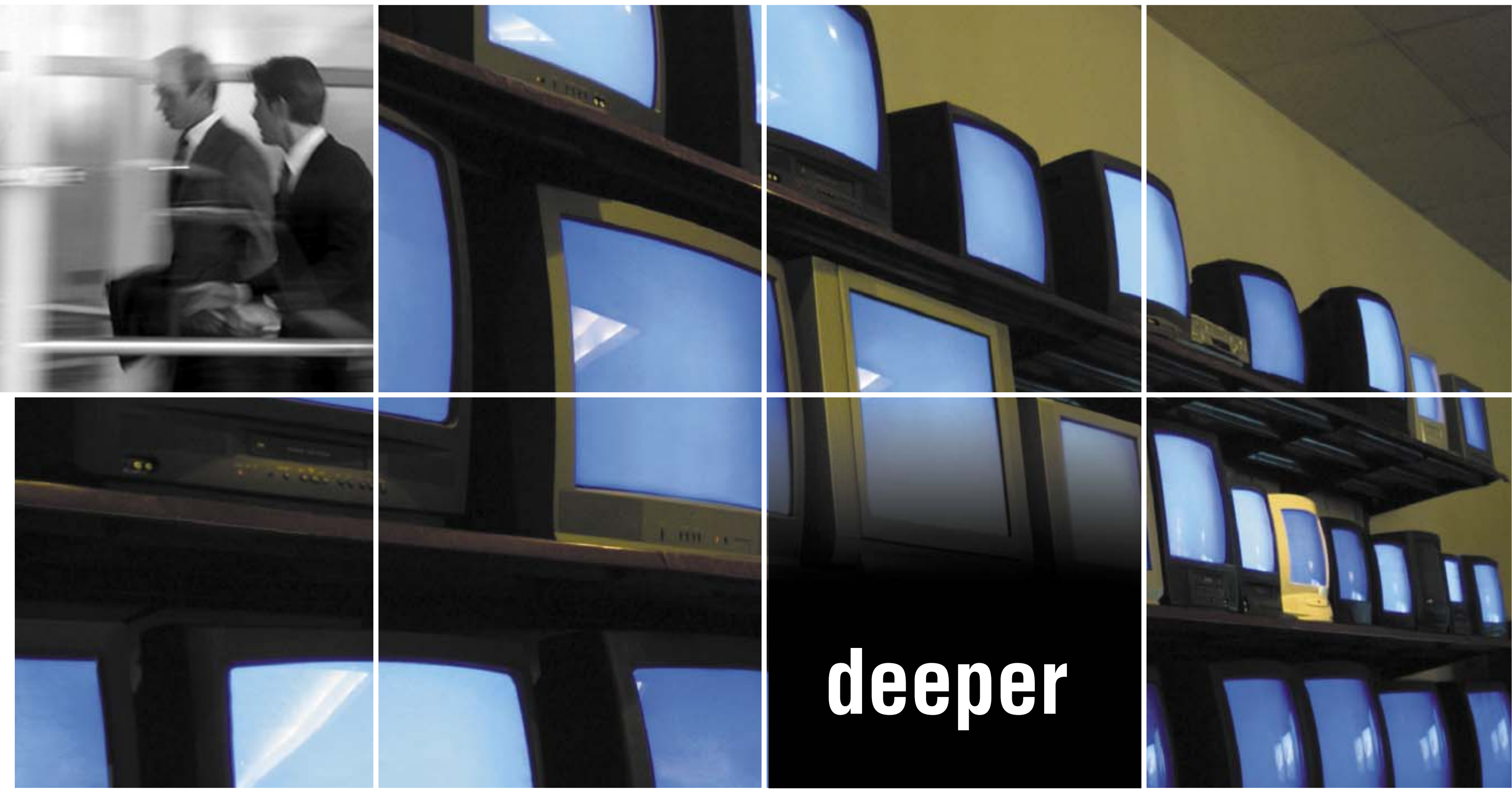
IBM Business Consulting Services

Driving an operational model that integrates customer segmentation with customer management



An IBM Institute for Business Value executive brief

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Overview

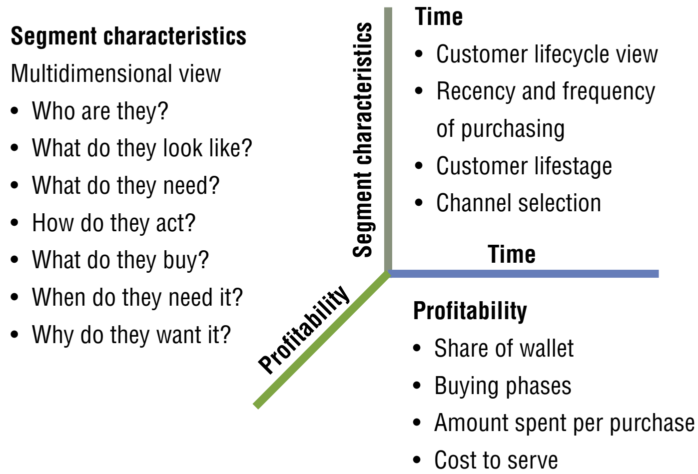
Very broadly, the goal of customer segmentation is to know your customers better, and to use that knowledge to enhance corporate profitability. Effective segmentation drives revenue growth through increased ability to meet customers' demands. Segmentation's greatest impact is on the top line, growing the number of customers, the amount of sales per customer, and the lifetime value of the customer. But it can also have a hand in the cost side, in aligning costs – to more economically serve each customer segment. In short, segmentation impacts customer profitability, which impacts corporate profitability. Companies paying attention to customer segmentation are reaping rewards.

Companies in general are embracing the benefits of segmentation. It is both insightful and exciting to see the quantitative and qualitative benefits companies are realizing from actively pursuing multidimensional, dynamic segmentation: double-digit million dollar revenue growth, 30 to 50 percent increases in customer asset retention, shifts of organizational structures to segment alignment, and expansions and changes to corporate strategy, to name a few.[1]

As you can imagine, there are opportunities for companies to learn from these results and to improve not only marketing performance (customer acquisition, retention, migration to higher value) but also to make knowing the customer a way of life in their organizations – using segmentation across functions and levels for multiple purposes. Paying attention to time-based characteristics, appending attitudes to understand why customers buy, and actively watching how customers change over time are opportunities not fully being taken advantage of by all companies today.

Interestingly, despite all the latest advances in technology, sophisticated algorithms and customer relationship management (CRM) capabilities available to companies, segmentation still requires thorough business analysis and interpretation to be truly viable and have impact. A focus on the key building blocks of segmentation – segment characteristics, time and profitability – will bode well for any company embarking on or improving upon segmentation.

Figure 1. Three building blocks of effective customer segmentation.



Source: IBM Institute for Business Value analysis, 2003.

However, exactly which segment characteristics are most relevant – and when – must be figured out by each company. Common methods for determining this are sophisticated means such as factor analysis and statistical models, as well as tried-and-true, trial-and-error methods. Segmentation choice is based on a host of drivers, including purpose of segmentation (for example, strategic versus tactical, company-wide versus initiative-based, one-on-one versus portfolio level), type of product versus service, and company and industry specifications.

In the following pages, we evaluate how successful companies are not only using segmentation to better reach profitable customers, but also how they are making segmentation a way of life in their companies, weaving it into all areas of the organization to improve business performance, top line and bottom line. As a result of this, opportunities have been identified which virtually all companies can apply and from which they have the potential to derive benefits.

What effective segmentation looks like

Today, customer segmentation is no longer a simple, or static, marketing technique; it is core to the way successful companies run their business. An executive from one of the top five U.S. financial services companies told us, “Segmentation results are used across the whole organization; segmentation is critical to many departments in our organization.” In fact, of the companies we surveyed (over

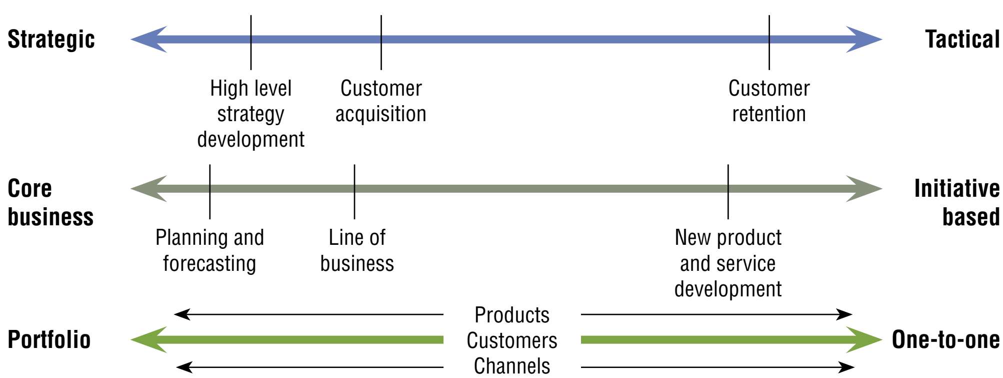
120 respondents, 90 percent with revenues over US$100 million), 77 percent cited segmentation as a valuable part of their go-to-market strategy, and 97 percent rely on segmentation in strategy development.[2]

In today's tough and uncertain economic times, knowing your customers and serving them profitably is critical to sustained corporate growth. Stakeholders have little tolerance for costly marketing mistakes, initiatives with a low return on investment (ROI), or misguided growth plans with limited customer appeal. Segmentation is providing relevant and much-needed direction for companies by bringing a comprehensive picture of the customer to bear on important, and often pivotal, decisions that corporations make.

How well do you know your customers? If you are breathing a sigh of relief because you have a Customer Relationship Management (CRM) system, think again. Having a CRM system is a good start, but it is not enough. Only 17 percent of companies with implemented CRM solutions use marketing and customer analytics applications; these are the applications that can help determine profitability of customers and segments, improve customer profiling, and automate targeted marketing efforts. A survey of 404 information technology (IT) and marketing executives found that 97 percent of respondents plan to increase spending on CRM technology within the next 24 months, but only 7 percent plan to allocate this spending to "improved profiling and targeting of customers."[3]

The companies we interviewed use customer segmentation for many purposes, and conduct segmentation studies at many levels.

Figure 2. Purposes and levels of segmentation.



Source: IBM Institute for Business Value analysis, 2003.

Depending on the goal, segmentation can be simple or complex, one-dimensional or multifaceted. One leading consumer packaged goods (CPG) company uses segmentation for strategic, high-level decisions that impact the core business and affect the entire portfolio of products, customers and channels. The company also uses segmentation data to direct more tactical, discrete initiatives such as targeting a single customer segment or channel. At a high level, this CPG company uses segmentation to aggregate and allocate its advertising media buys. Segmentation tells the company which advertising campaigns and brand positioning will appeal to which segments. From this information, the company is able to leverage portions of its advertising spend across multiple products and lines of business while targeting other portions to specific channels and customers, all while taking advantage of economies of scale of the aggregate spend. At a tactical level, the CPG company uses segmentation to help design new products to meet the changing needs of specific customer segments.

To get full value from segmentation and apply it correctly, companies must pursue comprehensive, dynamic segmentation. Customers today are on the move, always learning, constantly changing; companies have to know not only what customers look like today, but how their appearance will differ the next week and differ again the next month. On top of that, companies have to know how customers *act,* because, while first impressions reveal a great deal, appearances can be deceiving. Not all customers that *look* alike, necessarily act alike.

Figure 3: Needs and attitudes of similar lifestage and demographic mix: Grocery store example.

	Demographics	Lifestage	Needs	Attitudes
	Woman, early 40's, married, household income of $125,000	Two kids, working mom	Menu planning advice (low fat and value oriented), cooking club	Value shopper, prefers low fat products, enjoys cooking
	Woman, early 40's, married, household income of $125,000	Two kids, working mom	Ready-to-eat products, pre-cooked entrees, home grocery delivery services	Convenience shopper, prefers organic foods, does not like to cook

Source: IBM Institute for Business Value analysis, 2003.

Segmentation is the vehicle by which companies know and manage their portfolio of customers. Customer segmentation informs and directs and is directly linked to profitability. In effectively managing and growing the portfolio of customers, companies look to segmentation to tell them:

- *Highly profitable customers:* What can we do to keep these customers and keep them spending? How can we attract more like them?
- *Profitable customers:* How do we get more of these customers to adapt the habits (spend) like our highly profitable ones?
- *Unprofitable customers*: How can we phase out these customers and, in the meantime, serve them economically?

"The customer portfolio needs to become the basis for how companies get organized, measured, and managed."[4]

To make full use of customer segmentation's potential, companies should look at the dynamic interaction of three key variables: segment characteristics, time and profitability (see Figure 1).

Furthermore, companies relying on segmentation for traditional marketing efforts only must expand their use of segmentation. Companies should use segmentation throughout the company and across multiple functional areas. To take full advantage of segmentation's potential, they should also use it to improve forecast accuracy, to direct strategy development, and to determine organizational structure.

Building block #1: Segment characteristics. Almost three-quarters of the companies we surveyed, and 100 percent of those we interviewed, rely on a multidimensional view of the customer. "Multidimensional" means having a comprehensive picture of the customer: who they are, what they look like, what they need, how they act, what they buy, when they buy and why they buy.

Why customers buy is often shelved or ignored altogether because the information is difficult to obtain or because management views attitudinal data as "squishy." It is the "why" that drives many of the choices consumers make; "why" explains motivations behind purchases, and it actually accounts for nearly half of the purchasing decisions customers make.[5]

While all companies benefit from having a multidimensional versus one-dimensional view of their customers, the weighting, or importance, of each segmentation type varies by business and by industry.

Figure 4: Multi-dimensional segmentation looks different for different industries, companies and purposes.

Drivers of differences
- Purposes
  - Strategic versus tactical
  - Company-wide versus initiative based
  - One-on-one versus portfolio level
- Industry-specific benefits
  - Individual customer profitability
- Company-specific benefits
  - Attitudinal view, understanding motivations
- Product versus service
  - Portfolio level versus one-on-one

Steps to determine relevant characteristics
- Trial and error
- Factor analysis

Source: IBM Institute for Business Value analysis, 2003.

Building block #2: Time. Many companies de-emphasize the time variables, for example, reaching the right customer at the right time via the right channel. Of all survey respondents, only 37 percent use aggregate behavior, only 34 percent use lifestage, and only 21 percent use occasion-based segmentation characteristics.

"Identifying segments and knowing a little about them is not enough; you have to know a lot about them."
– Leading diversified retailer executive

Time variables are critical because they highlight how customers and their buying phases change over time. It's not enough for a company to ask, "Which customers should be targeted?" and "How much will a customer buy?" To be effective, segmentation must answer, "Which customers should be targeted *when?"* and "How much will a customer buy, *and* how often will a customer buy, with what recency will a customer buy, where is XYZ customer in his/her buying phase, which channels will the customer choose to make the purchase, and what is the predicted purchase propensity?" Companies should track customers as they grow and change to identify points of choice – times in a customer's life when they are changing their purchase patterns.

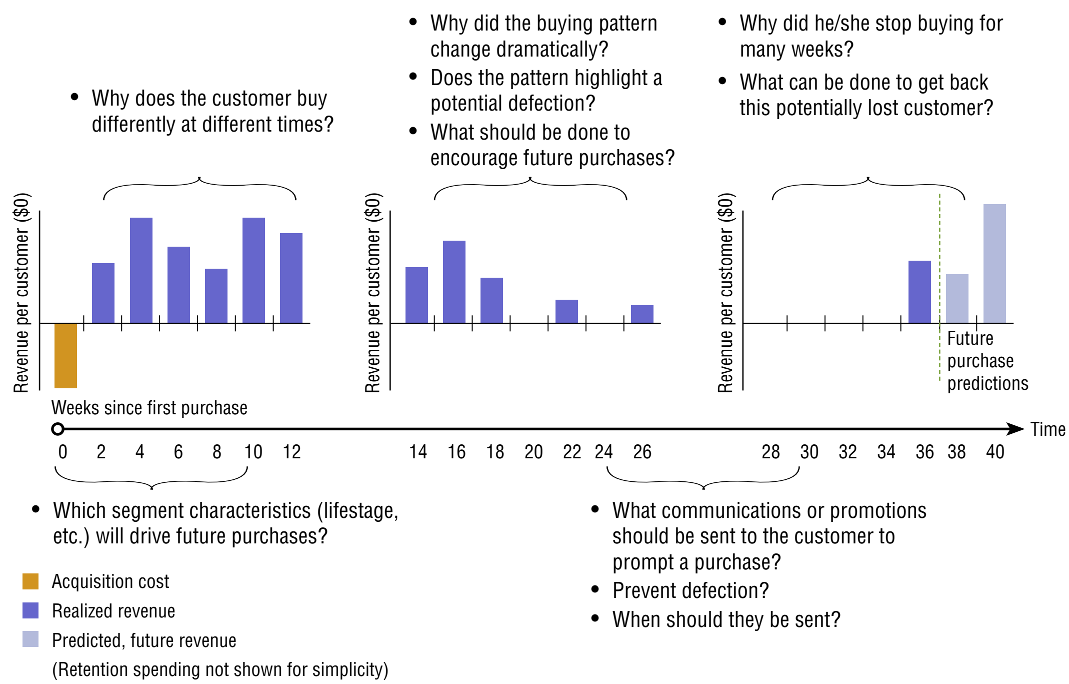
Building block #3: Profitability. Effective segmentation must be both qualitative and *quantitative*. To make accurate, segmentation-driven decisions, companies need to measure profitability at multiple levels, including individual, sub-segment, segment, and the total customer portfolio level. Companies must figure out measures of value – profitability variables that work best for them. Our research indicates that these measures vary by industry and by company, from recency, frequency, monetary (RFM) indices, to customer-value indices, to revenue per customer versus cost to serve.

One caution in selecting profitability measures: Make sure the measure chosen provides an accurate, comprehensive view of performance. Relying on per-customer revenue numbers only, for example, could be misleading; customers at the same sales levels could be profitable in a low-rent retail location but unprofitable in a high-rent retail location. Make sure measures are comprehensive.

Interaction of the three segmentation building blocks. Companies capitalizing on customers' changing patterns (defined as the interaction of segment characteristics, time and profitability) achieve ongoing value by acting first, before competitors, to reach customers at their points of choice (the times when their purchase habits change).

Changing-patterns analysis follows predictive modeling; changing patterns applies a business interpretation to explain why. The linchpin is timely action.

Figure 5: Changing patterns: Company analysis and interpretation (illustrative).



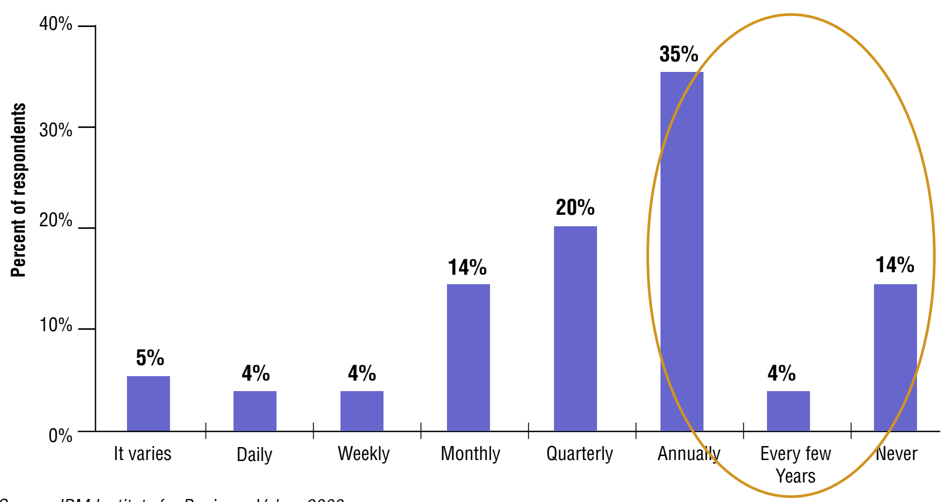
Source: IBM Institute for Business Value analysis, 2003.

Identifying and acting on customers' changing patterns is critical to beating competitors in the marketplace. One leading retailer incorporates changing-patterns analysis to focus and target its marketing and retention efforts. Clusters of customers are plotted on an opportunity map with each of the three building blocks representing one axis of the three-dimensional map. An executive from a leading retailer told us, "While it is important to let the data speak for itself, you also need to add business analysis into the mix to ensure the results are sensible."

It is only logical that competitors may have similar target segments; understanding and acting first on changing patterns can be the differentiator. What if the size of the opportunity is, say, US$70 billion spent in a year? That's the market size of the potential benefit of targeting newlyweds; they spend a total US$70 billion in their first year of marriage – that's more spending in one year than the average household spends in ten years! AOL Time Warner capitalizes on this by creating Newlywed Kits. AOL gets to newlyweds before competitors do by distributing billions of kits through town clerks' offices throughout the United States. Household brands such as Procter & Gamble, Clorox and Colgate-Palmolive vie for space in the kits.[6] "When everyone in the industry is doing the same thing, you're back to even."[7]

Despite the potential value of tracking customers' changing patterns, few companies today are expeditious about doing so; this equates to missed opportunities. Not paying attention to changing patterns could result in a company wasting months and dollars targeting a customer who is no longer (or never was) profitable.

Figure 6: Frequency of tracking and reevaluating customer profiles.



Source: IBM Institute for Business Value, 2003.

To be viable and timely, companies must move away from "annual" and "never" tracking of customers. Customers won't wait that long. Royal Bank of Canada (RBC) tracks customers monthly to understand current and future profitability and risk, likelihood of defection, channel preference, propensity to purchase additional products, and lifestage. The company tracks changes in the patterns of aggregate behavior and uses predictive analytics and business interpretation to determine what the patterns indicate. For example, a decrease in the number or amount of deposits may indicate a customer is about to defect, or the purchase of a mortgage may indicate a customer has a need for a home equity line. Customer tracking and customer understanding enable RBC to achieve a 30 percent response rate on its marketing efforts versus the 3 percent average in the banking industry.[8]

As can be imagined, the optimal rate of tracking customers varies based on industry, purpose of segmentation, and nature of customer interaction. Financial services companies, for example, have regular and frequent interactions with customers across multiple touchpoints. Thus, offering new products and services at just the right time requires frequent tracking of customer movement, often on a daily to monthly basis. CPG companies, on the other hand, interact with customers less often because they transact less frequently. Data is collected from these transactions and also through focus groups and customer surveys. For CPG companies, it often makes most sense to monitor customer movement on a quarterly to annual basis.

It is our belief that, to avoid missing valuable opportunities, companies, regardless of industry, should move away from annual and "never" tracking of customer movement. A nutrition company we interviewed is succeeding by tracking customers over time the easy way, by having the customers do it themselves. Customers update their own records online every 12 weeks. Having detailed, up-to-date records about each customer enables this company to push highly targeted and personalized messages and offers to its clients on a regular basis. This company has a 50 percent renewal rate for its hallmark service.

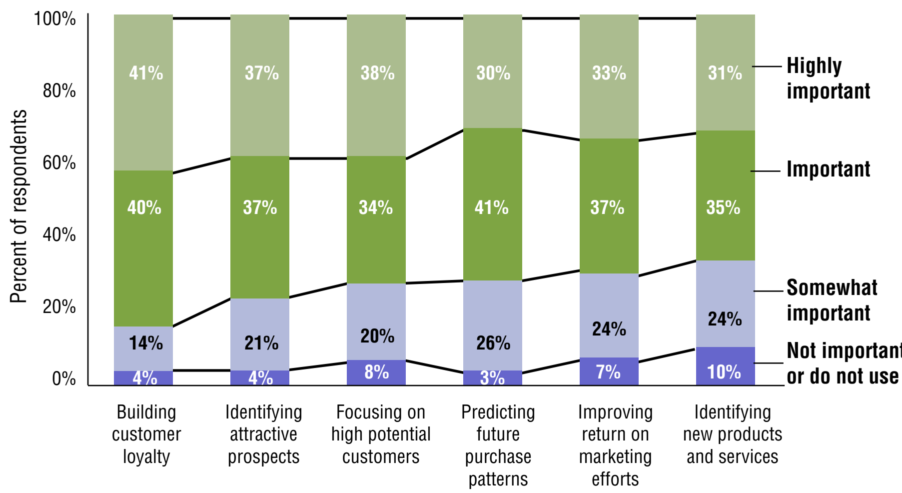
Finally, and very importantly, companies keeping a close eye on their customer are succeeding. Luminar, for example, tracks customers in realtime which helps enable it to optimize returns. Luminar is the UK's leading developer and operator of themed bars, nightclubs and restaurants. The company uses customer data collected on loyalty cards (customers get discounts on drinks for signing up) to track customers and migrate them throughout the night from club to club, bar to bar.

Advertising screens installed in the bars steer customers to high-margin offerings, and text-messaging systems offer discounts and promotions to coax customers from crowded locations to quieter locales. The company even collects data on 14- to 17-year olds at its under-18 nightclubs so that when they turn 18, the company can phone them and say: "You're legal; come and celebrate!" "You always grow a business when you're matching like-minded people with what they want," says Luminar's CEO.[9]

Using segmentation findings to reach profitable customers

Companies pursue segmentation to appeal to old customers in new ways, to attract potential customers in innovative ways, and to migrate high-potential customers to greater value. Survey results indicate that most companies believe segmentation to be "Highly Important" or "Important" to the successful execution of many of their traditional marketing activities.

Figure 7: Importance of customer segmentation in reaching profitable customers through marketing activities.



Source: IBM Institute for Business Value survey, 2003.

However, even if your company uses segmentation in each of these marketing activities, there are opportunities to improve upon these traditional uses of segmentation.

Improvement opportunities

1. *Competitive advantage:* Identify new sources of competitive advantage. Capitalize on changing patterns of loyal customers; keep a close eye on customers, then, cater to their changing needs before competitors do. Only 20 to 35 percent of companies surveyed do this today. Pay attention to time-based elements to know how and when customers change, and cater to their changing needs.

2. *Why buy:* Understand motivations behind why customers buy. Incorporate the attitudinal view to understand what motivates customers to buy; link to other segment characteristics to make viable comparisons. Only 20 percent of companies surveyed do this today.[10]

3. *Quantify segmentation:* Establish clear links to customer profitability and track performance. Strengthen the link between customer profitability and segmentation; use segmentation to optimize the profitability of the total customer portfolio.

The following case examples examine how top companies have improved on each of the six traditional marketing activities (highlighted in the graph) by taking the use of segmentation to the next level. In each case, the company has capitalized on some of the key opportunities for improvement noted above.

Building customer loyalty – improvement opportunity 1: competitive advantage. Hallmark is an excellent example of a company that effectively uses its knowledge of customer habits to customize marketing offerings and build loyalty. Introduced in 1994, the Hallmark Gold Crown Card loyalty program was the first consumer reward program in the greeting card industry. By 2001, Hallmark had 24 million customers in its CRM database, with 13 million of these customers using the Gold Crown Card.[11] The loyalty card allows Hallmark to capture detailed customer data about purchase patterns and purchase history. Aggregating the loyalty-card data with point-of-sale customer data and analyzing the data enables the company to segment customers according to buying habits. A Hallmark business development manager explains: "We need to understand as a corporation how, over time, we [can] maximize value and move [customers] up the ladder of loyalty from 'prospect' to 'buyer' to 'hooked'. The communication behavior from us should change as [the customers] move up."[12]

Cardholders accumulate points that can be used at Hallmark stores and at Hallmark.com. Customers are sent exclusive offers based on the number of points they have accumulated, and special promotional offers based on their past purchase history. Promotions and offers are focused on building loyalty through demonstrating understanding of the customer. Examples of this include:

- Developing marketing campaigns and promotions targeted at different customer segments (for example, collectors of specific product lines are sent promotions about products they collect).
- Releasing new product announcements to specific cardholder segments about products in which they may be interested (for example, announcements about a new seasonal ornaments are sent to ornament enthusiasts).[13]

Identifying attractive prospects – improvement opportunity 3: quantify segmentation. A top-five U.S. asset manager successfully maps customer segmentation results against external prospect data to identify attractive potential customers. This company segments customers into three primary segments based on the customers' current and future value: High Value, Core and Mass Market. Sub-segments, based on their potential to become highly profitable, are broken out within each of the three primary segments: High Potential – highly profitable, most valuable; Cultivate – reasonably profitable, much possible upside; Manage – low profit, low potential, minimal upside.

The company leverages its segmentation scheme to identify and market to the most attractive prospects. The company overlays its internal customer segmentation data on top of external, consumer data, to identify the best prospects. It is looking for customers that are most similar to the High Value, High Potential sub-segment. The company uses its knowledge about current customers in the High Value, High Potential sub-segment to focus and direct customer acquisition marketing efforts. Direct-mail offers are created based on knowing what similar, current customers have purchased.

Predicting future purchase patterns – improvement opportunities 1 and 2: competitive advantage and why buy. A top-ten insurance organization uses predictive modeling to identify and market to customers most likely to buy specific offerings. The company aggregates current and historical customer data from all of its systems into one datamart. It appends the internal customer data with demographic data and then creates a single, detailed profile of each customer. Using a purchase-propensity model, the company determines how likely customers are to buy specific products. It identifies who buys certain products now, and then overlays these customers against the entire population of current customers to determine who else may be interested in a particular product. The results are used to tailor marketing efforts for cross-selling and up-selling of offerings to current customers.

Improving return on marketing efforts – improvement opportunities 1 and 2: competitive advantage and why buy. The Body Shop International, a leading U.K. skin- and hair-care products vendor, successfully uses segmentation analysis to improve response rate and revenue per catalog on a new catalog mailing. The Body Shop wanted to 1) reduce the number of catalogs mailed by 50 percent, 2) improve the response rate of its mailings, and 3) increase revenue per catalog. The Director of Mail Order and New Business Development, Virginia Newman, said, "We knew it was going to be a tough economic year, and we wanted to be as profitable as possible."[14]

The company used predictive analysis to identify the 120,000 customers most likely to buy from a catalog mailing and most likely to have an order size greater than the company's historical average revenue per person. Customer data for the analysis was aggregated from several sources, including historical purchase data collected from all customer touchpoints – Web, catalog and in-store sales – demographic data purchased from a third party, and preferences and attitudinal data collected through customer surveys. The resulting segments grouped customers according to their likelihood to purchase and predicted purchase size. The results of the efforts were highly positive; overall response rate increased and revenue per catalogue increased 10 to 20 percent. Following the effort, Ms. Newman said, "We were able to intelligently target consumers who we thought were more likely to buy and increase our revenue per catalog in a measurable way."[15]

Identifying new products and services – improvement opportunities 1 and 2: competitive advantage and why buy). Marriott International uses customer segmentation and brand understanding to identify opportunities for new offerings. Marriott International has a robust segmentation strategy that enables the company to gain a deep understanding of the needs and wants of both individual customers and segments of customers. Segmentation data identifies gaps between brands (such as a price point that is not offered, a customer segment that is not appropriately served) that represent opportunities for brand improvement and chances to introduce new brands.

Brand improvements and expansions result when a group or segment of customers expresses that it wants specific new services to be provided at a current lodging brand. For example, through customer research, the company found that the price-shopper segment of customers who frequent the Fairfield Inn wanted bigger rooms with more amenities. Marriott launched a roomier version of the Fairfield Inn offering, and called the new rooms "Fairfield Suites."

New brands are pursued when a group or segment of customers desires a totally new set of services that are not aligned with a current brand. For example, through customer surveys, Marriott determined that the company was not meeting the demands and expectations of elite travelers. These travelers desired superior customer service and luxurious amenities. To meet these travelers' demands, the company acquired Ritz-Carlton Hotels.[16]

Putting it all together and making it viable – improvement opportunities 1, 2, and 3: competitive advantage, why buy, and quantify segmentation. This top-five financial services company makes segmentation viable across the entire organization. The company uses data mining and activity-based costing to segment customers into a tiered pyramid based on profitability and assets. Within each tier, customers with the highest growth potential are singled out and tagged as High Potential. Many of the company's segmentation-related activities are focused on retaining and migrating these High Potential customers up to the next tier. On the organization level, the sales force's incentive programs are linked and aligned with the company's goal of migrating customers tagged as High Potential up to the next tier of the pyramid.

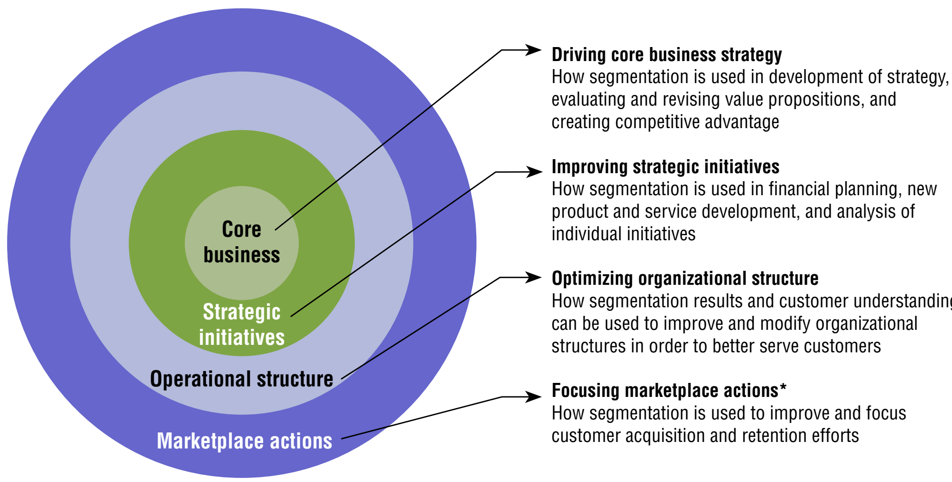
This company puts segmentation into action in three tactical ways. First, customer service representatives are empowered to deliver the appropriate service level based on customers' profitability. The company sets protocols for sales and service levels based on a customer's tier and sub-segment. When a teller accesses a High Potential customer's record, a flag appears designating the appropriate level of service and specific offers. Second, sales representatives can offer 50 basis point reduction to a customer in the High Potential sub-segment, but only 35 basis point reduction to a customer in a mid-level tier.[17] And finally, the level and quality of phone service extended to customers is also dictated by the company's segmentation scheme. Customers in higher tiers are routed to the front of phone queues and serviced by experienced customer service representatives. The company is dedicated across the organization to using its customer segmentation scheme to migrate its best customers up the pyramid to higher value.

Weaving segmentation into the fabric of organizations

Today, companies are using segmentation across numerous functional areas. Over three-quarters of survey respondents actively use customer segmentation across multiple functional areas in their companies, from marketing and product development to business development and strategic planning.

The most successful businesses make knowing their customers a way of life in their organizations.

Figure 8: Segmentation impacts strategy and structure.



Source: IBM Institute for Business Value analysis, 2003.

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Driving core business strategy

Customer segmentation is becoming an ever-increasing part of corporate strategy development. The majority of survey respondents use segmentation either in the beginning of their strategy development process or throughout the process to help ensure that the company is headed in a direction appealing to customers and one to which they will gravitate.

A leading international health products and services company serves as an excellent example of a company that successfully uses segmentation to drive business strategy. The company relied on attitudinal segmentation data to rationalize the business decision to transition from a products-oriented retailer into a health services company. The company addressed several key questions with its attitudinal research:

- To what extent would current customers be interested in a more service-oriented offering?
- Are there attractive segments of prospective customers who may be interested in the new offering?
- Which segments of customers would be most suited to the new positioning/offerings?

Understanding the mental attitudes and wants and needs of different segments of customers helped the company to structure the offering, set the prices for new services, and promote the offerings to the most appropriate customers.

Leveraging segmentation data enabled the company to differentiate itself from competitors. By understanding how its customers are segmented, the company was able to make educated business decisions, both strategic and tactical, that significantly increased its sales. For example, the decision was made to discontinue certain product categories and offer new product categories, which resulted in sales increases. This company is at a significant competitive advantage. They know their customers better than 90 percent of retailers in their region do, and they actively use this knowledge to win in the marketplace.

A top-tier international hospitality company also uses customer segmentation data to drive key business strategy decisions. It uses customer segmentation to refine and expand value propositions, to develop and revise customer service and brand strategies, and to prioritize strategic initiatives at both the corporate level and the individual brand level. This company has a franchise business model and uses segmentation results to gain widespread buy-in and rally support from franchise owners. For example, segmentation data was used to reinforce the vision statement and strategy around a specific new brand that overlapped with a current offering. Segmentation results were used to develop a unified marketing communications plan by which all franchise owners and constituencies now abide. Segmentation enables the company to tailor marketing communications for each brand and customer segment and is particularly useful in training and empowering front-line employees to deliver appropriate services.

Improving strategic initiatives

Executives told us that the results of segmentation studies are used to focus and direct many of their strategic initiatives. An executive at a top-tier office supply company explained how segmentation data helped them reorganize their loyalty program, saying "We used results of our segmentation studies to restructure our loyalty program and offer greater rewards to our highest value and most profitable customers." The financial planning department of a leading international lodging company relies heavily on segmentation data: "Analysts use predictive modeling to determine future 'stay patterns' based on historical 'stay patterns.' This data is used by the finance department to improve accuracy in financial planning."

An executive from a leading property and casualty insurance company detailed how segmentation data is used in strategic planning sessions: "Results of segmentation studies are disseminated to strategic planning committees and used to determine on which current and new market segments to focus in the future." Other companies find segmentation data to be valuable to their product development groups; an executive from a top-five U.S. asset management company told us, "Our product development group uses segmentation results to develop special targeted offerings only available to a select few of our highest-value [most profitable] customers."

Mercedes-Benz, a division of DaimlerChrysler, applies an understanding of customer segments to direct strategic initiatives. In the past, Mercedes-Benz primarily targeted aged 50+ affluent males. Through customer segmentation research, the company discovered an attractive, younger customer segment – that of successful, affluent, young professionals. This attractive segment actually did not exist even a decade ago; the segment is the result of many young people marrying later and making high salaries at a far younger age. Mercedes determined that by 2001, this "Entry Luxury Car Segment" accounted for 75 percent of the luxury car market sales.[18]

In 2001, Mercedes launched a sportier version of their C-Class car, called the C-Class sports coupe, and priced the offering at US$24 950. The Vice President of Marketing at Mercedes said, "The new sports coupe represents an enormous – and completely new – opportunity for us. The marketing behind it has to not only reach these younger buyers but also challenge their perceptions of Mercedes-Benz, both in terms of affordability and relevancy." To promote the new car, the company created a television advertising campaign featuring a joyful driver in his 30's, and ran it during programs watched by the target market, including *The West Wing,* *Frasier, Friends, The Tonight Show* and on the network *VH1*. The Mercedes Vice President of Marketing is quoted as saying that "Mercedes encourages entry-luxury buyers to 'Change Lanes',"[19] A Mercedes spokesperson reported, "We are seeing more young, successful people . . . deciding it's OK and cool to buy a Mercedes."[20]

It (Sony) decided to reorganize by customer segments to enable the company to target products and services according to customers' lifestages, preferences and needs.

Optimizing organizational structure

Sony used segmentation to create an entirely new organizational structure. In early 2002, to better understand and serve customers, Sony reorganized, internally and externally, by customer segments. It decided to reorganize by customer segments to enable the company to target products and services according to customers' lifestages, preferences and needs. An in-depth segmentation study resulted in the creation of new customer segments – the segments are: Affluent; CE Alphas (early adopters); Zoomers (55+); SoHo (small office/home office); Young Professionals/D.I.N.K.s (double income no kids, 25 to 34); Families (35 to 54); and Gen Y (under 25).[21]

Using this segmentation, the company shifted to a new segmentation-based organizational structure. This shift affected leadership positions and the company's go-to-market strategy across all divisions, including marketing, product development, retail merchandising, advertising and consumer loyalty programs. In the past, products were owned by and marketed by product managers. In the new organization, executives are assigned to champion and manage customer segments.[22] Additionally, the new product development division was reorganized and given the mission of designing a new generation of products based on the preferences of identified customer segments.

Sony created a new division, called the Consumer Segment Marketing Division, to support the reorganization. The new division provides segmentation research and analysis for marketing communications across each segment, and works to "develop an intimate understanding of Sony's end consumers … from cradle to grave." The company is committed. "Beginning with the new fiscal year, we will create and report a virtual [P&L] that restates our [approximately] US$8 billion consumer business by consumer segments."[23]

Putting it all together: weaving segmentation into the fabric of the organization

A leading diversified retailer shows how companies can weave segmentation into the fabric of their organization. This company makes knowing their customers a way of life by fostering a culture that supports this mission and actively seeking the necessary buy-in. The goal of the company's cross-company segmentations is to gain the deep customer understanding needed to drive viable, strategic decisions.

Segmentations are based on historical transaction data (from the last four years), survey data, interview data and third-party data. The company conducts segmentation using several key types of customer understanding: behavioral patterns, demographic, attitudinal and financial.

An executive from the company explained a key aspect of how they ensure buy-in, saying, "Regardless of how it's developed, segmentation must be intuitive, or people will not believe it or buy into it." The company gains corporate buy-in in many ways. Each month, the Customer Advisory Council, which includes the CEO and direct-reports, has a formal meeting. The main topic of the meeting is making segmentation viable, and the goal is to get the buy-in of top-level management. The company holds twenty or more, three-hour, one-on-one meetings with key vendors. At these vendor meetings, executives report to vendors the results of segmentation studies, and explain in detail what customers look like, why customers come to this company, and how customers are similar and different. Regularly, the company holds meetings with the heads of each of its lines of business (LOB) to determine how to make cross-company segmentations viable at the LOB level. An executive from the company explained why each of these different meetings is critical, stating, "Buy-in happens one step at a time."

Conclusion

Effective customer segmentation can contribute to a company's success far beyond determining its next marketing promotion. A comprehensive, dynamic, multidimensional approach will help ensure that companies know their customers and are equipped to fully take advantage of what they learn about their customers to serve them better. The resulting knowledge about customers should be used extensively, not only in marketing contexts, but also throughout the company, making the customer an integral part of strategy and decision-making.

Addendum: Leveraging tools and techniques to make segmentation viable

Taking a closer look at three of the more complex and effective segmentation tools reveals that using these and other proven techniques and technologies helps enable companies to do, in days, what could otherwise take weeks.

1) Predictive modeling and analytics – Tools that model historical data with assumptions for future conditions in order to predict how likely customers and prospects are to conduct themselves in a certain way (for example, buy a product, respond to an offer, default on a loan)
2) Customer pyramid tool – A tool used to "tier" customers according to their profitability and value to the company; it is also used to identify high-potential customers within each tier to focus on migrating them up the pyramid
3) RFM and RFA – Analysis that quantitatively identifies a company's best customers using recency (R), frequency (F), and monetary (M, how much a customer spends) or average (A, average purchase amount) variables.

Predictive analytics

Predictive modeling and customer analytics modules can help ensure a high return on marketing and business investments. With predictive analytics, companies can create complex models that incorporate hundreds of variables to make more accurate assumptions and predictions about their customers. There are several types of predictive analytics:

1) Forecasting: Using data mining algorithms to identify trends, predict future sales and predict future conduct
2) Predictive profiling (propensity analysis): Using data mining algorithms to predict a customer's or segment's likelihood to conduct themselves in a certain way (for example, buy a product, respond to an offer, file a claim, etc.)
3) Predictive mapping: Using models to identify the characteristics of profitable customers and applying predictive analytics to determine which current customers and which prospective customers are likely to conduct themselves like, and become, best customers.

The Westminster police force of Orange County, California, uses predictive analytics in a unique fashion. The police force uses predictive models in its crime analysis and prediction system to predict local crime patterns, distribute patrol forces and allocate resources. In the future, the system will be used to predict crime trends, improve patrol assignments and develop better crime prevention programs.[24]

IBM Research and Farmers Group Insurance teamed to develop a predictive modeling application for discovering homogeneous insurance risk groups to more accurately assess the risk posed by policyholders. Together, they created the Underwriting Profitability Analysis (UPA) application, which mines insurance policy and claims data to predict and assess risk. The IBM predictive data mining engine, ProbE, mines millions of policy records to generate rules for profit realization. The analysis found that applying the six rules with the highest profit potential in just one state could result in a net profit gain of millions of dollars. For example, one rule indicated that, if a sports car is not the only vehicle owned by a household, accident probability on the sports car is significantly reduced. In one estimate, allowing these drivers to insure their premium cars on the same policy as their everyday cars resulted in an additional US$4.5 million in revenue for the company over two years, without a significant rise in claims.[25]

The customer pyramid tool

The customer pyramid tool enables firms to identify differences in current and future customer profitability. The key to segmenting customers by profitability levels is combining per-customer acquisition and maintenance cost data with revenue information.

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There are several tactics that companies can employ to migrate customers up the pyramid, from Lead to Iron to Gold to Platinum, including:

- Becoming a full-service provider – To increase share of wallet, offer services that Gold customers may be purchasing elsewhere
- Broadening offering range – Offer products related to core offerings to entice Gold customers to purchase more
- Reducing nonmonetary costs of doing business – Instead of lowering prices (which lowers profits), make it easier for customers to do business with you.[26]

A top-five U.S. financial services company uses the customer pyramid to increase awareness and focus on customers, based on two primary factors: 1) depth of relationship (the number of products the customer has and the amount of assets the customer holds), and 2) customer profitability. Within each tier, customers are ranked according to their growth potential. The goal is to move the customers in each tier with the highest growth potential up to the next tier. Customers are flagged at each customer touchpoint so customer service representatives can serve each customer appropriately. High-potential customers are tracked and analyzed quarterly.

RFM and RFA

RFM and RFA are two popular, three-dimensional segmentation techniques often used to identify the best customers for direct-marketing purposes. RFM looks at three customer attributes:

- Recency (R): Customers who purchased recently are more likely to respond to the next promotion than those whose last purchase was further in the past
- Frequency (F): Frequent buyers are more likely to respond than less-frequent buyers
- Monetary (M): Heavy spenders often respond better than low spenders.

RFA uses average purchase amount (A) instead of total purchase amount (M) to determine the best customers. Why should companies use RFA analysis? The highest monetary segments do not always outperform the low monetary segments. Often, the segment with the highest average order outperforms the segment with the highest monetary rating. RFA is particularly useful when the average order is substantially different among segments. Additionally, average order is often a better predictor of future conduct than total monetary spend. Also, don't ignore costs when calculating monetary or average value, especially when costs are significantly different between products or when the associated customer service costs are high.

Direct-mail marketers for nonprofit organizations often use RFM to target mailings to people who are most likely to donate. Each customer is assigned a score of 1–5 for each of the variables (recency, frequency and monetary). The customers with a score of "5,5,5" are tagged as the best, and so on. In most cases, recency is the most powerful of the three measures, followed by frequency. It is important to note that the relative importance of each variable, whether it is R, F, M or A, varies from one customer base to another.

One case example examines how a collectibles cataloger, using RFM analysis, was mistaking its worst customers for its best customers. Using RFM analysis, the cataloguer started by making a list of customers that had bought in the last six months (R), made more than three purchases (F), and spent over US$300 (M). Upon careful analysis of the results, the company discovered that customers that looked like the best customers from the RFM scoring had actually made many small purchases (20+ that year). Many small purchases were resulting in a high total cost to serve this customer – the company was actually losing money on each sale. To rectify this error, the company decided to instead looking at the average order amount. Swapping in the criterion of average order amount (A) enabled the company to more accurately identify the best, most-profitable customers to whom to send the "Thank You" offer.[27]

Test your segmentation techniques

The best way to determine if RFM works better than RFA in a given scenario is to test one against the other. To determine if a test is worthwhile, review your database to check for the following information. If you answer "yes" to any of these questions, it makes sense to test RFA:

- Is there a large difference in the average order amount among your best customers? If the answer is yes, then looking at the average purchase amount is better than looking at the total monetary amount spent, because typically the segment with the highest average order outperforms the segment with the highest total monetary value. The most notable differences between A and M occur when the average order amount is substantially different between segments.

- Do most of your buyers have a low monetary value and a frequency greater than one? Although having many orders is good, many small orders can be costly. Examining the average order size helps differentiate between low-dollar buyers.

- Do your customers tend to order a consistent amount (high stays high, low stays low)? If the answer is yes, then “average” is a better predictor of future conduct than total spend. Many buyers exhibit a “comfort level” of how much they spend with each purchase; companies need to know the average order size and market to these customers accordingly.[28]

In summary, companies that leverage segmentation technologies and tools can effectively apply segmentation results to improve traditional business activities. Segmentation technologies and tools are designed to increase accuracy and decrease time. This, in turn, enables companies to more efficiently analyze customer data and put the results of segmentation studies to work in the marketplace.

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