

Understanding Segmentation

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Despite all of the data and technology available today, there continues to be a lack of understanding about customers. A common goal of marketing analysis is to develop a customer segmentation solution. A variety of approaches exist — some more credible than others — that allow a marketer to make sense of the different groups that together comprise a customer base. Let's look at some of the key methods of segmentation and how they can best be applied to the real-world issues marketers face.

First, what is segmentation? For our purposes segmentation will be defined as a relevant grouping of customers (households, observations) based on the extent they display similar attributes. Predictive modeling is sometimes referred to as segmentation, but is a different discipline whereby a specific outcome is predetermined and attributes are used to predict that outcome (response, say).

There are many approaches to segmentation, including primary research, demographic (life stage) analysis, financial analysis, product purchasing pattern recognition and channel usage. How can a marketer know which one is best? It depends on the marketer's specific goals.

It's conceivable that a company will have more than one segmentation scheme, depending on its needs. However, the more that different segmentation solutions are linked together, the more useful the solutions will be to the organization.

Strategic Segmentation

One way a marketer can use segmentation is for planning business and marketing strategy. This can take many forms, including syndicated research samples, primary research and database research. However, if one is trying to assess such things as marketplace positioning, competitive positioning or category consumption, primary research can be used.

In this setting, a segmentation developer uses the importance level of attributes such as price, quality, selection and service to determine consumer segments that value these attributes differently. In addition, for some analyses, your company is rated relative to competitors on these attributes. The segmentation exercise will define consumers with similar importance attribute weightings and may also include information on the competitors these consumers frequent or value. Of particular interest are your company's relative ratings on the attributes for each segment, the size of the segment and the total industry consumption of each segment. Once this is determined, competitive strategies can be developed to address the needs of specific segments.

Forward-looking marketers in data-rich companies can take those segments and use other information in the database to infer a household's segment. A typical approach is to use life-stage elements — age, income, kids, homeowner, marital status, etc. — and identify

which segment a household belongs to based on those elements. More sophisticated approaches utilize predictive modeling to fine-tune the segment assignments. The resulting segment definitions can then be applied to a prospect or customer universe containing the same life-stage data elements used for assigning the segments.

The assignment of segments is typically very rough, since it's initially based on some very specific characteristics (“*I prefer brand X to brand Y*”), and the inference is created using more or less general information (life-stage elements). But even in its rough form, this can provide the basis for prioritizing certain life stages over others.

Now that every customer and prospect can be assigned, these strategic segments can be tracked with respect to the types of products these individuals purchase, the amount of purchases, channel propensities, etc. As the strategy of changing attributes (quality relative to competitor X, price relative to competitor Y) comes to life, tracking reports of customer behavior should begin to show evidence of the impact of those changes.

Tactical Segmentation

An equally significant situation is the case in which a marketing director wishes to prioritize marketing activities across a fairly large customer base, targeting certain products, offers and creative to certain customers. This also applies to different offer levels, different creative or messaging, and potentially completely different marketing programs. In these cases, the customer database is used to define segments.

Information from the database, including specific categories or products purchased, spending levels, tenure, payment method, demographics, number of stores or channels

used and geography are the keys to defining specific components of a customer's relationship with a company. Each of these pieces of information defines a dimension of a customer's relationship. Long-standing customers who use your proprietary credit vehicle and have a decent spending level likely will be more loyal customers. However, even within this group, the products purchased by individual customers will vary.

A large issue in defining customer base segments is that some customers have a lot of information and others have very little. This is called “information density” and can cause many problems during the development of any segmentation strategy.

How density is defined depends on the specific type of business and the marketing objectives. Companies with many one-time buyers, for instance, may find it useful to develop a separate segmentation on those customers. The information is not as rich, and the resulting segments tend to be fairly broad (e.g., “first-time home fashion buyers”). For customers who have had many interactions with a company, the issues involved are more complex — mainly because the relationship is more complex.

Handling this complexity requires a large amount of organizational understanding and data manipulation. A recommended process is to define the specific dimensions of a customer relationship in a series of mini-segmentation solutions focused on a customer's specific aspect.

To illustrate, “tenure” will be a one-variable dimension describing the length of a customer's relationship with a company, defined by first purchase date, account open date or enrollment date. However, explaining the breaks in tenure requires some knowledge of where relevant changes in behavior can be identified. Do

relationships stabilize after two or more years? Then a two-plus-year customer means something to the organization and should be split out as a category within the tenure dimension. Is behavior highly erratic during the first six months of a relationship? Then that should be another split point.

Each dimension tells a company something very useful about its customers.

Life-stage dimensions (young parent? retiree?), when thoughtful, provide meaningful insights about a consumer's needs, and, when tied to primary research, provide additional information on likely product consumption and marketplace activity.

Product purchase dimensions tell us about products a consumer readily associates with a company. Some customers will identify with a specific product group that meets their needs, and will not even consider that company for other products or categories of purchase.

A dimension that depicts the relative margin a customer gives a company as a percentage of the average margin for a selection of products, can be very useful for direct marketers that are looking for discount-hungry customers — either to market to them or to ignore them. This is critical information that can be utilized in customized communications.

A common exercise in creating dimensions will yield approximately four to eight dimensions. Each can have as few as two categories or as many as six. Marketers and analysts should understand each of the dimensions on their own to ensure that the specific components of a customer's relationship are defined in a way that provides value to the organization.

Once life-stage dimensions are established, the challenge then is to create segments, or groups of customers that have some commonality among the dimensions.

The exercise begins by grouping customers absolutely on their dimension categories (two-plus-years tenure, apparel purchases, high margin, older customers). What results is a large number of groupings.

For example, if there are six dimensions and each has four categories, there are 4^6 combinations, or 4,096 groups. This is obviously a larger number of groups than a marketer can understand, so a process of reduction follows. Latent class segmentation is a technique ideally suited for addressing this problem. The basic idea here is that there are unobserved (“latent”) segments that exist, and we have these 4,096 groups to define the unobserved segments. The analyst defines the number of segments, and, like most analytic endeavors, evaluates the results and iterates on the number of segments until the “right” segments are defined. Each customer is then defined with a probability of belonging to each of those segments, and usually the customer is assigned to the segment for which he or she has the highest probability of membership.

A good segmentation solution will yield between eight and 15 segments. Too few segments tend to result in very general segments, and too many segments results in lots of small segments that may not be meaningful.

During this process, it may be determined that some attributes (such as tenure) do not contribute greatly, or at all, to the definition of the segments. Such attributes can be removed, or can remain, without doing much harm to the result. If the segments are well defined, the user should be able to draw or presume key insights about the customers' needs. Some surprises may



also well emerge. However, this is when the fun begins.

To best appreciate segments, the most complete profile should be developed, using as much information as possible. In addition — and this is critical — the dynamics of segment membership should be tracked over time. How do customers move from segment to segment? Where do new customers typically go? Where is there high retention? When do customers expand their relationship, and when does that relationship contract?

Also review the response behavior of segments to different types of prior mailings and contacts to understand potential receptivity to different types of communications. Now you have the live information you will need to begin setting goals.

If there was one more piece of information that could help round out the picture, it would be the primary research insights about each of the segments, with respect to competitive positioning, price sensitivity or industry consumption.

This would help with positioning products creatively, determining investment spending levels, devising offers, or other characteristics of customized communications. It could even tell an organization which segments are ripe for a loyalty program and which ones are so far away from a meaningful customer relationship that further efforts with that segment probably will not yield positive results.