



# Understanding Customer Value to Make Segmentation Pay

By Scott Wilkerson

In the current business environment, marketers must do more with fewer resources. Understanding which customers are driving value, pinpointing their needs and targeting them with compelling value propositions is more important than ever.

It sounds egalitarian, but some customers simply are more valuable than others. In fact, at most companies about a third of the customers aren't profitable – and two-thirds of those never will be. In many companies, the bottom 20% of customers can drain profits by 80%, while the top 20% can generate 150% of a company's profit. In the current economic climate, understanding which customers drive value and which destroy it is more important than ever.

Marketers are increasingly recognizing this reality. However, many lack sufficient insight on which customers

are actually most valuable. Marketers often do not have access to the data needed to determine profitability at the customer level, or sometimes not even at the segment level. A recent CMO Council survey indicates that fewer than half of marketers worldwide have "good insights into retention rates, customer profitability and lifetime value." And more than three quarters believe they are not realizing the full potential of their customers.

As a result, when marketing is charged with segmentation, it is usually done with an insufficient understanding of customer value. All too often, segmentations are derived primarily by attitudinal, behavioral, demographic and/or psychographic dimensions – with customer value either missing or playing an insignificant role. If implemented, these types of segmentations are not only non-actionable but they can perpetuate

poor relationships, or even worse, result in acquisition of (more) unprofitable customers.

## **Balancing Customer Needs and Value**

Don't misunderstand – I recognize that in order to be actionable, customer segments must always share a common set of needs that can be met with a common value proposition. I also note from experience that segments developed based solely on value metrics usually fall short on these criteria. However, developing segments with insufficient insight into their value is a risky proposition – you may end up targeting customers that you really don't want!

## **Recommended Approach**

Based on my work with market leading companies across a variety of industries, I suggest the following approach for

developing and implementing segmentation more firmly rooted in customer value.

**Step 1: Align on how the segmentation will be used.** It may seem obvious, but it is critical to gain alignment among relevant stakeholders on the business objectives and potential marketing applications of the segmentation before conducting any market research. Failure to align on these issues often leads to unmet expectations. A segmentation that promises to be “all things to all people” almost always ends up meeting the needs of no one. One way of avoiding this trap is to hold one or more cross-functional working sessions – including stakeholders in marketing, sales, market research and other relevant functions – in which these issues are addressed early in the process.

Key issues to consider include:

- Will the segmentation be used to drive acquisition of new customers or retention of existing ones?
- How important is it to be able to target individual customers (vs. targeting at the segment level)?
- What type of marketing campaigns will the segmentation support?
- What types of measures (value or

otherwise) are currently used to segment customers?

- What does a valuable (and not valuable) segment look like?

Understanding how the segmentation that will be used should influence the design of the segmentation as well which dimensions are used to segment the market, thus dramatically increasing the odds that it will be actionable.

**Step 2: Understand which customers are most valuable.** While it may seem counterintuitive to understand customers’ value before assessing their needs, there are several reasons why this is optimal. First, an understanding of which customers account for the lion’s share of value can be eye-opening. Second, it is critical to know how behaviors and other customer characteristics differ among the least and most valuable segments. These insights will be useful in constructing actionable needs-based segments. Third, it is important to analyze a representative sample of customers across the value continuum when assessing customer needs (or perhaps focus analysis on only the most valuable).

This issue leads back to a central question – which value metrics should be

used? Answering this question involves both art and science, and requires making trade-offs based on data availability, time and budget constraints. For example, in some organizations profitability is tracked at the customer level; in others it is not known. As a first step in developing segmentation, marketers should investigate what data is available, at what level, and for which customers. This likely will involve reaching across functions to counterparts in finance and accounting, or even evaluating secondary sources. Based on this assessment, marketers can then evaluate which value metrics can be used to develop and profile the segments.

While not meant to be exhaustive or detailed, the following provides an overview of the most commonly used customer value measures for segmentation, from least to most complex:

- 1. Revenue** - Prior year sales or revenue is typically the most readily available value metric in almost any industry. In some cases, revenue can be highly

*(Continued on page 24)*

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(Continued from page 23)

correlated with profitability, in which case it represents a good proxy. However, there are many instances where high-revenue generating customers actually drain value due to an even higher cost to serve. Think of a retail customer that buys frequently, but only items on sale, or a financial services customer with a high account balance that is constantly in the branch or on the phone with customer service. I therefore challenge marketers and market researchers to identify better value metrics whenever possible.

## 2. Market Opportunity/Revenue

**Potential** – A more holistic way to think about value includes both actual and potential customer revenue. For example, a frequent business traveler might fly a particular airline infrequently but would be open to using that carrier much more often if a stronger value proposition were provided. Focusing only on the current revenue this traveler generates for the airline would underestimate his potential future value as a customer. Potential revenue can be estimated based on overall spend in the category and/or by potential growth in revenue over time.

**3. Current Profitability** – Customer profitability is a better value metric than revenue alone because it accounts for the cost to serve the customer. There are many different ways to calculate customer profitability, but all involve allocating costs such as sales and marketing acquisition costs, service/support and R&D, ideally at the customer level.

**4. Customer Lifetime Value** – Customer Lifetime Value (CLV) is a more comprehensive, but also more complex method of assessing customer value. CLV treats customers as corporate assets – recognizing that the cost of acquiring a customer is an investment that may be recouped over time. CLV is calculated by estimating the future profit stream (revenues – service and product costs) generated by the customer, discounting it to its present value at the firm's cost of capital, and then subtracting the cost to acquire the customer. There are many available models to calculate CLV as well as many software programs to compute the values.

**5. Customer Influence** – Customer influence metrics can take many forms. Their primary benefit is that they



help pass the holistic value that a customer provides by including not only the value of goods and services they purchase, but also how much they influence other customers to buy. These metrics are most useful in industries where a small number of customers exert a disproportionate share of influence on others' buying decisions. Influence can be measured in many ways – including level of customer knowledge about the product/category, degree of enthusiasm in promoting or demoting a product and size of influence network. Influence can be tricky to reliably measure, however. Marketers, even those with extensive relationship-marketing programs, are often limited by databases that don't take into account the influence potential of consumers.

Note that the measures above are not mutually exclusive, and marketers need not limit evaluation to just one value metric. In fact, multivariate segmentation enables incorporation of multiple value metrics in the segmentation itself. What's most important is that the organization actually buys into them. In general, "simple" metrics that have broad acceptance are sometimes better than more complex measures based on assumptions that are not understood.

Once the most appropriate value metric(s) have been selected, the relevant customer set should be "scored" using these measures. This may require utilizing different data sources depending on the business objectives. Internal customer data will most likely be used if the objective is improving

retention. If the objective is enhanced acquisition, secondary market data and/or survey data will most likely be needed to supplement internal customer data.

Once all customers are assigned a value, it is useful to array them into quintiles or deciles based on the proportion of value they contribute.

## Step 3: Segment based on customer needs, attitudes, behaviors and value.

You may be thinking, why can't we stop here? Why not just segment the market on customer value alone? While there are some instances where a purely value-based segmentation is appropriate – for example, when making decisions about sales resource allocation – in most cases this approach is not sufficient to meet marketing objectives. Since the goal of most marketing segmentations is to develop customized messages and/or value propositions, a viable marketing segment must have differentiated needs, attitudes or behaviors. Unfortunately, most segments developed using value metrics alone do not fulfill this criterion.

Thus an understanding of "softer" measures – including customers' buying needs, behaviors and attitudes about the product and category – will be critical to develop customized marketing communications. This type of information is best collected through quantitative market research with customers or prospects. In many cases an online survey with a representative sample of customers is the most cost effective way to get this data.

When designing the survey, insights are needed around:

- Customer (or prospective customer) attitudes, emotions and perceptions about the brand and the category
- Purchase behaviors – brand loyalty, competitor brand usage, future purchase intent, etc.  
Unmet needs – how they can be better served
- Service requirements
- Targeting information – demographics/firmographics, channel and media usage; geography, etc.

Once this data has been collected, the next step is to understand how needs, attitudes and behaviors map to key value measure(s). This can be done through a number of methods. One approach is to compare how needs, attitudes and behaviors differ among the most and least valuable customers. This analysis provides clues as to the type of customers desirable for acquisition or the types of behavior to reward.

Another effective approach utilizes correlation analysis. Again, the goal is to uncover the needs, attitudes and behaviors that are correlated with customer value. When conducting multivariate segmentation, this exercise can be especially useful to narrow down the list of potential variables to drive the segmentation.

Lastly, one or more of the value metrics themselves should be included as “active” or “driver” variables in the segmentation. This will further differentiate segments by their value. Additionally, it can potentially result in segments that have different sources of value (i.e. one segment may be valuable because it has low churn and low service costs, whereas a different segment might be valuable because it has enormous revenue potential, despite relatively low influence).

#### **Application and Tracking of the Segmentation**

None of the approaches above should be considered “revolutionary.” However, by segmenting on the needs, attitudes and behaviors that are most correlated with value, marketers and market researchers can avoid the trap of non-actionable segments that are differentiated on attitudes, but provide little insight into which customers to target. This approach ensures that the resulting segments will be differentiated based on their needs and the potential value they offer, which can be used to support a number of business/marketing objectives.

If the goal is customer acquisition, the segmentation can enable marketers to target new customers with the most potential to enhance profitability with a compelling value proposition. If

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customer retention is the objective, marketers can develop tactics to reward the most valuable customers and encourage other customers to adopt their behaviors. Segmentation can also be useful in determining which customers not to target. In some extreme cases, it can lead to policies that result in “firing” unprofitable customers, or at a minimum changing the terms of the relationship to those more amenable to the provider.

Lastly, incorporating value metrics facilitates better measurement and tracking of segment performance. Key marketing metrics such as awareness,

consideration, response rates and even ROI should be tracked at the segment level. Even shareholder value is tracked by segment in the most customer-centric organizations. The ability to demonstrate improvement in these areas, especially among the most valued customers, provides a strong business case for senior management.

Ultimately, a successful value-based segmentation should result in improved ability to target the right customers, pinpoint their needs, and offer them a truly compelling value proposition. In today’s business environment, this kind of competitive advantage can be the difference between lackluster and superior business performance.




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