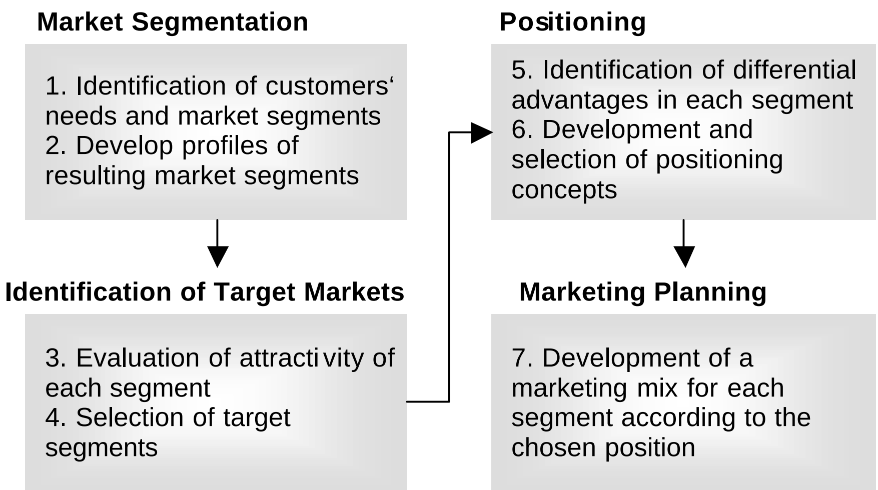
Why Segmentation?

Introduction and Definition

When it comes to marketing strategies, most people spontaneously think about the 4P (Product, Price, Place, Promotion) – maybe extended by three more Ps for marketing services (People, Processes, Physical Evidence).

Market segmentation and the identification of target markets, however, are an important element of each marketing strategy. They are the basis for determining any particular marketing mix. Literature suggests the following steps:



Adapted from Kotler and Doyle

The importance of market segmentation results from the fact that the buyers of a product or a service are no homogenous group. Actually, every buyer has individual needs, preferences, resources and behaviors. Since it is virtually impossible to cater for every customer’s individual characteristics, marketers group customers to market segments by variables they have in common. These common characteristics allow developing a standardized marketing mix for all customers in this segment.

Definition:
Market segmentation is the segmentation of markets into homogenous groups of customers, each of them reacting differently to promotion, communication, pricing and other variables of the marketing mix. Market segments should be formed in that way that differences between buyers within each segment are as small as possible. Thus, every segment can be addressed with an individually targeted marketing mix.

Criteria for Market Segmentation

There are a huge number of variables that could be used for market segmentation in theory. They comprise easy to determine demographic factors as well as variables on user behavior or customer preferences. In addition, there are differences between private customers and businesses. The following table shows the most important traditional variables for segmentation.

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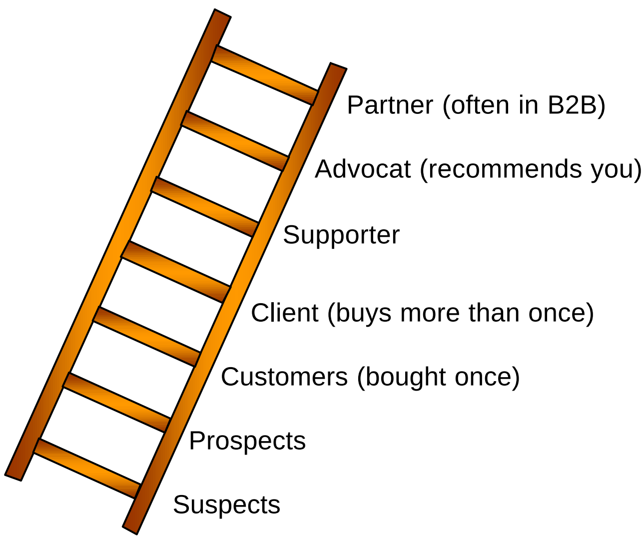
Consumer Markets	Industrial Markets / Business Markets

Geographic:
• Land or region
• Rural or metropolitan area
Demographic:
• Age, sex, marital status
• Income, occupation, education
• Religion, nationality, ethnical group
Psychographic:
• Social status
• Lifestyle-type
• Personal type
Behavioral:
• Intensity of product use
• Brand loyalty
• User behaviors
	• Industry
	• Intermediary or final consumer
	• Type of corporation (public or private sector)
	• Size of corporation
	• Geographical location
	• Intensity of product use
	• Organization of purchasing function
	    • Centralized or decentralized
	    • Purchasing policies, rules and criteria

Since customer orientation of organizations is growing, segmentation as the basis for establishing customer relationships and customer loyalty gains importance. In this context, the elements of the loyalty ladder model could be used as segmentation variables:



Marketers have to choose those variables that are relevant for segmenting the market for a particular product. The basic rule is to focus on a limited number of important variables. To segment the market into too many small, slightly distinct segments would require splitting up the marketing budget into too many ineffective chunks. Such varied marketing activities in the diverse segments could confuse customers and would lead to cannibalization effects.

Kotler mentions five criteria for an effective segmentation:

- **Measurable**: It has to be possible to determine the values of the variables used for segmentation with justifiable efforts. This is important especially for demographic and geographic variables. For an organization

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with direct sales (without intermediaries), the own customer database could deliver valuable information on buying behavior (frequency, volume, product groups, mode of payment etc).

- **Relevant**: The size and profit potential of a market segment have to be large enough to economically justify separate marketing activities for this segment.
- **Accessible**: The segment has to be accessible and servable for the organization. That means, for instance, that there are target-group specific advertising media, as magazines or websites the target audience likes to use.
- Distinguishable: The market segments have to be that diverse that they show different reactions to different marketing mixes.
- **Feasible**: It has to be possible to approach each segment with a particular marketing program and to draw advantages from that.

Reasons for Market Segmentation

As already stated, segmentation is the basis for developing targeted and effective marketing plans. Furthermore, analysis of market segments enables decisions about intensity of marketing activities in particular segments.

A segment-orientated marketing approach generally offers a range of advantages for both, businesses and customers.

<u>Better serving customers needs and wants</u>

It is possible to satisfy a variety of customer needs with a limited product range by using different forms, bundles, incentives and promotional activities. The computer manufacturer Dell, for instance, does not organize its website by product groups (desktops, notebooks, servers, printers etc), but by customer groups (privates, small businesses, large businesses, public/state organizations). They offer the same products to all customer groups. Nevertheless, they suggest product bundles and supporting services that are individually tailored for the needs of each particular group. As an example, Dell offers to take on all IT-administration for companies. This service provides a huge potential for savings for corporate customers. However, it would be absolutely useless for private customers. Thus, segment-specific product bundles increase chances for cross selling.

<u>Higher Profits</u>

It is often difficult to increase prices for the whole market. Nevertheless, it is possible to develop premium segments in which customers accept a higher price level. Such segments could be distinguished from the mass market by features like additional services, exclusive points of sale, product variations and the like. A typical segment-based price variation is by region. The generally higher price level in big cities is evidence for this.

When differentiating prices by segments, organizations have to take care that there is no chance for cannibalization between high-priced products with high margins and budget offers in different segments. This risk is the higher, the less distinguished the segments are.

<u>Opportunities for Growth</u>

Targeted marketing plans for particular segments allow to individually approach customer groups that otherwise would look out for specialized niche players. By segmenting markets, organizations can create their own ‘niche products’ and thus attract additional customer groups.

Moreover, a segmentation strategy that is based on customer loyalty (see loyalty ladder

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model) offers the chance to attract new customers with starter products and to move these customers on to premium products.

Sustainable customer relationships in all phases of customer life cycle

Customers change their preferences and patterns of behavior over time. Organizations that serve different segments along a customer's life cycle can guide their customers from stage to stage by always offering them a special solution for their particular needs.
For example, many car manufacturers offer a product range that caters for the needs of all phases of a customer life cycle: first car for early twens, fun-car for young professionals, family car for young families, etc. Skin care cosmetics brands often offer special series for babies, teens, normal skin, and elder skin.

Targeted communication

It is necessary to communicate in a segment-specific way even if product features and brand identity are identical in all market segments. Such a targeted communications allows to stress those criteria that are most relevant for each particular segment (e.g. price vs. reliability vs. prestige).

Stimulating Innovation

An undifferentiated marketing strategy that targets at all customers in the total market necessarily reduces customers' preferences to the smallest common basis. Segmentations provides information about smaller units in the total market that share particular needs. Only the identification of these needs enables a planned development of new or improved products that better meet the wishes of these customer groups. If a product meets and exceeds a customer's expectations by adding superior value, the customers normally is willing to pay a higher price for that product. Thus, profit margins and profitability of the innovating organizations increase.

Higher Market Shares

In contrast to an undifferentiated marketing strategy, segmentation supports the development of niche strategies. Thus marketing activities can be targeted at highly attractive market segments in the beginning. Market leadership in selected segments improves the competitive position of the whole organization in its relationship with suppliers, channel partners and customers. It strengthens the brand and ensures profitability. On that basis, organizations have better chances to increase their market shares in the overall market.

Summarizing all these advantages, the need for market segmentation is closely related to strategic decisions:

Market segmentation is the basis for customer orientation and differentiation.

It is well known that suppliers in mass markets mostly compete on price. Demand for those products that are clearly differentiated from competition and that offer a particular value to customers do has a lower price elasticity; hence, only those products can sustain a higher price level and higher margins. The precondition for providing such value added is detailed knowledge about customers' preferences. These preferences will probably diverse in the total market, but fairly homogenous within distinguishable segments.

Focus on attractive market segments is of special relevance in our fast moving times of Internet economy. Kalakota and Whinston[1] say in their law of differentiation:

As the blurring of distinctions among firms increases in electronic markets, survival requires identifying your unique role in the marketplace in terms of value to the customer.

[1] Ravi Kalakota and Andrew B. Whinston: Do or Die: Market Segmentation and Product Positioning on the Internet; verfügbar unter: http://cism.bus.utexas.edu/res/articles/segmentation.html

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Following that, Kalakota and Whinston perceive segmentation as the basis for offering superior value to particular customer groups and thus for developing a stable and profitable market position.

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