Strategic segmentation

Customer segmentation: More than just a marketing tool

Managers are always jumping on the bandwagon to try the latest and greatest management tool. Meanwhile, one of the most powerful strategy development tools is under-used or ineffectively used: customer segmentation. Customer segmentation has been around forever, and many companies have used it as a marketing tool. But in our experience, few get the bottom-line results that they should. And since most agree that all elements of a good strategy—from product design to pricing to distribution to competitive positioning—should in some way derive from the goal of meeting the key requirements of target customers, customer segmentation itself is a critical tool for strategy development. Why, then, do many companies not see bottom-line results? Most often it is because the output ends up being interesting but not actionable, or the results are used only for limited marketing purposes, not as a strategy tool to guide the entire organization.

Segmentation divides customers into groups based on the underlying needs or characteristics driving their purchase decisions. Truly distinct customer segments respond to different value propositions and require different strategic approaches. When properly used, segmentation helps you allocate resources throughout all levels of
your organization to create a value proposition that uniquely serves your target customer groups. In other words, if strategy is the art of allocating scarce resources, then segmentation—and the understanding it provides about your core customer groups—is part of the science informing that allocation.

Take, for example, Dell Computer. Competing in a narrow margin segment of the computer industry—hardware manufacturing—Dell has been leading the pack with execution and innovation unmatched by its competitors. But things have not always been so rosy for Dell. Business expanded rapidly and profitably from 1989 to 1993, but then the company posted a loss. Kevin Rollins, the company’s vice chairman, attributes the loss in earnings to the loss of focus: Dell had neglected its most profitable customer segments and placed too much emphasis on the retail channel.

Faced with declining profitability, Dell systematically analyzed every piece of data to find where the company was making money and where it was not. Dell then redirected its attention to the most profitable segments, such as corporations, and pulled out of its retail channel. But focusing on the direct corporate channel was not the only change. Dell’s entire value chain and organization then had to adapt to these target segments. Consequently, its decision to target certain customer segments led to a change in its entire business model.

Dell also realized that to maintain its leadership position within the direct channel, it had to constantly segment and resegment its customer base. Using this direct, continuously updated knowledge of its customers, Dell has been able to refine its business models for different customer segments, consistently keeping competitors at bay.

**Making the exception the rule:**

**Segmentation as a strategic tool**

For Dell, customer segmentation has been an incredibly powerful tool, both for formulating strategy and as a guide for allocating the company’s resources to carry it out. Yet in many cases, managers conducting segmentation studies find only frustration. All too often, after the data has been tabulated and analyzed, management is presented with customer profiles that may be ‘interesting,’ but are not clearly focused on the critical customer needs or characteristics driving purchase behavior. They, therefore, are not the guide needed to drive resource allocation decisions.

The success of Dell and other companies Bain has assisted illustrates some of the key steps you can take to make customer segmentation not just a marketing tool, but also a powerful tool for allocating scarce resources.
Take, for example, a manufacturer of children’s apparel. The company segmented customers along a number of criteria, including whether their apparel purchases were planned or unplanned, and whether they brought their children with them to the store. This “shopping habits” segmentation provided little insight into what drives people to choose one brand of apparel over another.

A more meaningful segmentation would separate customers based on their needs and purchase criteria: sensitivity to price, requirements for durability and quality, the value they place on style and fashion, and so on. Knowledge of these more tangible factors would allow the manufacturer to make changes such as a price point adjustment or a switch to 100% cotton fabric that would actually enhance its value proposition to the customer and result in higher revenues.

Think profit, not revenues
That being said, improved profits (not just revenues) should be the goal of customer segmentation. A common pitfall of companies defining target segments is to focus on revenue potential instead of bottom-line profit potential. This myopic view can lead a company to go after the wrong customers, growing sales even as the bottom-line suffers.

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Involve senior management
Since strategic decisions are typically made by senior management, companies with the greatest customer segmentation success are invariably those where senior management—specifically the CEO or division head—is involved from step one through to implementation of the actions highlighted by the segmentation. Because marketing departments often have no direct operations responsibility, senior management support is critical to ensure that customer segmentation does not become merely a database for fine-tuning marketing and promotional efforts. The CEO should define the key strategic questions to be addressed and then champion the segmentation process. He or she should provide leadership in choosing which customer segments to pursue and the aspects of the value proposition that must be modified to best serve them. Most importantly, the CEO should be instrumental in driving actual change throughout the organization.

Segment only on what truly drives purchase behavior
Customer segmentation divides customers into groups based only on those needs and factors actually driving purchase decisions. A common mistake is to segment customers based on peripheral characteristics that, while interesting, provide no help in achieving the fundamental goal of segmentation: selling more product more profitably.

Senior management support is critical to ensure that customer segmentation does not merely become a database for fine-tuning marketing and promotional efforts.
One example of this is a retail drugstore chain that we’ll call RxWorld. In the 1980s, RxWorld built a strong competitive position around their ability to offer convenience and superior service to a core group of customers. In the early 1990s, however, RxWorld strayed from this vision and began to compete more broadly on price. To increase store traffic, it increased its promotional activities and began to offer a wide array of loss-leaders such as soft drinks and paper towels. It distributed an expensive weekly flyer highlighting these discounted items, and successfully maximized store traffic levels.

Sales swelled under this strategy, but at significant cost: profits fell as the mix of business shifted towards less profitable products and store staffing levels increased to accommodate the stocking and movement of the large volume loss leaders. Furthermore, non-pharmacy players like Wal-Mart and supermarket chains were adding pharmacies to their stores and encroaching on RxWorld’s base business. Something had to be done.

In an effort to re-focus its selling efforts on a core, profitable group of customers, RxWorld decided to understand their customer as never before. They identified four customer segments based on their shopping needs. These customer segments ranged from the highly price-sensitive—“Cherry-Pickers,” coming to RxWorld primarily for the loss-leader items, to “Convenience Shoppers,” who would gladly pay higher prices for the utmost in convenience. (Figure 1) Not surprisingly, RxWorld made far less money on the Cherry-Pickers than on the Convenience Shoppers. In fact, RxWorld was losing more than 20 cents on every dollar of product sold to the Cherry-Pickers, while Convenience Shoppers, comprising less than 40% of RxWorld revenues, provided more than 80% of profits! (Figure 2)

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Armed with this information, RxWorld management set about making dramatic changes to its business with the goal of focusing on Convenience Shoppers. The weekly flyers and most of the loss-leaders that attracted the Cherry-Pickers were eliminated. Advertising dollars were re-allocated to reflect the new focus on convenience and service. To make the shopping experience easier and more convenient, additional store personnel were hired to roam the floors and assist customers in choosing and locating products. Even store locations and layouts were modified to maximize customer convenience. In short, RxWorld used its customer segmentation to redirect its internal resources and overall strategy, with a new concentration on the more profitable convenience-focused customer groups. In all, RxWorld projected a profit increase of 60% from strategically reallocating resources (Figure 3) and achieved this within a two-year period.
Play to your strengths

As the RxWorld story indicates, you cannot successfully serve all customers. Different customer segments have different needs, and therefore respond to different value propositions. Because any given company has finite resources and a unique set of strengths and weaknesses, it has to choose which customer segments to pursue. These decisions can be difficult. By necessity, choosing one set of customers implies not actively targeting others.

As you choose the right customer segments to pursue, you must first defend and reinforce your core customer franchise. RxWorld, despite radically altering its value proposition, did so with the needs of its current core franchise in mind: almost 40% of its revenues and 80% of its profits already derived from Convenience Shoppers. The changes RxWorld made were designed to strengthen the chain’s bond to this core group, increase the chain’s share of this group’s drug store expenditures, and hopefully attract more customers like them.

Moving beyond a company’s current core customer franchise can also yield high returns, but only if the firm’s existing organizational capabilities mesh with your new customers’ needs. In many ways this was a new business for the company; it had never before offered a delivery service. But because it built on its core strengths of low cost, no-frills office products for small and medium-sized companies, it was able to very quickly grow the business into a significant revenue and profit contributor without disrupting its core business model.

Use an understanding of today’s needs to drive market innovation

Finally, focusing on today’s customer needs does not mean focusing solely on today’s market. Fundamental changes in customer needs are rare. However, significant marketplace changes can result from product ideas that better meet the customer’s underlying needs. A company overly focused on the present-day marketplace might miss opportunities for innovation that would drive the future marketplace. Strategic segmentation can reveal such opportunities.

This was the case for a brewery that had traditionally “owned” the market in a European country. Sales were softening, and competitors’ shares were increasing. A segmentation that categorized people based on the type of beer they drank—stout, ale or lager—showed what was happening: Customers were leaving the stout and ale categories and switching to competitors’ lager.
Once a company understands its customers’ true needs—not just their characteristics or habits—it is free to innovate in a way that leads to the creation of breakthrough products.

**Sharpening organizational focus**

Customer segmentation is at its most powerful when it is used as a fundamental part of the strategic process, instead of just as a marketing tool. A sound segmentation allows one to choose from the vast spectrum of potential target customers and focus on the distinct groups that an organization is best suited to serve. After aligning your organization to serve these target groups, the company can then craft a differentiated and defensible value proposition which its competitors will have difficulty emulating.

You can ensure that your organization receives the full benefit of segmentation by taking an active role in the process: getting the right people involved, and making sure that the segmentation is based on the customer needs that really drive purchase behavior. You also will need to guide the choice of customer groups your organization can most effectively and profitably serve and then drive the required operational changes throughout the entire organization. Finally, you will need to ensure that every organizational function (not just the marketing department) understands the target customer and is single-mindedly focused and structured to meet these customers’ needs.

Although this consumption-based segmentation highlighted the problem, it did not show which customers’ tastes were shifting, why, whether the trend would continue, or what to do to protect market share.

So, the brewery did a segmentation that highlighted customer needs and it discovered that the marketplace had changed and now required different offerings for different segments. Younger beer drinkers—the ones who listened to foreign bands, watched American movies, and backpacked around Europe—were turning from home-brewed stouts and ales to imported lagers. Lager equaled import, and imports were glamorous. Europe was integrating and, for certain segments, pride in drinking home-brewed was evaporating. Competitors were attracting younger beer drinkers by offering imported, foreign-branded lagers.

Although the customers’ underlying need for beer hadn’t changed, the marketplace had. The influx of lagers had created a threat that was siphoning off the brewery’s market share, but it had also created an opportunity. Once the “future” segment was defined, the brewery was able not only to fine-tune its traditional lager offering, but also to innovate—to introduce a licensed lager, locally brewed, but bearing a high-profile foreign brand. The new lager—a high-end, aspirational import—was introduced to capture the youth market. And the existing lager was repositioned and promoted as a “working man’s” price-value brand—to capture traditional beer drinkers as they branched out from stouts and ales. Both were highly successful and came with a significant cost advantage over the importers. By probing needs-based segmentation, and acting on the information thus revealed, the brewery reclaimed its “ownership” of the market.

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