SPEED READ

What can go wrong with a segmentation:
- It's not driven by a clear rationale
- Too many (or too few) segments
- Confusing traits with experience
- It doesn't predict behaviour
- Too few (or too many) dimensions
- There's no cost-benefit analysis

Segmentations promise to maximise customer value and satisfaction by targeting customer groups with the most appropriate propositions. But do they deliver? Dr ERAN HERMELIN reveals why segmentations can frequently leave stakeholders frustrated and confused.

Segmentation: Steering through the minefield

There are six major pitfalls that typically plague customer segmentations. Taking note of these key challenges will assist decision makers in critically evaluating segmentation proposals – and hence determining if they are likely to be fit for purpose.

It's not driven by a clear rationale:
Before commissioning a new customer segmentation, strategists need to be very clear about what they want to get out of it. Will it be applied exclusively to existing customers or be capable of segmenting prospective customers, too? Will it focus on maximising customer value or on improving customer satisfaction?

Without a clear *raison d'etre*, a customer segmentation often starts with a cluster analysis of all the easily accessible customer variables. This aims to identify customer segments that best satisfy a statistical optimisation criterion. The main problem with this approach is that it assumes the optimal statistical solution will also deliver the best business solution. In practice, this is unlikely: statistical analysis can deliver an optimal solution to a narrowly defined problem, but it still has to be guided by a clear strategic context if it's to deliver on the business objectives.

> CUSTOMERS' BEHAVIOUR DOESN'T JUST DEPEND ON THEIR INDIVIDUAL TRAITS, BUT ALSO ON THE WAY THEY'RE BEING TREATED.

That's why it's important to pre-specify the customer variables that, in line with the segmentation's stated purpose, should logically drive and define the customer segments.

The customer variables pre-selected for increasing customer satisfaction, for example, are likely to be quite different from those pre-specified to maximise customer value.

Too many (or too few) segments:
The number of customer segments should not outstrip the organisation's ability to manage them effectively. It may seem desirable to produce 80 different customer segments, but it's doubtful whether many organisations have the resources to test and target such a large number of segments.

A proliferation of segments may also mean that some are so small they'd best be incorporated into larger segments from both a testing and ROI perspective. Conversely, a very small number of segments is likely to result in poor customer targeting. Ultimately, the number and nature of segments should ensure that the segmentation solution doesn't overwhelm the end user and allows the marketing community to arrive at a shared understanding of each segment.

Confusing traits with experience:
Customers' behaviour doesn't just depend on their individual traits, but also on the way they're being treated. If a group of customers receives a 50% increase in their annual renewal premium, for instance, and 90% of them subsequently lapse, they should not necessarily be used to profile customers who are most likely to lapse. After all, if their premiums hadn't been increased, they might not have been any more likely to lapse than others. So, while it can be difficult to tease apart customer behaviour based on individual attributes from that driven by the customer experience, it's well worth the effort.

A segmentation that unwittingly classifies customers simply in terms of how they had been treated in the past, will fail to capture those behavioural variations that are driven by individual customer characteristics. Targeting customers with inappropriate offers that don't take account of their individual preferences and circumstances can seriously damage an organisation's credibility: engaging more closely with customers requires a targeting tool that doesn't make a mockery of these aspirations.

It doesn't predict behaviour:
A useful targeting tool needs to be forward-looking and capable of predicting customers' responses to different propositions. Allocating a customer to a segment shouldn't therefore be based purely on that customer's past behaviour, but on statistical models that predict the behaviour or attitudes they're likely to exhibit in the future. This provides a much more useful view of the customer than a backward-looking classification which simply tells us whether the customer has behaved in this way in the past.

Similarly, segmenting customers purely on their attitudes and/or demographic characteristics, will be less effective at predicting behaviour. Whilst past attitudes may be reasonably good predictors of current attitudes, they tend to be relatively poor predictors of behaviour. If we want to predict customers' future behaviour, we'd be better off using a model relating their current behaviour to their past behaviour.

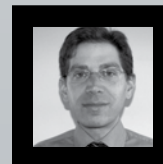
Too few (or too many) dimensions:
If the segmentation has been designed to improve customer satisfaction, it cannot necessarily be relied upon to maximise customer profitability (or the other way round). Moreover, if the segmentation is simply based on a "statistically optimal" clustering solution, it's likely to dilute the differentiation of customers on the key dimensions that ought to inform our CRM activity.

THE NUMBER OF CUSTOMER SEGMENTS SHOULD NOT OUTSTRIP THE ORGANISATION'S ABILITY TO MANAGE THEM EFFECTIVELY.

If the resulting customer segments are differentiated from each other on 50 dimensions, for example, we'd struggle to apply them for a purpose that requires maximum discrimination on just two variables (e.g. customer loyalty and customer profitability).

Conversely, some segmentations provide an incomplete view of the customer due to the absence of key customer variables. One customer segment, for instance, may be more likely to purchase a given product but might, at the same time, also be at a higher risk of defaulting on credit payments. Without taking the higher default risk into account, targeting those customers could be detrimental to the organisation. So it's important to use customer data from multiple sources to capture all the characteristics likely to be relevant to the purposes for which the segmentation is to be deployed.

There's no cost-benefit analysis:
Building a customer segmentation can be expensive and should be preceded by a detailed financial analysis to determine if the associated costs of building and using the proposed segmentation solution are likely to yield an ROI to justify this expenditure. When deciding between different solutions, it's also important to consider the trade-offs between segmentations designed to perform multiple tasks and those to be used within a narrow remit – for example, segmenting and profiling customers in terms of their profitability and advocacy. The latter segmentation is likely to be much more accurate at targeting customers on these pre-specified dimensions, but will be more limited in informing a broader range of CRM activity.



Dr ERAN HERMELIN is Director of Insight Marketing Analytics. Contact: www.insightmarketinganalytics.com