Should You Segment Your Customers? (unpublished, 2019)

Blog Part 1:

To segment or not to segment, that is the question (with apologies to Shakespeare). Any organization wanting to understand its customers must decide whether to segment customers into meaningful categories or to examine customers one by one.

Let's start with a definition: "Market segmentation is the activity of dividing a broad consumer or business market … into sub-groups of consumers (known as segments) based on some type of shared characteristics … such as shared needs, common interests, similar lifestyles or even similar demographic profiles. Market segmentation assumes that different market segments require different marketing programs – that is, different offers, prices, promotion, distribution or some combination of marketing variables." (Wikipedia, The Free Encyclopedia, March 20, 2019)

The question of customer segmentation comes to the forefront when an organization develops an advanced managerial costing and profitability system. The customer is, or should be, the focus for such decision systems. Segmenting customers into relevant buckets is appealing to companies with tens of thousands or even millions of customers. The technique provides simplicity and is a springboard to understand customers without having to analyze reams of individual customer data.

Customer segmentation certainly makes the marketing department's life easier, but is it the right thing to do? Regardless of the characteristic used to segment customers, combining customers into groups necessitates the usage of averages to guide the marketer. Averages mislead and hide the behavior of individual customers. After all, customers behave as individuals, not segment averages.

Let's examine the idea of customer segmentation by looking at data from a mid-sized Credit Union with their advanced managerial costing and customer profitability system based on individual customer transactions. Full disclosure – I was the lead consultant in the implementation of this institution's customer profitability management system.

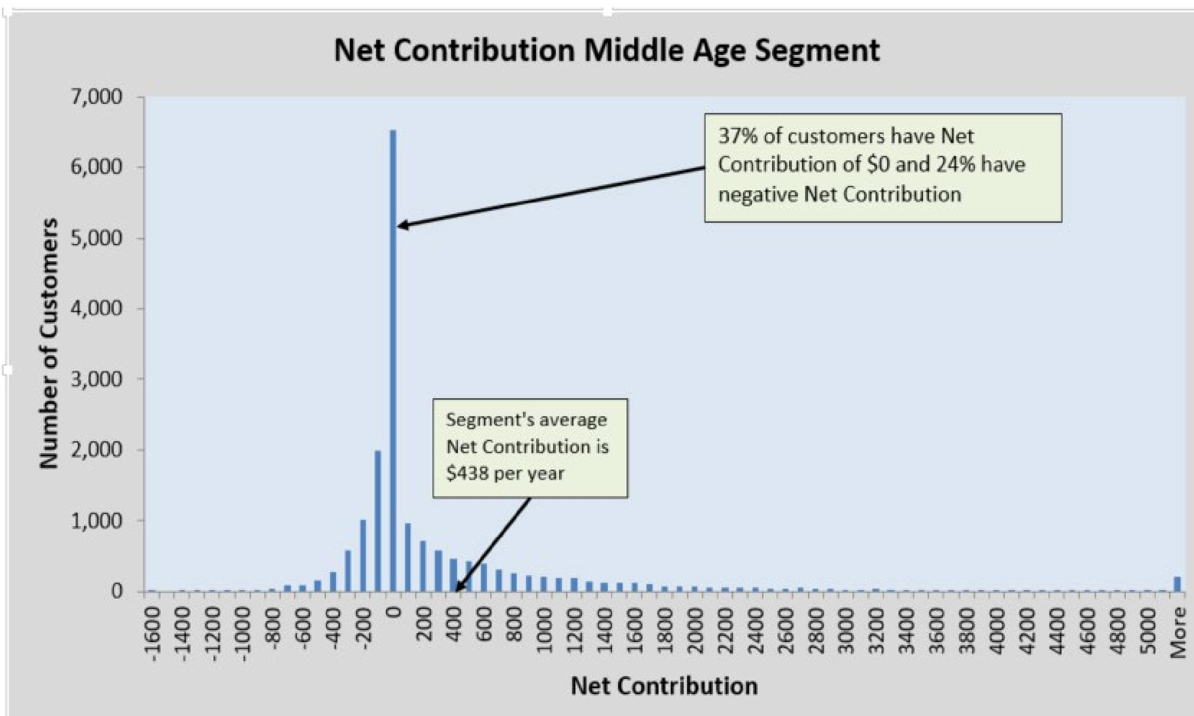
In this example we will use age as the characteristic to segment customers. Using age, or any typical demographic, is the lazy marketers' segmentation characteristic of choice. Nonetheless, we'll use age here because it is readily available and will demonstrate the point that customer segmentation misleads and distorts. Figure 1 contains the institution's customers segmented by age:

Figure 1: Credit Union Customers Segmented by Age

Age Segment	Segment Description	Count of Customers	Total Net Contribution	Average Branch Withdrawals per Customer	Average ATM Withdrawals per Customer	Average Net Contribution per Customer
0 - 17	Child	873	$ 49,592	3.1	0.7	$ 56.81
18 - 24	Young Adult	2,979	$ (196,751)	9.3	5.4	$ (66.05)
25 - 39	Adult	12,370	$ 2,218,547	9.4	6.2	$ 179.35
40 - 59	Middle Age	17,612	$ 7,715,362	14.5	8.6	$ 438.07
60 - 74	Mature	9,975	$ 4,533,414	17.7	6.3	$ 454.48
> 75	Senior	2,925	$ 1,564,320	15.0	3.4	$ 534.81
TOTALS		**46,734**	**$ 15,884,484**	**13.3**	**6.8**	**$ 339.89**

Take a look at the Middle Age segment, which is overall the most profitable segment and averages $438.07 in Net Contribution per customer. Is this a reliable indicator of the profitability of the customers in the Middle Age segment? If we acquire another Middle Age customer can we expect to make another $438.07? Unfortunately, the average Net Contribution is not representative of the segment. Figure 2 shows a histogram of the Net Contribution per customer in the Middle Age segment.

Figure 2: Net Contribution by Customer



We can see that the segment's average applies to only a small percentage of customers in the segment. Over half of the Middle Age customers are either break-even or unprofitable. It's the 23% of customers in this segment earning above the average Net Contribution that offsets those with no or negative returns. Assuming each Middle Age segmented customer will make the institution $438.07 is incorrect and can lead to erroneous and harmful decisions.

In part 2 of this blog we will continue to examine how customer segmentation can distort and mislead.

Title: Should You Segment Your Customers?

Blog Part 2

Part 1 of this blog defined customer segmentation and showed how the average Net Contribution of an age based segment had no predictability to the individual Net Contributions of the customers in that segment.

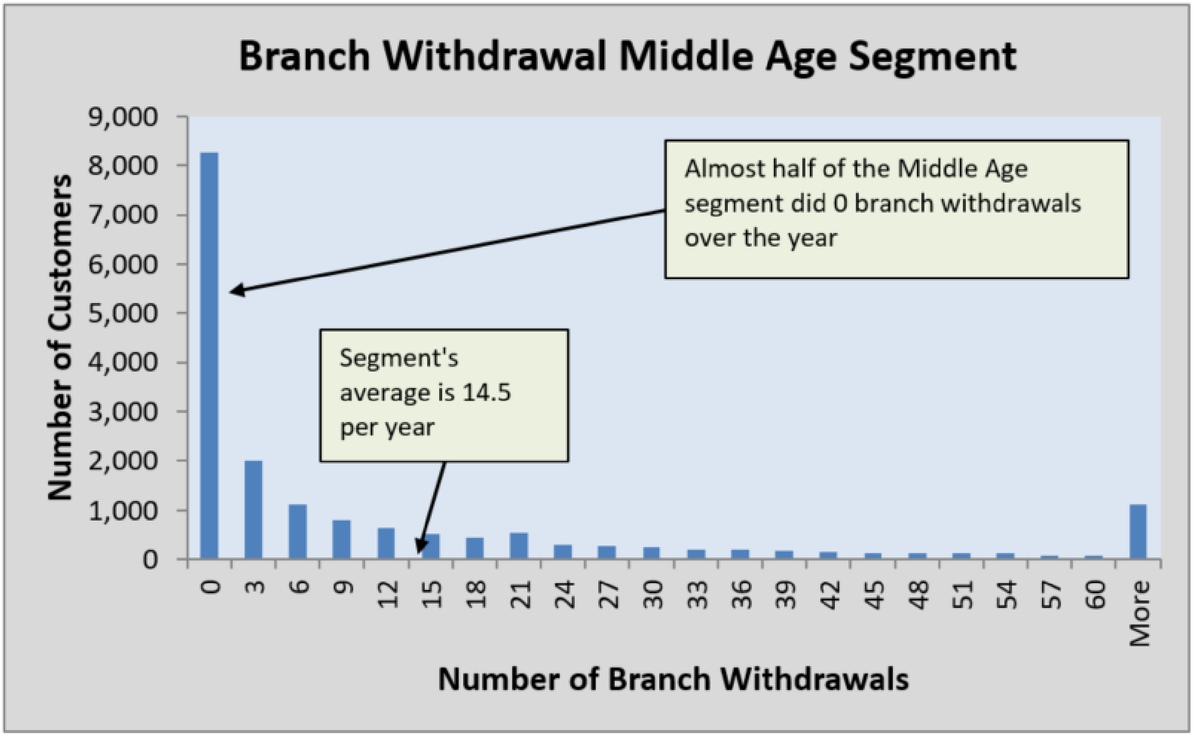
Before continuing our discussion of customer segmentation, in this case at a Credit Union, let's turn for a moment and talk about the current state of affairs in the Banking industry. Banks and Credit Unions have spent the last 30 years cutting costs and working to maximize efficiency in all things they do. So if Banks have cut the costs of processing transactions to the bone, where is there room to improve costs and efficiency? Here's where: reduce the number of transactions being processed in expensive manual channels (e.g., branches) and move those transactions to inexpensive automated channels (e.g., ATMs – automated teller machines). How? By motivating customers to change their behaviors.

Given the desire to move customer transactions from manual channels to automated channels, let's look again at the Middle Age segment, which has the most number of customers of the segments and a fairly high number of branch withdrawals per customer (see chart in Part 1). It also appears this segment is the most receptive to technology as they have the highest average ATM withdrawals of all of the age groups.

So marketing devises a campaign to address the high branch transaction volumes from the Middle Age segment and will measure its success using the segment's Net Contribution. The direct mail marketing campaign starts by providing incentives to stop using branches and move to ATM's. Will this work?

First we'll examine the assumption that the average number of branch withdrawals is representative of the customers in the Middle Age segment. Figure 3 is a histogram showing the frequency of branch transactions by customer.

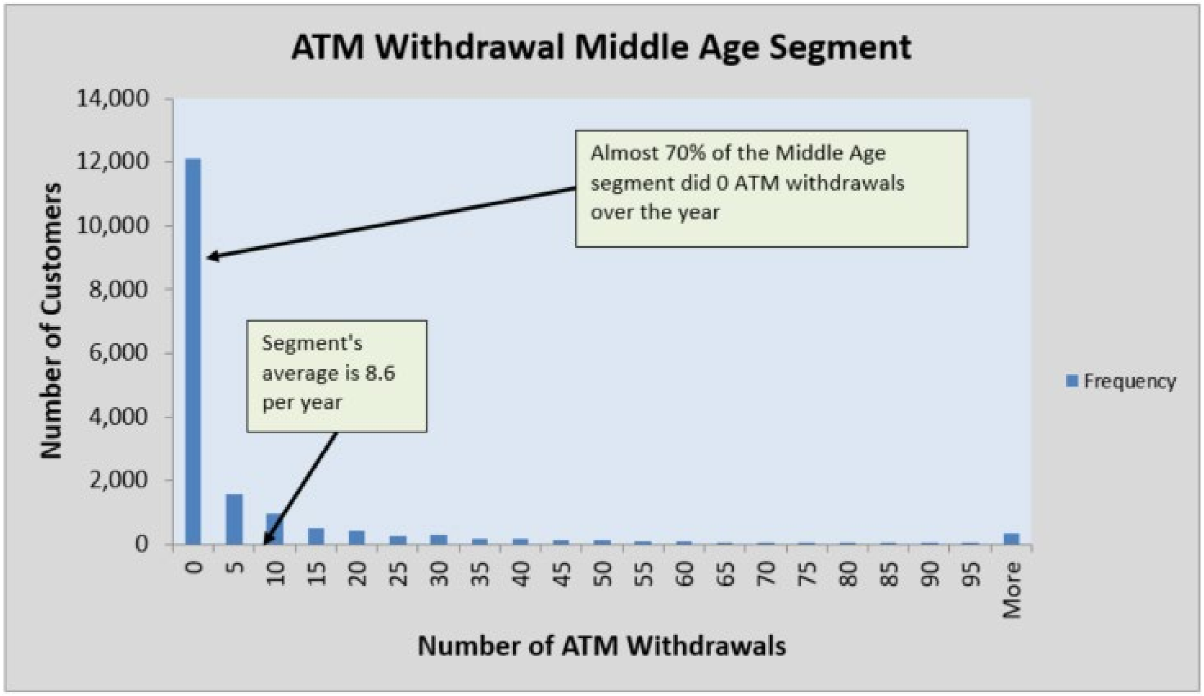
Figure 3: Number of Branch Withdrawals by Customer



We can see from Figure 3 that almost half of the customers in the Middle Age segment did no branch withdrawals during the year. So what will these customers think when they receive a direct mail piece encouraging them to move their non-existent branch transactions to an ATM. "This bank doesn't know me or my needs" would be a likely reaction.

OK, but we'd be on safe ground assuming the Middle Age segment is receptive to using an ATM for their transactions, correct? Again, no, as we can see in Figure 4, which is a histogram showing the frequency of ATM withdrawals by Middle Age customer.

Figure 4: Number of ATM Withdrawals by Customer



When it comes to automated channels, almost 70% of the Middle Age segment did not make an ATM withdrawal during the year. Assuming the Middle Age segment is technologically savvy would be a blunder as a large percentage do not avail themselves of this automated channel.

Customer segmentation makes the assumption that all customers in the segment have similar characteristics and, therefore, similar behaviors. This assumption can lead the marketing department down the wrong path and into an embarrassing marketing campaign that likely hurts customer satisfaction and retention.

Customer segmentation is a popular and appealing approach to understanding an organization's customers. In reality customer segmentation misleads and misinforms. Better to analyze customers as individuals – which is the way they behave – and then combine into like-kind groups for marketing campaigns. This way you can segment for simplicity, but you have the underlying data you need to fully understand how each customer's behaviors impact their costs and Net Contribution. Your marketing campaigns will have the right message delivered to the appropriate customers.

Customers behave as individuals. It's about time companies start to understand them that way!