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Water
Energy
Environment
→ Retailing
Transport
Financial services
Healthcare
Telecoms
Media
Post
Competition policy
Policy analysis and design
Regulation
→ Strategy
Contract design and evaluation
Dispute support services
Market design and auctions

MAY 2012

Oranges and lemons

MAKING CUSTOMER SEGMENTATION MORE EFFECTIVE

Many companies invest in analysis that enables them to segment their customer base. How much of what they learn is useful? Frontier's work with clients suggests that too many businesses build up complicated profiles that tell them little about how customers will react to tailored offerings – often because the focus is on what the business wants to sell rather than what the customer wants to buy.

Identifying different groups of customers who react in different ways helps businesses to tailor their offerings to each, and extract more of these customers' willingness-to-pay. This may not only increase revenues but also reduce costs, if it enables frills that certain customers do not value to be stripped out of the offering to them. Common examples of product tailoring include variations in branding, quality, style, service and sales channel, and also differential pricing. It is not, however, as easy as some businesses think to make customer segmentation work.

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Just as a starter, the segments need to be:

- **distinct** – meaning that customers must not feature in more than one segment, or you will not be able to make a unique offering to them;
- **readily identifiable** – meaning that a theoretical segmentation is of no value unless you can tell into which segment each customer falls; and
- **separable** – meaning that you must be able to target the different segments directly, or create propositions that encourage them to self-select.

Above all, the segments need to be identified in ways that reflect the likelihood that they will respond differently; and this is where segmentation often goes wrong. Studies often provide vast amounts of detail on what customers eat, earn and read, and even on their health. But not all of these characteristics are correlated with their willingness to buy from you. As a Frontier client put it: "I don't care if 17½% of my customers are Guardian readers who holiday in Europe – I want to know what to sell them". So here are a few warnings:

- Data that is easy to collect isn't always easy to use. Off-the-shelf omnibus surveys and research agencies' proprietary datasets may be useful, but socio-economic profiles and details on the purchase of unrelated products are only of use if they correlate with how your customers respond to what you offer.
- Media-based research may be relevant for advertising decisions, but otherwise add little. National newspapers and TV channels reach large and diverse groups, so their data rarely helps you identify distinct and separable segments.
- Empirical techniques such as cluster analysis are valuable, but sensitive to the underlying assumptions. Watch they don't become a "black box".
- Segment identification can lead to exaggerated stereotyping, and at worst to offensive labelling. How many of your customers would like to think of themselves as "subsistence scrimpers" or "old-age dwindlers"?

Problems arise, above all, when companies fail to distinguish between customer characteristics and customer behaviour. Not all differences between segments will lead them to buy differently, as the box opposite shows. A related problem concerns a set of customer characteristics of enormous importance: how profitable they are to you. However tempting it may be to segment them on these lines, and push products at the profitable segments, there is no point in doing so unless you understand how they are likely to react. The second example in the box opposite illustrates this trap.

In our experience, companies often fall into this trap because they become so focused on the profitability of different products or customers that they neglect

Oranges and lemons

How not to cut up your customers

A high-street furniture retailer commissioned a segmentation study to help in refreshing its product ranges. The results identified three key customer groups which each accounted for more than 20% of the customer base:

- First-time fighters had recently bought their first home. Typically couples in their mid-20s to early 30s, they had jobs but were struggling with mortgage payments and tight budgets. Security and comfort were important to them.
- Canny investors were looking to furnish buy-to-lets. They tended to be over 35, with above-average incomes. The BBC, M&S and Sainsbury's brands resonated strongly with them, and they tended to be newspaper readers.
- Footloose renters tended to be in their early 20s, living in shared housing and spending as much on socialising as on their homes. Media-savvy and heavy internet users, they liked designer clothes and ate lot of take-away food.

Armed with a wealth of detail on the incomes, working habits, and media preferences of these segments, the buying team set about developing the new furniture ranges. Within weeks, however, the segmentation report was forgotten. Why? Because, despite their different characteristics, these groups of customers all wanted to buy much the same thing: simple, modern, stylish, low-price, flat-pack furniture. So the study provided no useful segmentation of demand.

Another example of mistaken segmentation comes from the actions of a retail bank. Its marketing department commissioned a detailed study intended to segment customers by their degree of loyalty – defined as a mix of the length of time they had been with the bank and the number of bank products they had bought. The six-month study involved qualitative and quantitative surveys, discussion workshops, analysis of the bank's accounts data and a process of trying to map externally-purchased demographic data on to government statistics.

Once the customer segments had been defined, some test profiles were created and matched to bank information on customer values to see if any links to loyalty could be identified and exploited. The front end of the bank's Customer Relationship Management system was re-engineered to prompt staff to offer advice tailored to different segments, in an effort to increase the number of products sold to them.

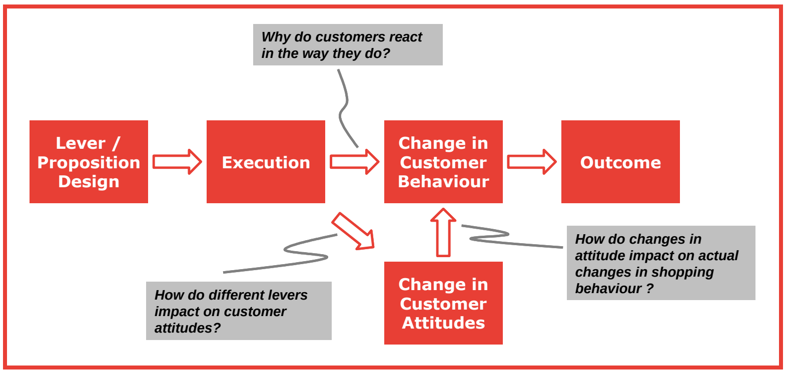
However, customers in the test groups did not seem any more likely to take the advice, product take-up was disappointing and loyalty did not seem to be increasing. This was a classic example of a common strategic failing – the bank had spent too long thinking about what it wanted to sell to particular groups of customers, too little thinking about what customers might actually want to buy.

analysis of the links between supplier actions and customer reactions. In other words, such businesses segment by outcomes rather than behaviour. Another reason for this is that data on outcomes – the profitability of different customer

Oranges and lemons

segments – is easier to collect than data on behaviour – how customers respond to different elements in the offering. Yet it is only by tailoring products and services to groups whose responses you can predict that you can hope to exploit differences between them. Effective segmentation depends on working out how to go with the grain of customer behaviour to generate more value. The key to success is to start with the levers in the company's hands – the ability to change prices, to engage in promotions and advertising, to change product ranges and so on – and work through to identification and analysis of customer reactions. These may be direct – having an immediate tangible impact on sales – or indirect – leading, through a change in attitudes, to tangible results later on.

To take actions that stimulate the customer reactions you want, you need to understand why customers react in different ways. In the figure below, the arrows highlight the questions. Suppose, for example, your analysis indicates that younger customers are less loyal. If you know whether this is because they are more likely to check prices on the internet, or because they feel no affinity to the retail brands you offer them, this will help you tailor your offering towards them.



Key links on the customer reaction chain

Source: Frontier Economics

So next time that your marketing executives, or your consultants, propose a customer segmentation exercise, try asking the following three questions.

- What are we going to learn about how customers behave?
- How will we know why they behave this way?
- What changes to our offer are we able to make to target different customers?

The last is a crucial reality check: there's no point in, for example, discovering which customers hate queuing if there's no way of getting them out of the queue.

The same questions can be used to evaluate the results of a study, and to test proposition design. They will help you to check whether, in fact, your carefully-constructed segments will turn out to respond in exactly the same way to changes in product offerings. By raising these challenges, and getting to the bottom of customer behaviour, you can not only separate apples from oranges, but also prevent your customer segmentation strategy from turning out to be a lemon.

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