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Market segmentation

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Summary

Before designing any sort of marketing strategy, organizations should have a thorough understanding of their best potential customers. Enter market segmentation. Market segmentation involves dividing your market into groups of consumers sharing similar priorities—then targeting them with specific, customized marketing messages that seek to meet each segment's unique needs, desires and motivations. Done right, market segmentation can help organizations increase profits, reduce costs, successfully develop new products and enter new markets.

This Blue Paper® discusses the evolution of market segmentation, its benefits and potential pitfalls and how it serves as the foundation of any marketing strategy. It also offers an in-depth, six-step guide to help organizations get started.

Market segmentation: Target your most valuable customers

Your product is so attractive, functional and life changing that everyone would buy it if they just heard your sales pitch, right? It's worth every penny, and the whole world should know, you say. Well, you may be right. But you'd be crazy to try to market to everyone.

For the vast majority of products and services, a marketing scheme designed for everyone would effectively reach only a few potential customers—or none at all. What you need to know before designing any marketing strategy is who your best potential customers are. Where do they live? How old are they? Are they loyal to particular brands? What's most important to them—price, status, safety, convenience, something else?

Discovering the answers to these questions is part of market segmentation. With a well-researched market segmentation strategy, your promotional efforts will move from targeting *everyone* to targeting *someone*—or a few different groups of *someones* who have the potential to be your most loyal and lucrative customers.

The definition of market segmentation, why it matters and the nuts and bolts of how to do it will be presented within this Blue Paper®. We'll address the development of market segmentation, how it serves as the foundation of a marketing strategy, the types of segmentation to consider and the process of developing a market segmentation strategy. Finally, the future of segmentation, specifically predictive modeling, will be highlighted.

The evolution of market segmentation

Market segmentation divides a market into clearly identifiable segments of consumers with similar priorities. Once identified, those segments can be targeted with a specific marketing mix tailored to each segment's unique needs, desires and motivations.

To understand how segmentation evolved, you have to go back to the Mad Men era of the 1950s and 60s. At that time, most marketers viewed consumers as one large mass. Mass marketing depended on the dominant mass media of the day—radio and periodicals, and later on, broadcast television. If segmentation did happen, it was usually based on basic demographic information, such as age or gender, because that was the readily available data. Laundry detergent was marketed to women a' la June Cleaver, and automobiles—from the family wagon to sleek convertibles—were generally pitched to men, regardless of who would actually end up driving the vehicle.

Sounds a little like stereotyping. But until marketers had a means to gather and analyze data on individual consumer behavior, they could only make sweeping generalizations. That's no longer the case.

"It's critical to understand the difference between stereotyping and segmentation," says Glenn Tecker, principal consultant, chairman and co-CEO of Tecker Consultants International. "If I say, 'because you are part of this group you will behave this way,' then I'm stereotyping. If I say, 'because you behave this way you are part of this group,' then I'm segmenting."[1]

As advertising costs rose in the 1970s, marketers started to pay more attention to the idea of market segmentation. Fueling the interest in segmentation was greater access to information about potential customers. New insights made it possible to start segmenting with psychographic data as well, using customer traits and attitudes toward products and services to imagine more fleshed out segments.

Marketers continued to work on developing more specific customer profiles. They extracted information from transaction databases and real-time point-of-purchase data. This led to segmenting based on customers' behavior toward products. Now marketers could segment customers based on their age, income, psychographic information and buying behavior.

1 Tecker, Glenn. "Segmentation vs. Stereotyping." Tecker International. N.p., 15 Apr. 2014. Web. 5 Mar. 2015. <http%3A%2F%2Fwww.tecker.com%2Fsegmentation-vs-stereotyping%2F>.

For example, in the mid-2000s, consumer electronics retailer Best Buy® went as far as redesigning its stores for various market segments it had identified: "Jill" (soccer mom, educated, main shopper of family, dislikes electronic stores), "Ray" (family man), "Buzz" (young techie), "Barry" (wealthy professional male) and so on. "Barry" stores featured leather couches in front of large screen TVs connected to high-end sound systems. "Jill" stores featured nooks where moms and kids could try out new games. Retail employees within stores were assigned to "Jill segment teams" or "Buzz segment teams" and trained to recognize a person who fit their respective segment when he or she entered the store.

But the real key was the purchasing behavior that shaped Best Buys' identified segments—for example, Best Buy knew that "Jills" entered one of its stores only once or twice a year, but when they did, they made a major purchase.[2] In the past, a customer segment that visited infrequently, might have been written off as less desirable, but Best Buy had the data behind the purchasing behavior of the Jill segment to know this was not the case.

More recently, predictive modeling is helping marketers use consumers' past behavior to predict the likelihood of future business.

Why market segmentation is important

Mass marketing is sometimes referred to as shotgun marketing—with a shotgun approach, you increase the odds of hitting an unfocused target. Market segmentation, on the other hand, is more like a high-precision rifle that accurately hits a specific target.

Mass marketing remains advantageous for certain kinds of products and services, such as essential, nondurable consumables (think shampoo or deodorant) with high sales and low prices. For everyone else, market segmentation—breaking a market into segments and then picking the one(s) the company is best able to reach and profit from—is a much better strategy. Successful market segmenting will help you clarify the four Ps of marketing—product, place, price and promotion.[3]

- **Product:** Through your research, you'll discover how your product might be refined with new features tailored to your best customers. You'll achieve a higher retention rate because your product is exactly what a particular

2 *"In Retail, Profiling for Profit." Washington Post. The Washington Post, 17 Aug. 2005. Web. 05 Mar. 2015. <http://www.washingtonpost.com/wp-dyn/content/article/2005/08/16/AR2005081601906.html>.*

3 *"Section 4. Segmenting the Market to Reach the Targeted Population." Chapter 45. Social Marketing of Successful Components of the Initiative. N.p., n.d. Web. 04 Mar. 2015. <http://ctb.ku.edu/en/table-of-contents/sustain/social-marketing/reach-targeted-populations/main>.*

market segment wants. And you will better understand your company's market position, as compared with your competitors'.

- **Place:** Different market segments are best reached via different channels. Market segmentation will tell you which channels are most effective with each segment.

- **Price:** Market segmentation will reveal which segments are most price sensitive, and which will absorb a price increase without batting an eye, increasing your profit margin effortlessly.

- **Promotion:** What types of promotions does each market segment respond to the most? Is seasonality important? Are early-bird deals effective? Market segmentation will provide the answers to these and many more questions, allowing you to devise the most cost effective and efficient promotional campaigns.

Rajan Sambandam of research and analytics firm TRC provides a case study of how market segmentation offers benefits beyond the potential for new sales: A regional bank had attracted many new customers by offering a multi-featured deposit product. Sounds like a successful marketing campaign! But many of the new customers weren't using most of the features, and the features were expensive for the bank to maintain for all customers. Relying entirely on customer account data, TRC identified three market segments based on account size and feature use—"Committed" (customers with high balances who were using the multiple features), "Active" (customers with low balances and frequent transactions who were least likely to use multiple features) and "Parkers" (customers who had large accounts but limited transactions). Once the segments were identified, a phone survey of each segment was conducted, and the bank ultimately devised three account versions based on the identified segments, giving each segment of customers what they valued most at a reduced cost to the bank.[4]

How to segment your market

The steps you choose to take in the market segmentation process will depend on a number of factors including your goals for market segmentation, available customer and industry data, the extent of any market research and analysis you choose to pursue and whether your products or services are intended for a retail

4 *"GreenBook, The Guide for Buyers of Marketing Research." Market Segmentation: One Method, Four Examples. N.p., n.d. Web. 05 Mar. 2015. <http://www.greenbook.org/marketing-research/examples-market-segmentation>.*

market, business-to-business (B2B) or a mix. Here are four different approaches to market segmentation:

1. **A *priori* segmentation** involves identifying segments based on known demographic criteria such as age, sex, economic status, or, for B2B markets, company characteristics such as number of employees. While it is the easiest approach, Tien Ahn Nguyen of OpenView® Venture Partners cautions that *a priori* market segmentation may not always be valid. For example, in a B2B market, companies in the same industry and of the same size may have different needs.[5]

2. ***Attitudinal* segmentation** uses attitudinal research to identify customer segments with similar opinions. Data may be derived from surveys using formats such as agree-disagree or 1-10 rating scales. Using cluster analysis, marketers can experiment with organizing segments according to different variables until useful segments emerge. "If the marketer/analyst is not satisfied that the segments produced are logical, then they simply repeat the process using different variables or different numbers of segments/clusters," writes marketing author and educator Geoff Frip. "This process of looking at the output from different variables continues until the marketer has a segmentation which helps provide a useful way of looking at the market for the firm."[6] Discovering what attitudinal differences separate customer segments can be as valuable as what binds a particular group together.

3. ***Needs-based* segmentation** is based on differentiated, validated drivers (needs) that customers express for a specific product or service being offered. The needs are discovered and verified through primary market research, and segments are established according to those needs.[7]

4. ***Usage-based* or *value-based* segmentation** groups customers according to their economic value, such as heavy versus light users. Using customer data, this approach has the potential to reveal a segment's profit potential to the business. (Remember Best Buy's "Jill" who only shopped a couple times a year but made a major purchase whenever she did.) Usage segmentation may establish underlying driving forces from other demographic variables. For example, if women are more likely to be heavy

5 *"Customer Segmentation: A Guide | OpenView Labs." Openview Labs. N.p., 03 Oct. 2012. Web. 05 Mar. 2015. <http://labs.openviewpartners.com/customer-segmentation/>.*
6 *"Main Tools for Segmentation." N.p., n.d. Web. 05 Mar. 2015. <http://www.segmentationstudyguide.com/understanding-market-segmentation/main-tools-use/>.*
7 *"Customer Segmentation: A Guide | OpenView Labs." Openview Labs. N.p., 03 Oct. 2012. Web. 05 Mar. 2015. <http://labs.openviewpartners.com/customer-segmentation/>.*

users, would it be easier to convert more light users who are female, rather than target their male counterparts?[8]

A six-step approach

Are you ready to add market segmentation to your marketing strategy? Here is a six-step approach, adapted from Geoff Frip, to help you get started:[9]

Step 1: Define the overall market

Before getting too deep into segmenting, the first step is to clearly define the overall market. A market that is too broadly defined won't produce meaningful segments.

Let's imagine a party rental business—Everyone Loves a Party Rental Company. ELP Rental Co., for short. Because everyone loves a party, right? But "everyone" is too broad of a target for ELP Rental Co.'s marketing efforts. Most people will go through their lives without ever renting party tents, tables and chairs. ELP Rental Co.'s overall market is comprised of individuals and businesses that need to rent party and event goods and are located within the company's geographic service area.

Step 2: Identify potential market segments

Each market segment needs to have at least one factor that binds it together while separating it from other groups. With that in mind, there are many ways to go about breaking up a market. Here are a few possibilities for segmenting groups in a consumer market:

- Geographic—by country, region, city, zip code, or some other geographic basis.
- Demographic—by characteristics such as age, sex, occupation, marital status, family size, language spoken, etc. You can discover a lot about your target population from the latest census data.
- Psychographic—by lifestyle, interests, opinions, political views, social attitudes, etc.
- Behavioral—by the relationship people have with the product you are trying to sell; for example, heavy or light users, loyal customers or switchers, etc.
- Benefits—by the specific benefits customers are looking for, such as convenience or status.[10]

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8 "Market Segmentation." Research and Processes. N.p., n.d. Web. 05 Mar. 2015. <http://www.dobney.com/Research/segmentation.htm>.

9 Frip, Geoff. "A Step-by-step Guide to Segmenting a Market." Market Segmentation Study Guide. N.p., n.d. Web. 05 Mar. 2015<http%3A%2F%2Fwww.segmentationstudyguide.com%2F>.

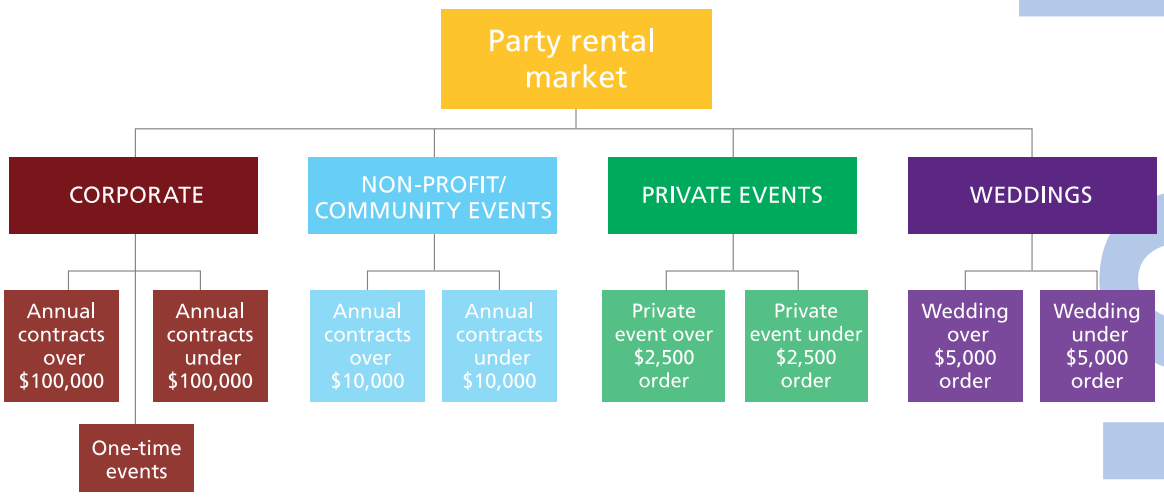
10 Frip, Geoff. "Choice of Consumer Segmentation Bases." Market Segmentation Study Guide. N.p., n.d. Web. 05 Mar. 2015. <http://www.segmentationstudyguide.com/segmentation-bases/choice-of-segmentation-bases/>.

Be aware that segmenting a market according to any of the above groupings will only be helpful if the resulting segments reveal similarities and differences in consumer values and behaviors—ones that you can build marketing campaigns around. Market segmentation isn't just organizing your customers into convenient categories. All identified segments should be clearly identifiable, measurable, easy to reach with promotional messages and appropriate to a company's practices and resources.

For our party rental business, the most obvious way to segment its market would be according to basic types of events—weddings, company picnics, sporting events, fairs and festivals and so on. But those categories don't tell us a lot about the behavior of the customers behind those events and the profit potential of any particular category. For example, some weddings are expensive, high-end affairs, and others are simple, low-budget celebrations. If lead-time is a critical factor for the company's job costs, ELP's rental management software would be able to cluster jobs according to long lead-time, average lead-time and short lead-time customers. One-time events could form one market segment, while jobs with annual contracts could form another.

At this point, a segmentation tree that graphically shows potential segments can help to flesh things out. See figure 1 below.

Figure 1. Segmentation tree



Step 3: Evaluate the identified segments

Once you have identified potential market segments, the next step is to evaluate them against some form of criteria to determine if the segments make sense for your company and offer a real economic opportunity.

Figure 2 shows a quick process for evaluating segments. Identified market

segments should be homogeneous, heterogeneous, measurable, substantial, accessible, actionable and responsive.

Figure 2. Segment evaluation

Evaluation criteria	Assessment
Homogeneous	Consumers in a segment must have at least one quality that binds them together.
Heterogeneous	Each segment should be distinct from other segments.
Measurable	There needs to be a source of data for measuring the size of the market segment.
Substantial	The market needs to be profitable enough to warrant attention.
Accessible	It should be possible to communicate with and distribute to the segment.
Actionable	It has to be possible to develop a distinctive marketing mix for the segment.
Responsive	The segment must respond better to a distinct marketing mix than to a generic offering.

If a segment does not meet each of these criteria, it should be reevaluated.

Another means of evaluating potential market segments is to develop hypotheses about them. This is especially crucial with needs-based and usage-based segmentation because the hypotheses will form the basis of any primary research you choose to undertake. "Developing variables and hypotheses is important for a variety of reasons, but its primary purpose is to provide a framework for the customer-segmentation research process," Nguyen of OpenView explains. "Once you have established a clear hypothesis and the variables that you need to test, you can begin executing the intricate process that will help you identify your best current customer segments."[11]

11 *"Customer Segmentation: A Guide | OpenView Labs." Openview Labs. N.p., 03 Oct. 2012. Web. 05 Mar. 2015. <http://labs.openviewpartners.com/customer-segmentation/>.*

A hypothesis for ELP Rental Co. may look like this:

- Wedding clients with more than a $5,000 order tend to be in Segment A.
- Wedding clients with less than a $5,000 order tend to be in Segment B.
- Segment A is a higher value segment.

Any hypothesis needs to be testable with either existing data or primary research. ELP Rental Co. will need to determine whether or not Segment A is actually a higher value segment.

Step 4: Develop segment profiles

It's time to start developing segment profiles, or detailed descriptions of the market segments across a range of factors and measures. The goal is to describe the consumers in each segment to understand their needs, especially with regard to how they are distinct from other market segments. Segment profiles should provide your company with a deep understanding of the potential consumers within each segment for comparison and strategy purposes.

The segment profile should outline important aspects of consumer behavior such as consumer needs, brand preferences, product usage levels, price sensitivity and so on. It should also provide a demographic and psychographic description of the segment.

Using data from its customer management software and surveys of wedding clients from the past three years, ELP Rental Co. puts together a profile of the "Jessica and Michael" market segment—wedding clients with an order totaling more than $5,000. Customers in the segment:

- Are highly likely to be working with a wedding planner
- Are open to up-sell items
- Plan their wedding a year in advance, offering the company a long lead time
- Are heavy social media users
- Expect personalized service and customization of their event
- Have a budget but will stretch it to achieve the wedding they desire
- Use ELP Rental Co. as a "one-stop shop" for all of the rented items for the event
- Schedule weddings in the months of May, June, or September
- Are college graduates celebrating their first marriage

Step 5: Evaluate the attractiveness of segments

With the segment profiles in hand, it's time to start identifying the most attractive segments for your business. An attractive segment offers solid current and/or long-term profit potential. You'll want to evaluate the segments according to a variety of criteria:

- Competitors: How much competition will you have for this segment? Are you better at serving this market segment than your competitors?
- Company resources: Do you have the right strengths to compete in this segment?
- Segment size: Does this segment offer enough potential sales?
- Segment growth rate: Is the segment growing or shrinking? What's its future?
- Segment profitability: Does this segment have a high or low profit margin?
- Segment accessibility: Can you reach the segment through clear communication and distribution channels?
- Segment differentiation: Is the segment distinct enough that it will respond to product and service offerings differently than other groups?

For ELP Rental Co., there's a lot to like about the "Jessica and Michael" wedding segment—particularly long lead times, the opportunity for up-sells, and easy accessibility through social media. But this is the step that may change the picture. Perhaps in the company's geographic service market, there is more competition at the sophisticated end of the event scale, or the market size for high-end weddings is small. The company may not currently stock inventory to meet the sophisticated desires of this segment. Maybe this segment's job costs result in a lower profit margin. And the future of this segment may be questionable—what if young college graduates, burdened with student loans, start choosing to scale down wedding budgets? These are the kinds of questions ELP Rental Co. will need answer to determine if this market segment is worth targeting.

Step 6: Select target markets

You should now have enough information in front of you to select one or more market segments that fit with your company's strategy and offer good potential for growth. But this isn't the end! Remember, the purpose of segmentation is to provide a foundation for your marketing efforts.

Everything discussed here is the just first step in what is known as the STP process:

segmentation, targeting, and positioning (see figure 3). Targeting is the selection of the target markets, and positioning is the process of defining a product in a way that sets it off from your competitor's product—essentially, it's how you convince consumers that your product is the one with the features and benefits they desire. The goal of this three-step process is to develop an appropriate marketing mix.

Figure 3. The STP process[12]

Be aware!

As you can imagine, there are many points in the segmentation process where you can start to go down the wrong path. Here are some common mistakes to avoid:

- **Targeting customers, instead of dollars.** Always keep the focus on the profit potential of each market segment.
- **Overlooking the universals.** If you focus too much on finding differences between segments, you risk missing valuable information that applies across all segments.
- **Replicating the traditional, predictable segmentation of a particular market just because that's the way everyone has always viewed it.** It may very well end up that this is the best way to segment the market. Alternatively, it may be that the traditional market categories are based on old ideas that miss out on emerging niches.
- **Creating too many segments.** Here, you run the risk of dividing the market into chunks that are too small to target or that require too many different marketing campaigns to manage.
- **Focusing too heavily on the present and not the future.** "So many segmentation studies go to great lengths to study recent customer behavior but pay little or no attention to how this might change in

12 Frip, Geoff. "What Is the STP Process?" Market Segmentation Study Guide. N.p., n.d. Web. 05 Mar. 2015. <http://www.segmentationstudyguide.com/stp-process/what-is-the-stp-process/>.

the future," writes Edmund Bradford of Market2Win. "If the economy is about to change or if a new technology looks set to take off, then behavior could change as well. If a new market, reorganization or procurement strategy is about to be implemented, this could change who the decision makers are and what they are looking for. Understand where the ball is going, not just where it has been."[13]

- **Assigning loaded names to segments.** Remember, segmentation is based on measurable consumer behavior, not stereotypes. Names that carry cultural connotations such as "bridezilla" and "hipster" will be interpreted by your employees to mean certain things that are not necessarily reflected in your research.

The future of market segmentation

The era of overgeneralization is coming to an end, according to Josh Brown of business and IT consulting company Iconic Mind. "Big data is how successful companies are building more detailed models of consumer behavior," he writes. "Instead of relying on the traditional demographic models that marketers used when we were operating in a mass consumption environment and had nothing better, big data capitalizes on developing market trends to allow businesses to become far more specific when segmenting their customers."[14]

One of the big trends in market segmentation is predictive modeling. This involves looking at a consumer's past behavior to assess how she or he will act in the future. These models use variable factors likely to influence future behavior or results—gender, age, purchase history and so on—to predict the likelihood of a future sale. For example, predictive modeling could help determine which customers are most likely to, say, renew a subscription. With this information, special retention offers can be extended only to those customers most likely to cancel.

In predictive modeling, a model is developed, predictions are made, and the model is validated, or revised, as further information becomes available. It also involves using models to find subtle data patterns that answer questions about customers. These models can employ a simple linear equation or involve complex neural networks that are mapped out by sophisticated software.

13 "6 B2B Market Segmentation Mistakes to Avoid." N.p., n.d. Web. 05 Mar. 2015. <http://www.market2win.com/blog/582/>.

14 "Data Helps Marketers Move beyond General Stereotypes - Marketing Forward." Marketing Forward RSS. N.p., 10 Sept. 2013. Web. 05 Mar. 2015. <http://www.experian.com/blogs/marketing-forward/2013/09/10/data-helps-marketers-move-beyond-general-stereotypes/>.

"The starting point might be to use segmentation to develop your overall strategy and to use predictive modeling as a way to analyze transactional and other data to predict the likelihood that customer segments will respond to marketing messages," explains Jamie Turner, chief content officer of 60 Second Marketer.[15] Stereotypes and generalities don't cut it in today's marketplace. Consumers expect personalized experiences, social relationships and a deep understanding of their needs and desires. You can't offer all of this to everyone, but successful companies offer it to someone—the customers that make up their most valuable market segments.

15 *"Customer Segmentation and Predictive Modeling." AskJamieTurner RSS. N.p., 24 Jan. 2011. Web. 05 Mar. 2015. <http://60secondmarketer.com/blog/2011/01/24/customer-segmentation-predictive-modelin/>.*