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READING + INTERACTIVE ILLUSTRATIONS

Segmentation and Targeting

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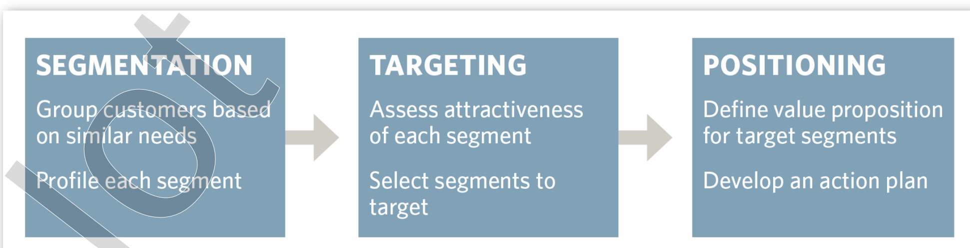
1 INTRODUCTION

When booking accommodations, would you prefer to stay in a five-star or a three-star hotel? Would you prefer a room at the hotel's luxury level, with breakfast and snacks included, or a basic room with no view? Do you think those preferences have anything to do with the kind of computer you use when searching for hotels online? Marketers think so. In fact, when booking through the online travel website Orbitz.com, identical searches for hotels, cars, and flights performed by a Mac user and a PC user often produce different lists of results.

Why the difference? In 2011, Orbitz made a discovery while searching past transaction data: The average Mac user would pay between $20 and $30 more per night on hotel rooms than the average PC user. Similarly, Mac users had a 40% higher chance of selecting a four- or five-star hotel. Even when choosing to stay in the same hotel, a Mac user would often pick a more expensive class of room than a PC user. While Orbitz always offered the same prices for the identical rooms to each user, it would show a Mac user a more upscale selection of hotels in certain markets, such as Miami Beach, Florida, and Baton Rouge, Louisiana, with rooms that cost 10% to 13% more than those shown to a PC user.[1]

Increasingly, organizations are recognizing differences in customer preferences and needs when designing their product offerings. The marketing process of segmentation, targeting, and positioning (or STP) identifies a firm's potential customers, selects which customers a firm should pursue, and formulates its value proposition for its target customers (**Exhibit 1**).

EXHIBIT 1 Segmentation, Targeting, and Positioning (STP)



The first step of the process, ***segmentation***, groups customers with similar needs into *customer segments* and then determines the characteristics of customers in those segments. For example, a company that sells packaged tea leaves might uncover two customer segments—price-insensitive customers and relatively price-sensitive customers. These price-sensitive customers may have lower incomes but perhaps buy tea frequently and know a lot about the product category.

The next step is ***targeting***, or selecting segments that the firm wants to focus on for its products or services. This is done based on the attractiveness of segments (such as size and potential profitability), intensity of competition, and a firm's capability to serve customers in each segment. The tea company might decide to focus only on the price-insensitive customers by offering a premium product. For these customers, the company might offer an attractive tin containing loose tea mixed with bits of fruits and flowers, or a tin filled with individual, pyramid-shaped linen sachets. Or it might aim for both segments by offering two different tea products, perhaps targeting the price-sensitive segment with tea packaged in a box containing simple, flow-through paper teabags.

The final step is ***positioning***, or formulating the firm's value proposition for the target segments, and developing an action plan for them. In our example, the tea company may position its high-priced product as a premium/luxury product designed for the consumer with good taste, while its low-priced tea could be positioned as a good value for the smart consumer. This positioning is communicated to consumers through the ways in which the product is designed, packaged, distributed, and advertised.

In this reading we will focus mainly on segmentation and targeting. (Positioning—the third phase of the STP process shown in Exhibit 1—will be discussed in detail in a separate reading. See *Core Reading: Brand Positioning* [HBP No. 8197].) We begin the Essential Reading with a look at why segmentation is important, what constitutes a good segmentation, and how to actually go about segmenting customers. From there we will move on to how to select target segments. Next we examine the ethical and privacy issues surrounding the process of segmenting and targeting, followed by a look at how to formulate a marketing strategy based on segmentation and targeting choices. Finally, the Supplemental Reading examines three analytical methods commonly used to carry out segmentation.

2 ESSENTIAL READING

2.1 Segmentation Fundamentals

What Is Segmentation?

At its most basic, segmentation is simply separation of a heterogeneous group of customers with different needs into homogenous subgroups or segments of customers with similar needs and preferences. This allows firms to tailor their products and services to better meet the needs of each segment.

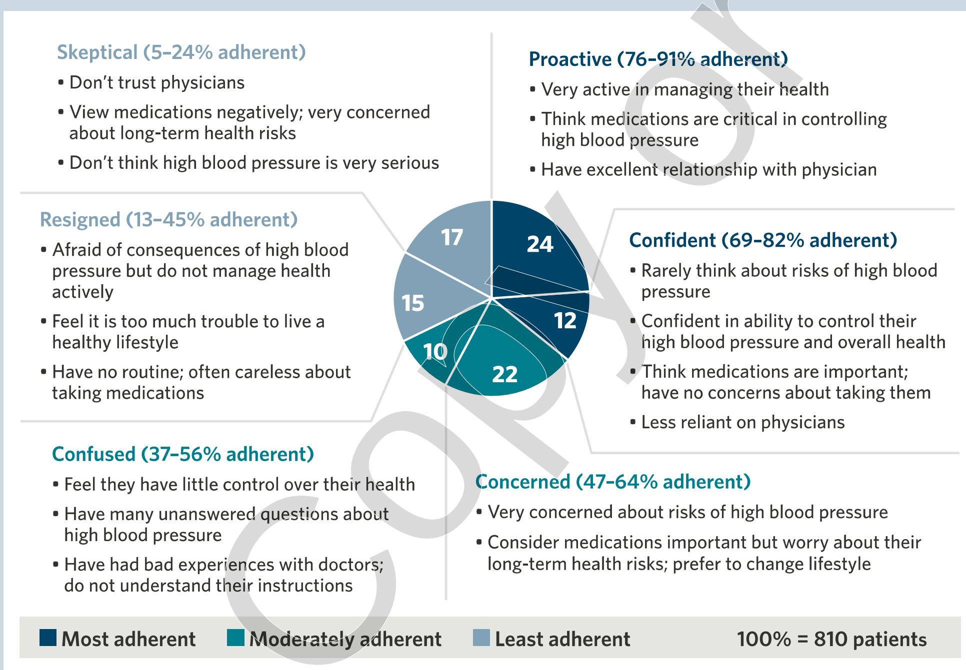
Without segmentation, companies will often overlook opportunities as they continue to provide a single solution for everybody. For example, if half of a tea company's customers liked iced tea and the other half liked hot tea, producing tea that brewed only at a lukewarm temperature would not appeal to either group. Segmentation also informs a company about potential new opportunities. Segments with unmet needs are opportunities that can drive business strategy and new product development.

Note that firms do not *create* segments; they only *uncover* them. (See the sidebar "Segmenting Patients.") The market consists of consumers with heterogeneous segments, regardless of whether or not a firm decides to segment the market. Indeed, different companies may segment the same market differently, depending on how they view consumers and their needs.

Segmenting Patients

In 2005, management consulting firm McKinsey & Company conducted a study to understand the attitudes of people with hypertension (high blood pressure) toward the disease in order to improve their compliance with treatment. Using a survey of 810 patients, McKinsey uncovered six patient segments, based on their attitudes and self-reported adherence to medication regimens. The segments ranged from proactive patients (24%), who actively managed their health and considered medication critical to controlling their blood pressure, to skeptics (17%), who did not trust their physicians and did not consider high blood pressure a serious condition (see **Exhibit 2**).

EXHIBIT 2 Characteristics of Hypertension Patients and Their Adherence to Medication Regimens, by Segment (Percentage of Total)



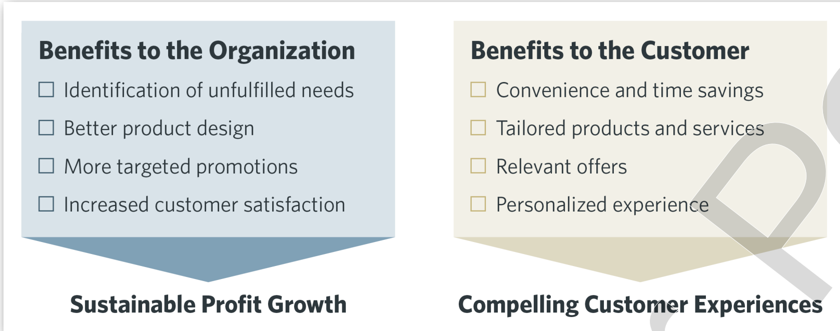
Source: Adapted from exhibit from "Getting Patients to Take Their Medicine," June 2006, McKinsey & Company. Reprinted by permission.

The study found that *concerned patients* were more likely to respond to information about their medication's safety, while the compliance of *confident patients* was influenced more by programs that reward consistent, long-term usage. This insight can help pharmaceutical companies and policy makers design better programs to improve drug adherence.

Why Segment the Market?

Segmentation benefits both the customers and organizations in a number of ways (**Exhibit 3**). Customers benefit from products and services tailored to their needs because they provide convenience, save time, and enrich the customer experience. Henry Ford, the founder of Ford Motor Company, once said, "Any customer can have a car painted in any color that he wants so long as it is black."[2] Automobile companies have come a long way, from mass producing the same car for everyone to producing a product line with many models that satisfy customers with different needs. Digital technology and customer-level data have allowed firms to customize solutions for individual customers—such as when Amazon.com recommends a book based on your online purchase history, or the video-subscription service Netflix suggests movies for you to watch based on past viewing behavior.

EXHIBIT 3 Benefits of Segmentation to Organizations and Customers



For example, as a result of market segmentation, Amazon offers "Amazon Mom," a service aimed at the new parent segment. During what could be a sleepless and overwhelming period in parents' lives, Amazon saves them time and money with automatic suggestions about what new parents might buy, based on the purchase history of other parents; discounts and automatic shipping on commonly used items like diapers and baby wipes; free two-day shipping for a set amount of time after signing up; and the convenience of being able to order from the comfort of one's home 24 hours a day.

Organizations benefit from segmentation because it helps them identify underserved customers and unfulfilled customer needs. Better products and services result when companies aim to satisfy these segments. Segmentation also allows firms to better target their promotions and customize their products; both strategies increase customer satisfaction. Gaining a growing number of satisfied customers is a good way to achieve sustainable profit growth.

Characteristics of a Useful Segmentation

There are often multiple ways to segment a market; however, for a segmentation to be useful, it must be identifiable, substantial, accessible, stable, differentiable, and actionable.[3]

- *Identifiable.* An organization should be able to identify customers in each segment and to measure their characteristics, such as demographics or usage behavior. In Africa, for example, Procter & Gamble and Unilever target low-income consumers by selling small packets of products, such as detergent or salt, at small kiosks.[4]
- *Substantial.* Although the increasing availability of data makes it possible to create microsegments, it's usually not cost-effective to target small segments. To be useful, a segment therefore needs to be substantial—large enough for a firm to serve profitably. Consider Coca-Cola's 2004 launch of Coke C2, a beverage aimed at 20- to 40-year-old males who liked the taste of regular Coke but not the calories and who disliked the taste and female association of Diet Coke. Coke C2 tasted like regular Coke but had half the calories and carbohydrates. The drink was not a success, however; the intended male target audience was looking for a full-flavored drink with no calories, not reduced calories, and market data showed that any product sales of Coke C2 were just cannibalizing sales of existing Coca-Cola beverages. Not long after its launch, Coke C2 was replaced with the more successful brand, no-calorie Coke Zero.[5]
- *Accessible.* There is not much value in creating a segmentation scheme if an organization cannot reach the segments. To be accessible, a segment needs to be reachable through communication and distribution channels independent of other segments. For example, young consumers, who increasingly use social media, have become more accessible to firms that are eager to engage them via Facebook, Twitter, and blogs.

- *Stable.* A segment should be stable over a long enough period of time that any marketing effort would be successful and profitable. For example, lifestyle is often used as a segmentation variable but the stability of lifestyle segments in the international context appears to be low. Many experts believe in the global convergence of consumer needs and wants, which also suggests that international segments may be very dynamic and constantly evolving.[6]
- *Differentiable.* Consumers in a segment should have similar needs, and these needs should differ from the needs of consumers in other segments. In Japan, for example, there is a new market segment for alcohol-free drinks, from nonalcoholic beer to wine to gin and tonic mixes. Sales in this segment doubled between 2009 and 2012 to 12 million cases of beverages and are expected to grow another 10% to 20% in 2013. Sapporo released a premium, beer-flavored beverage to meet the demand, and Suntory and Kirin are also releasing nonalcoholic beers.[7]
- *Actionable.* An organization should be able to create products and marketing programs for attracting and serving customers in the segments identified. For example, a leading U.S. insurance company spent a lot of time and money on segmentation, only to realize later that it could neither identify customers in those segments nor design any specific actions to target them. Not surprisingly, it abandoned its segmentation effort.[8]

2.2 How to Segment Consumers

There are a number of different ways to segment consumers, such as age, income, usage rate, lifestyle, etc. **Exhibit 4** lists the common segmentation variables for consumer products, and **Exhibit 5** shows typical variables used to segment business markets.

EXHIBIT 4 Major Segmentation Variables for Consumer Markets

Geographic	Country, region, city, urban/rural, climate
Demographics	Age, income, gender, generation, marital status, family size, occupation, education, ethnicity, religion
Psychographics	Lifestyle, personality, activities, interests, opinions
Behavioral	Usage rate, loyalty, product knowledge, involvement, purchase occasion, buying stage
Benefits Sought	Convenience, value, safety, status

EXHIBIT 5 Major Segmentation Variables for Business Markets

Geographic	Country, region, city, urban/rural
"Firmographics"	Industry, firm size, global/regional, ownership
Buying Approach	Centralized or decentralized purchase, purchase policies, involvement of decision makers
Behavioral	Volume, purchase frequency, attitude toward risk, loyalty, urgency
Benefits Sought	Price, product quality, service, relationship

Source: Republished with permission of Lexington Books, from *Segmenting the Industrial Market* by Thomas V. Bonoma and Benson P. Shapiro, 1983; permission conveyed through Copyright Clearance Center, Inc.

Given this long list of segmentation variables, which variable should be used? Segmentation is more of an art than science, so it is hard to give a precise answer to this question. However, it is helpful to group these segmentation variables into three categories of *who* buys, *what* they buy, and *why* they buy it (**Exhibit 6**).

EXHIBIT 6 Bases for Segmentation

Who Are the Customers?

While the ultimate goal of segmentation is to group consumers with similar needs and preferences, often it is easy to form these groups on the basis of readily available and identifiable information about consumers, such as their age, income, education, lifestyle, or family size. In business to business (B2B) segmentation, the equivalent characteristics could be type of industry or size of business. This identifiable information makes the task of segmentation easy and actionable, and the manager hopes that consumers' demographic and related characteristics correlate highly with their needs and preferences. For example, low-income consumers are more likely to be price-sensitive and to look for value brands than high-income consumers.

Note, too, that it is quite common to use a combination of various demographic, geographic, and lifestyle factors to segment a market.

Here are a few examples of how various companies have segmented their markets, not always successfully:

- *By demographics*. In March 2013, the computation software manufacturer Wolfram Research offered the standard edition of its program, Mathematica, at a price of $2,495. However, it also offered a student version with limited features at less than half the price of its standard version. Wolfram knows that students cannot afford the higher priced version and perhaps would not need to use all the sophisticated features of the standard product. The company wants students to start using its software, so they become accustomed to its product and become regular customers later on when they graduate.

  Or consider the pen manufacturer Bic, which in 2012 released a line of "Bic Cristal for Her" pens, which were designed to be thinner and were produced in a palette of soft colors. They were also priced higher than regular pens. Women were offended, however, by the suggestion that they might use pens differently from men and would be willing to pay more. There was an intense backlash, including creatively expressed opinions of the pens through Amazon reviews, which then spread rapidly on Facebook.[9] The pen market was not as heterogeneous along gender lines as Bic had anticipated. (See the sidebar "Segmenting U.S. Millennials" for more about segmentation by demographics.)

Segmenting U.S. Millennials

In 2012, Boston Consulting Group (BCG) used consumer lifestyles to segment U.S. millennials (people between the ages of 16 and 34 at the time of the study) into six distinct segments. BCG found that while all millennials often showed a strong affinity for technology, they differed markedly in their attitudes and behaviors (**see Exhibit 7**).

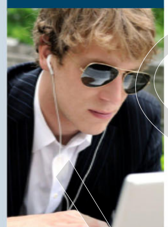
EXHIBIT 7 Six Segments of Millennials

Hip-ennial
29%

"I can make the world a better place."

- Cautious consumer, globally aware, charitable, and information-hungry
- Greatest user of social media but does not push/contribute content
- Female-dominated, below-average employment (many are students and homemakers)

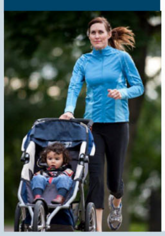
Gadget Guru
13%



"It's a great day to be me."

- Successful, wired, free-spirited, confident, and at ease
- Feels this is his best decade
- Greatest device ownership, pushes/contributes to content
- Male-dominated, above-average income, single

Millennial Mom
22%



"I love to work out, travel, and pamper my baby."

- Wealthy, family-oriented, works out, confident, and digitally savvy
- High online intensity
- Highly social and information-hungry
- Can feel isolated from others by her daily routine
- Older, highest income

Clean and Green Millennial
10%

"I take care of myself and the world around me."

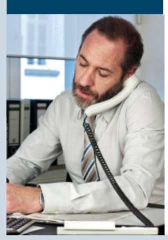
- Impressionable, cause-driven, healthy, green, and positive
- Greatest contributor of content, usually cause-related
- Male-dominated, youngest, more likely to be Hispanic, full-time students

Anti-Millennial
16%

"I'm too busy taking care of my business and my family to worry about much else."

- Locally minded, conservative
- Does not spend more for green products and services
- Seeks comfort and familiarity over excitement/change/interruption
- Slightly more female, more likely to be Hispanic and from the western United States

Old School Millennial
10%



"Connecting on Facebook is too impersonal. Let's meet up for coffee instead!"

- Not wired, cautious consumer, and charitable
- Confident, independent, and self-directed
- Spends least amount of time online, reads
- Older, more likely to be Hispanic

While these segments are interesting and different in their attitudes, for them to be useful, a firm has to be able to clearly identify and access these segments—and be able to design distinct products and marketing programs for each segment.

Source: *The Millennial Consumer: Debunking Stereotypes.* © 2012, The Boston Consulting Group. Photos, from top left to bottom right: © iStock.com/Squaredpixels, © iStock.com/sstop, © iStock.com/jMichl, © iStock.com/Pamela Moore, © iStock.com/monkeybusinessimages, © iStock.com/audioundwerbung.

- *By geographics.* McDonald's customizes its burger classics and other menu items regionally and seasonally to meet varying geographic tastes and customs. For example, McDonald's serves lobster rolls in Maine during the summer, sells durian milkshakes in Singapore, excludes beef from its menu in India, and keeps pork out of its restaurants in Israel and some Muslim countries.
- *By psychographics.* By assessing intangible consumer characteristics such as lifestyle, personality, interests, values, and attitudes, psychographics allows companies to segment customers by traits that are not easily identified. For example, PRIZM, a system offered by Nielsen (a U.S.-based market research company) to client companies, is a commonly used lifestyle segmentation scheme that groups consumers into 11 lifestage groups and 14 social groups.[10] Another company, Kenya-based CfC Stanbic Bank, segments African customers for loans based not only on repayment rate of previous entrepreneurial seed loans, but also on results from "psychometric" testing of loan candidates. This includes anything from motivation questionnaires to reasoning tests—which gathers useful information not usually found on a loan application.[11]

GE Healthcare provides a good example of customer segmentation. Click on **Video 1** to view the beginning of a six-part video mini–case study on how the company developed and applied segmentation for its Imaging Systems business.

VIDEO 1 GE Healthcare Case: Part 1

Scan this QR code, click the icon, or use this link to access the video: bit.ly/hbsp2pJBRkg

What Is Customer Purchase Behavior?

While "who" variables focus on customer characteristics, "what" variables emphasize customers' purchase behavior. In the age of big data, it is easy for firms to collect and store transaction data, web traffic, multichannel buying patterns, and a host of other purchase-related information. This allows firms to segment customers based on variables such as how recently and frequently they made purchases, their brand loyalty, or their share of wallet (money a customer spends with a firm as a share of all the money spent on that category). Since consumers' past purchase behavior is generally a good predictor of future behavior, purchase-based segmentation provides firms with an actionable strategy to target the right customers.

Companies such as L.L.Bean that have traditionally used catalogs to reach their customers often segment them based on three factors, called RFM: ***r**ecency, **f**requency,* and ***m**onetary value* of purchases. This approach is commonly used in database marketing and is easy to implement for companies who track their customers' transaction data. Research has shown that segments based on this RFM model correlate well with customers' future purchases.

Customer loyalty—or the likelihood that a customer will return to buy a company's products over those of a competitor's—is another important variable for segmentation. A study of the banking markets in Belgium, Germany, and Italy revealed that loyal bank customers bought 40% more products and generated 30% to 70% more value for the banks over the life of their relationship when compared to average bank customers.[12] This study suggested segmenting bank customers based on the bank's share of wallet and their loyalty to the bank. Customers with high share of wallet, but low loyalty, are valuable customers who are at risk of defecting, so a bank should invest resources to improve its relationship with them.

Please click on **Video 2** to begin Part 2 of the GE Healthcare case, on the customer buying process.

VIDEO 2 GE Healthcare Case: Part 2

Scan this QR code, click the icon, or use this link to access the video: http://bit.ly/hbsp2uoAugd

Why Do Customers Buy a Particular Product?

While studying consumers' past purchase behavior and loyalty is a good way to assess their future purchase behavior, it is only through knowing *why* consumers make the decisions they do that we can truly understand their needs and preferences—the fundamental bases of segmentation. Such insight helps firms convert nonloyal consumers into loyal consumers, design new products to appeal to new groups of consumers, or change their marketing strategy to increase share and profitability. (See the sidebar "Segmentation in the Business-to-Business Market" for an example of how understanding customer needs and segmenting customers based on them improved performance at Hill-Rom, a healthcare equipment manufacturer.)

Segmentation in the Business-to-Business Market

In 2000, Hill-Rom, a healthcare equipment manufacturer and service provider in the business-to-business (B2B) market, aligned its sales force by segmenting its customers based on the size of the healthcare facility using data such as the number of staffed beds. Since hospital size was likely to influence client spending on healthcare equipment, this segmentation and sales force strategy seemed logical.

In early 2001, a new CEO took over Hill-Rom and reexamined customers' buying behavior. A study commissioned by the company unveiled eight segments that were later grouped into two large groups for ease of implementation. These two groups consisted of *key* customers and *prime* customers. For example, key customers were looking for a comprehensive solution and viewed purchases as investments. They had higher capital expenditure on medical products and on average replaced products 40% sooner than did prime customers. The primary decision maker, the purchase drivers, and the important brand factors were quite different for these two groups (see **Exhibit 8**). Facility size was no longer the driving factor—there were 50-bed and 250-bed nursing facilities in the same segment.

EXHIBIT 8 Hill-Rom's New Customer Segments

	Key Customers	Prime Customers
Decision Making		
Primary decision maker	Nurses	Administrators
Purchase drivers	Patient satisfaction Physician requirements Return on investment	Necessity Low maintenance costs Low risk, low liability
Deciding factors on brand	Performance Patient outcomes and safety Caregiver safety	Reliability Ease of use Price
Product Preferences		
Product configuration	High-end to moderate	Moderate to low-end
System or Stand-alone	System	Stand-alone
Replacement cycle	Shorter	Longer
Required response times:		
Product service	Shorter	Longer
Shipment lead time	Longer	Shorter

Source: Reprinted from "How You Slice It: Smarter Segmentation for Your Sales Force" by Ernest Waaser, Marshall Dahneke, Michael Pekkarinen, and Michael Weissel, *Harvard Business Review*, March 2004. Copyright © 2004 by the Harvard Business School Publishing Corporation; all rights reserved.

Further research revealed that the company was selling to both segments in the same manner, resulting in overall high sales costs. For example, the cost of sales to prime customers was four to five times higher than it was for key customers, because the sales force was trying to sell prime customers a level of service and innovation that they neither valued nor could afford.

The company restructured its sales force to better align it with the two segments. Within two years, customer satisfaction improved significantly, revenue per employee increased by 11%, and operating income per employee increased by 51%.

Consider the following exercises and how asking *why* can yield deep insights about consumer buying behavior.

Imagine that you have been hired as a consultant by a dog food manufacturer to help complete a segmentation study. How would you segment the dog food market? Would you segment the dogs, the owners, or both? Click on **Interactive Illustration 1** for an example of how this market could be segmented.

INTERACTIVE ILLUSTRATION 1 Segmenting the Dog Food Market

Source: Reprinted from Harvard Business School, "General Foods: Opportunities in the Dog Food Market," HBS No. 578-162 by Scott Ward. Copyright © 1978 by the President and Fellows of Harvard College; all rights reserved.

Scan this QR code, click the text above, or use this link to access the interactive illustration: bit.ly/hbsp2pHLtgd

What is the best way to segment the market for products that enable at-home early pregnancy testing in a cost-effective manner? And how would your marketing strategy differ for the various segments? Click on **Interactive Illustration 2** to help work through this dilemma.

INTERACTIVE ILLUSTRATION 2
Segmenting the Market for Early Pregnancy Test Devices

Source: Exhibit from "A Segmentation You Can Act On," August 1999, McKinsey & Company. Reprinted by permission.

Scan this QR code, click the text above, or use this link to access the interactive illustration: bit.ly/hbsp2IVa1dv

Please click on the **Video 3** icon to begin Part 3 of the GE Healthcare case, on better understanding the needs of the customer.

VIDEO 3 GE Healthcare Case: Part 3

Scan this QR code, click the icon, or use this link to access the video: bit.ly/hbsp2uoAuNf

Please click on the **Video 4** icon to begin Part 4 of the GE Healthcare case, on the basis of GE's segmentation.

VIDEO 4 GE Healthcare Case: Part 4

Scan this QR code, click the icon, or use this link to access the video: bit.ly/hbsp2utt0c4

Note that companies often use a combination of *who, what,* and *why* variables to segment their markets. The choice of variables and how they combine to form segments makes this process an art that leads different companies to segment the same market quite differently.

2.3 Targeting

Now that you've segmented your market based on *who, what,* and *why,* how do you decide which segments to choose? Targeting involves evaluating the attractiveness of each market segment, selecting one or more segments to pursue, and then designing marketing programs to serve them. The goal is to select segments that improve the organization's chances of maximizing its long-term profitability in those segments.

A firm's choice of target segments depends on the level of segmentation in a particular situation or marketplace, which ranges from mass market to customization, or one-to-one marketing.[13]

Some markets may be *undifferentiated,* meaning that there are virtually no differences in the needs of customers. In these markets, companies may decide to adopt a *mass-marketing* approach by designing the same product for everyone. Large global firms such as Coca-Cola tend to follow this approach by appealing to the largest number of customers via broad distribution and mass communication. This approach allows firms to reach the largest potential market at low cost because of economies of scale in product design and marketing. The risk, however, is that competitors (e.g., Snapple or Poland Spring) are able to nibble at the edges of large firms like Coca-Cola by carving out a niche for themselves.

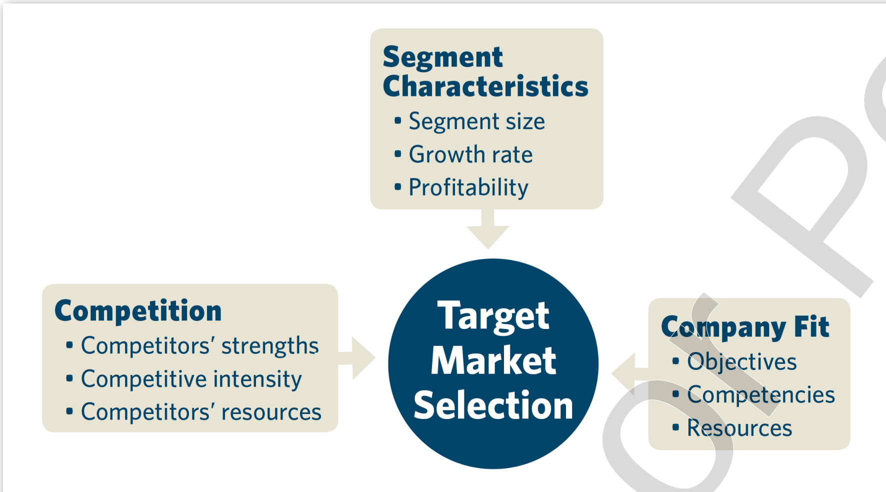
On the other extreme, companies can customize their products and services for individual customers. Firms' ability to collect immense amounts of data and reach customers in real time through the Internet can enable ***one-to-one marketing*** and ***mass customization***. Thus companies are able to offer customers the ability to design or personalize their own products on a mass scale, effectively turning customers into a "segment of one." Levi's now offers customizable jeans, Google's Gmail offers ads based on the content of an individual's emails, home improvement retailer Lowe's can match a paint color to a fabric swatch, and Shutterfly.com allows customers to design their own holidays cards, calendars, and photo books. IBM even offers a medical app that draws on extensive medical research and patient cases.[14] The app, based on data compiled by IBM's Watson supercomputer, can be accessed through any computer or tablet and offers personalized recommendations on cancer treatments for oncology patients based on their medical records and insurance.

But mass customization is not suited for all products. It is appropriate either for technology products and services where the cost of a new product version is virtually zero (e.g., a personalized ad) or for industries where flexible manufacturing technologies exist to make customized products in a cost-effective manner, and where customers are willing to pay a premium for products and services tailored to their needs.[15] Paying more for customized jeans that look good and fit well is more appealing to many customers than paying more for customized toilet paper or laundry detergent. For most products, the reality falls somewhere in between these two extremes of *mass customization* and *mass production,* and that is why segmentation remains a very important and powerful concept in marketing.

When choosing among segments, it is tempting for a company to target segments that are large, have high growth potential, and where the share of the company's brands is low. The implicit assumption in this choice is that the firm has a lot more room to grow in a large segment with low share. But the segment share for a company might be small because its products do not appeal to that segment or because of intense competition in that segment.

In general, three factors should influence the selection of segments (**Exhibit 9**). First, a firm should consider the *characteristics of various segments*, such as how large they are, how fast they are growing, and how profitable they are likely to be. Second, the firm should consider *its own competencies and resources* that are available to address the needs of the different segments. Even if a segment is large and growing, a firm may not have the capability to address the needs of this segment. Managers should also consider their long-term objective in pursuing a segment; for example, they may want to target a small and emerging segment, since it may allow their organization to build unique skills that provide it with a strong competitive advantage in the future. In this case, the choice of target segment may be driven less by profits and more by the desire to learn and develop long-term skills. Finally, a firm should consider *current and potential competition* in each segment. A large and growing segment is likely to draw attention from many competitors, which may eventually lead to a price war and low margins. Sometimes it may be better to pursue a small niche segment that does not attract the attention of large and powerful competitors.[16]

EXHIBIT 9 Selecting Target Segments



These criteria may lead a firm to choose one or more segments. Small firms or firms with a unique product (e.g., Ferrari) may choose to focus on a single segment and pursue a *niche* strategy. This strategy allows a firm to have a dominant share in its segment, and even if this segment is small in size, it can have high profit margins.

Some companies target multiple segments simultaneously, often by designing different products to meet the needs of different segments. Automobile companies target multiple segments with sports cars, minivans, hybrid cars, sports utility vehicles, and so on. Sometimes companies design a strategy with a sequential entry into multiple segments. In such a case, a firm may start by building a strong position in one segment of the market and slowly expand its reach in adjacent segments. For example, Porsche started with an exclusive focus on the sports car segment and later expanded its product line with the launch of Porsche Cayenne, a midsize luxury crossover (station wagon), and Porsche Panamera, a four-door luxury sedan.

In some cases firms may decide to target *all* segments in the market. For example, Sansiri, a residential housing developer in Thailand, targeted market segments along the full price range—high, medium, and low—and supplied all types of housing—houses, townhouses, and condos.[17] This strategy is often used to preempt the competition from gaining a foothold in any of the segments and later encroaching on a firm's more profitable markets. Even so, the approach not only requires significant investment but also carries a risk of failure because of its lack of focus.

2.4 Ethical and Privacy Issues

As technology improves and makes it easier for companies to reach customers on an individual basis, how far should a company go? Even if it is possible to segment and target at a micro level, certain considerations such as public reaction, privacy, and ethical concerns—such as those raised by targeting children—should be taken into account when finalizing a strategy.

For example, online retailers can tell if customers have come from competitors' websites and can offer lower prices if they feel the customer is comparison shopping. This approach, however, if discovered, may not sit well with loyal customers paying the higher prices. In 2000, Amazon conducted such a price test on DVDs, sparking a backlash from consumers. Jeff Bezos, Amazon's CEO, later apologized and called this experiment a mistake.[18]

In late 1999, Coca-Cola Company faced a similar backlash when it designed a vending machine that could change prices depending on the weather; presumably consumers should be willing to pay more on a hot, humid day than on a cold, dry day. When the public reacted in disbelief and indignation, Coke abandoned its technologically advanced vending machines.[19]

Firms increasingly mine customers' purchase data to target them, but this tactic raises privacy concerns among consumers. In 2012, the retailer Target set out to identify when a customer was in her second trimester of pregnancy in order to have a head-start wooing new parents (a very lucrative segment) who had highly flexible brand loyalties. The company developed a pregnancy-prediction score based on the purchase of certain products, such as unscented lotion and vitamins, which allowed it to estimate a due date for the baby. Armed with this information, Target used a specific schedule to send certain coupons to attract pregnant women to the stores. Once in the stores, women would receive a broader array of coupons at checkout for things they might need in addition to baby products, such as groceries and clothing. This worked quite well for a year, until a father of a high-school student walked into a Target store, furious that the company was sending his daughter coupons for baby supplies. This incident made Target reconsider the public relations risk of customization, even though it turned out that Target was actually right—the teen was pregnant and had not told her parents.[20]

2.5 From Segmentation and Targeting to Strategy Formation

Segmentation and targeting significantly influences an organization's resource allocation and marketing strategy. Specifically, this process can influence the organization's product, pricing, communication, sales force, and customer management strategies.

Product strategy. Gap Inc. has mapped out a product-line strategy based on its consumers' shared values of being urban and fashionable, but has differentiated its offerings based on age, aspirations, and income. While Gap's apparel is moderately priced, clothing at Old Navy, its sister store, is aimed at younger people and is even more affordable. Gap Inc.'s top-end clothing store, Banana Republic, is aimed at people with even higher incomes and aspirations. For the bargain hunters in each category, the Gap and Old Navy brands also offer outlet stores, which sell their own lines of clothes as well as extras from the regular stores. Gap Inc.'s brand family also includes Athleta, a store that carries a line of athletic wear, and Piperlime, an online boutique that sells designer shoes, bags, and women's clothing. All of these are examples of product strategy in the clothing business. But we can see similar strategies played out in other industries, such as automobile companies, which typically offer different products to appeal to different segments. Similarly, we saw in Interactive Illustration 2 how Quidol introduced two pregnancy test packages to appeal to two segments of women, those who hoped to be pregnant and those who feared they were pregnant. Finally, a strategy used in an age-old industry, book publishing, delays the production of soft cover versions of books to ensure that publishers extract higher prices from the most avid readers, who are willing to pay more for the hard cover versions.

Pricing strategy. Airlines segment their customers into leisure and business travelers. Leisure travelers are price-sensitive, while business travelers care more about schedule, frequent flier miles, and the ability to book at the last minute. It is difficult to identify leisure or business travelers based on demographics or similar variables. Consequently, airlines devised their strategy of offering lower prices for leisure travelers who are willing to book several weeks in advance and to stay overnight on Saturday—factors that are less appealing to business travelers. Customers from each segment could pay very different prices for the same seat on the same flight. Supermarkets, on the other hand, offer coupons to appeal to price-sensitive customers who take the time and effort to clip and redeem coupons, while customers who are not price-sensitive pay the regular price. In this way, coupons serve as a tool that allows a company's customers to self-select into price-sensitive and price-insensitive segments.

Communication strategy. Knowing the target audience for a product helps advertising agencies design appropriate ads and choose the right media. Toyota's Tundra truck appeals to consumers who must transport and carry heavy loads as part of their jobs, so its ads highlight the toughness of its trucks on construction sites. These ads would appear in magazines or on TV shows that this target audience is most likely to read and watch. Apple computer ads highlight the attitude and profile of its customers by comparing a hip and unflappable Mac user with a bumbling PC nerd.[21] Similarly, companies that are trying to reach younger audiences are investing more advertising dollars into digital and mobile channels, such as Facebook and Google, where these groups spend so much time.

Salesforce and channel strategy. Business-to-business companies often segment their customers based on the volume of transactions and their potential value to the firm, as we saw earlier in the case of Hill-Rom, the healthcare equipment manufacturer. Many companies set up different channels with different sales teams to target each segment. For example, national account teams call on service-oriented customers who want and value consultation with the sales team, while low-value, infrequent customers are serviced either by a different sales team that is more transaction-focused or by independent manufacturer representatives that cost less.

Customer management strategy. As mentioned earlier, companies such as L.L.Bean use customers' past purchase behavior and RFM segmentation (how recently or frequently purchases were made or the monetary value of the purchase) to decide which customers should receive catalogs and how frequently. Airlines' loyalty programs reward their best customers by offering them free upgrades, lounge access, and priority boarding.

At this point, we present the final two parts of the GE Healthcare case. **Video 5** describes how segmentation changed GE Healthcare's business strategy, while **Video 6** illustrates how GE Healthcare changed to achieve an actionable segmentation.

VIDEO 5 GE Healthcare Case: Part 5

Scan this QR code, click the icon, or use this link to access the video: bit.ly/hbsp2uo6JfB

VIDEO 6 GE Healthcare Case: Part 6

Scan this QR code, click the icon, or use this link to access the video: bit.ly/hbsp2utt5fS

For a more in-depth discussion of the various aspects of marketing strategy, see *Core Reading: Framework for Marketing Strategy Formation* (HBP No. 8153). For a final example of how segmentation can differentiate and improve a company's marketing strategy and business performance, see the sidebar, "Segmentation, Targeting, and Strategy Formation at the Gas Pump."

Segmentation, Targeting, and Strategy Formation at the Gas Pump

In the early 1990s, price wars at the gas pump threatened the profitability of oil companies, as gas stations often matched prices to the penny, which significantly eroded their margins. Oil companies inherently assumed that consumers were extremely price-sensitive, and that small differences in price would drive them away to competitors. To better understand its customers and their price sensitivity, Mobil conducted a study of 2,000 customers and uncovered the following five segments.

Road Warriors (16% of buyers). Customers, such as salespeople, who used their cars as part of their profession. They typically drove between 25,000 and 50,000 miles a year, tended to be middle-aged men with higher incomes who preferred credit cards to cash, liked to buy food during their visit, and would use the car wash from time to time.

True Blues (16% of buyers). Brand-loyal and occasionally station-loyal consumers, with moderate to high incomes, who preferred to pay in cash and buy premium gas.

Generation F3 (27% of buyers). Upwardly mobile young consumers who drove often and habitually purchased a lot of snacks. Roughly 50% were under 25 years old.

Homebodies (21% of buyers). Stay-at-home mothers who valued gas station proximity, either to their homes or to their normal travel routes for their children's activities.

Price Shoppers (20% of buyers). Customers on a budget who rarely bought premium gas and were usually not brand- or station-loyal.

What surprised Mobil was that only 20% of customers were Price Shoppers, and they spent an average of $700 per year. In contrast, Road Warriors spent as much as $1,200 annually on gas and were not particularly price-sensitive. Instead of low prices, these customers were looking for well-lit gas stations that were open long hours, offered snacks and drinks, and made it easy for them to get in and get out quickly.

This insight led Mobil to focus on the 80% of the non-price-sensitive market. Mobil redesigned its gas stations with better lighting, kept many of its stations open 24 hours, and offered a larger variety of snacks and drinks, which were high-margin items. It also started Mobil Speedpass, which was linked to customers' credit cards and offered contactless payment at the pump. Once Mobil decided to focus on segments that were not price-sensitive, it increased its average price at the pump by two cents a gallon. These changes led to more than a 20% increase in sales and an extra $118 million in annual earnings.

Source: Adapted from Allanna Sullivan, "Mobil Bets Drivers Pick Cappuccino Over Low Prices," *The Wall Street Journal,* January 30, 1995, section B1.

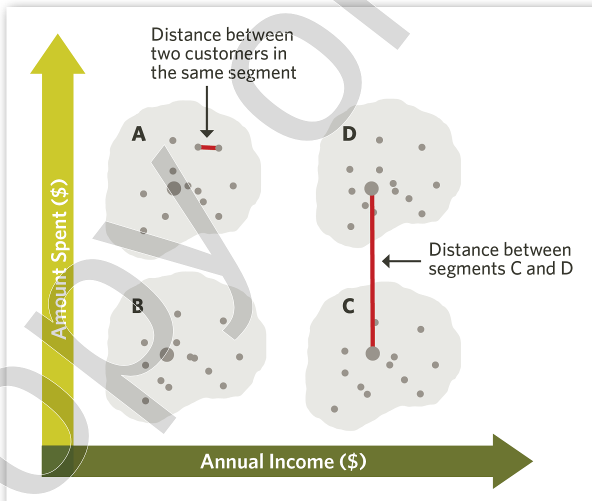
Customers differ in their preferences, and it is critical for a company to understand these differences and to design products and marketing strategies that appeal to different consumer groups. Therefore segmentation, or the process of finding groups of consumers with homogeneous needs, is one of the most fundamental concepts in marketing. Segmentation can be done using a variety of variables such as demographics or purchase behavior. The process of segmentation remains more of an art than science, however, and a manager's careful judgment is needed. Once segments are defined, the company needs to decide which segments it wants to pursue and how it wishes to position its products in those segments. (Positioning will be discussed in detail in *Core Reading: Brand Positioning* [HBP No. 8197].) The process of targeting depends on three major factors: segment characteristics (e.g., its size and growth); fit with company resources and capabilities; and the competitive intensity in the various segments. After selecting the target segments, a firm designs its products and marketing programs to specifically meet the needs of the chosen segments.

3 SUPPLEMENTAL READING

What analytical methods do companies use to identify their customer segments? In this section we briefly describe three commonly used segmentation techniques: cluster analysis, preference-based segmentation, and response-based segmentation.

3.1 Cluster Analysis

EXHIBIT 10 An Example of Cluster Analysis



Cluster analysis is a method to group customers based on a set of variables so that customers in one group are similar to each other but are different from customers in another group. For example, if a company decides to segment its customers based on their annual income and the amount of money they spent on the company's product last year, then we can plot each customer in a two-dimensional space, as shown in **Exhibit 10**. Cluster analysis then attempts to group these customers and determine the number of clusters or groups so that the distance between two customers in a cluster is small, but the average distance between the two groups is large. In Exhibit 10, Cluster A (Segment A) is the group of customers with low incomes but high expenditures on the company's products, while Segment C represents high-income consumers who spend relatively less on the company's products.

In general, segmentation is carried out with more than two variables. For example, a firm may decide to segment its customers based on several demographics (e.g., age, income, and occupation) and several purchase behavior characteristics (e.g., RFM). Cluster analysis creates a "distance" metric between these multiple variables and creates groups in a manner similar to the one shown in Exhibit 10.

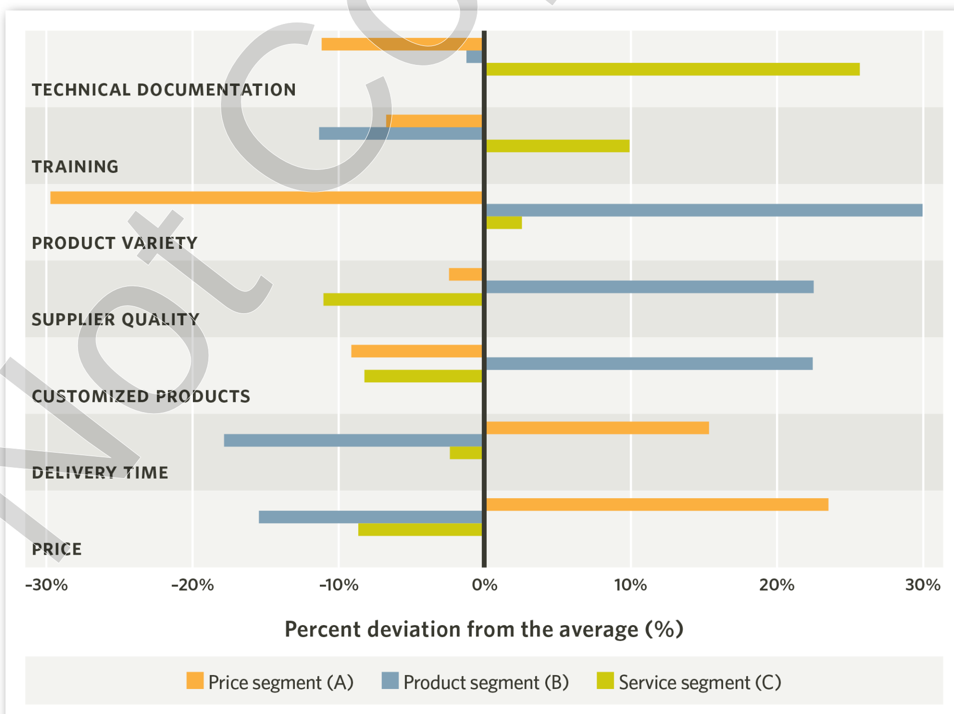
3.2 Preference-Based Segmentation

Ideally, segments highlight how customers in different groups differ in their needs and preferences. There are two broad approaches in performing such a preference-based segmentation. The first approach, called the ***multi-attribute model***, explicitly asks consumers about their preferences for a variety of attributes that a manager may consider relevant for their purchase decision. For example, in choosing a mobile phone, consumers may consider the brand (e.g., Apple or Samsung), screen size, data storage capacity, price, and the number of apps available for the operating system. A survey would then ask consumers to divide 100 points across these attributes in the order of importance, and then group consumers with similar preferences. As a result, we may find that 30% of consumers find price to be the most important variable, that 20% choose mobile phones primarily on the basis of brands, and so on. (See *Core Reading: Creating Customer Value* [HBP No. 8176].)

While this method is simple, it is often difficult for consumers to articulate the relative importance of various product attributes. The second approach, called ***conjoint analysis***, works around this problem by forcing consumers to make tradeoffs between several pairs of products that differ on a carefully designed combination of attributes. For example, would you choose a house with a large kitchen but a small backyard or a similar house with a small kitchen but large backyard? Your choice tells researchers about your preferences and what you consider more important. Repeated paired comparisons of this kind can be used to infer how a consumer weighs different attributes. Consumers can then be grouped into different segments based on the similarity of their preferences. (See *Core Reading: Marketing Intelligence* [HBP No. 8191].)

Exhibit 11 shows the results of three segments for a B2B company derived from conjoint analysis. The bars in this chart show the percentage deviation of a segment's attribute importance from that of the average customer. Segment A (labeled as the price group) is more sensitive to price and delivery time than the average customer; Segment B gives greater weight to customized products, supplier quality, and product variety (therefore called the product group); and Segment C cares more about training and technical documentation than the average customer (hence labeled as the service group).

EXHIBIT 11 Preference-Based Segmentation for a B2B Company



3.3 Response-Based Segmentation

While preference-based segmentation can assess how consumers may respond to a firm's offerings such as price discounts, these results are based on customer-stated intentions in a survey or a conjoint experiment. If a firm has data on consumers' past purchases, it can predict their response to marketing actions based on their actual purchase behavior and then segment customers based on, for example, their price sensitivity.

This approach is simple if we have a large data series for each consumer that would allow us to run a statistical analysis, such as *regression analysis,* to infer each individual consumer's price sensitivity, which in turn can be used as a variable in a cluster analysis for segmentation. In reality, this is rarely the case, however. Often consumers only buy from a company a few times a year, and the data series are not long enough to do individual-level analysis. Using data from many years is also problematic, since consumer behavior may change over time.

In such cases we can use a statistical technique called ***latent class analysis*** that allows us to infer latent, or hidden, segments from limited individual-level data. Assume we randomly divide consumers into two groups and run a regression on each group separately to assess its price sensitivity. We may find that Group 1 is more price-sensitive than Group 2. We then go back to each customer in Group 1 and statistically assess his or her chance of belonging to this group. For example, if a customer has always bought at regular price, she probably does not belong to the price-sensitive Group 1. In such a case, this person is reassigned to Group 2, and the process is repeated. Research has shown that this iterative process eventually converges to give us the appropriate allocation of consumers in the two groups and the price sensitivity of the two segments. Since our choice of two segments was arbitrary, the process is repeated with three or more segments, and statistical measures are used to assess the right number of segments.

4 KEY TERMS

conjoint analysis A market research technique that asks customers to make a series of trade-offs between component attributes; analysis of these trade-offs helps companies determine how to develop and price the features of products and services.

latent class analysis A statistical method for identifying unmeasured class membership among subjects using categorical and/or continuous observed variables.

mass customization A product delivery approach utilizing flexible, computer-aided manufacturing systems. Each customer can select and customize the product's final features to his or her individual preferences.

multi-attribute model An approach that analyzes a consumer's evaluation of an object (product, brand, service, etc.) as a function of the beliefs that he or she has toward the object on various attributes and the importance of these attributes.

one-to-one-marketing A marketing approach based on customer relationship management (CRM), emphasizing personalized relationships with individual customers.

positioning Defining a value proposition for the target segments; differentiating a product or service (or its brand) from others in the perception of consumers.

segmentation A marketing planning process that involves dividing a broad target market into subsets or groups of consumers who have common needs or characteristics.

targeting Selecting the potential customer segments to whom a company wishes to sell products or services, after an analysis of each segment's attractiveness.

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