

05898 Spring 2018- Data Science for Product Management

Homework 4: Customer Segmentation using K-means clustering

Introduction: K-means Clustering

K-means clustering is an algorithm commonly used for customer segmentation analysis. K-means clustering aims to partition n observations into k clusters in which each observation belongs to the cluster with the nearest mean, serving as a prototype of the cluster. k-means clustering is an unsupervised learning technique, which means we don't need to have a target for clustering. Applying k-means algorithm to customer segmentation problem, we can put customers that exhibit similar behaviors into the same cluster for further analysis. In this assignment, you will have the opportunity to apply the k-means algorithm to the Cannondale bikes data set to perform some basic customer segmentation analysis.

Dataset

The dataset contains bicycle orders. The first datatable bikes.xlsx contains information about various bike models. The second datatable bikeshops.xlsx contains information about bike shops. And the third datatable orders.xlsx contains the actual order histories with the manufacturer Cannondale. Note, in the orders.xlsx, customer.id refers to the IDs of bikeshops who ordered the bike and the product.id refers to the IDs of specific bike models.

Task

In this assignment, you will first go through some data preprocessing steps and then perform a k-means clustering analysis to analyze customer segmentation of bikes purchasing.

Before delving into the analysis, we need to develop a hypothesis for customer trends. Developing a hypothesis is necessary as the hypothesis will guide our decisions on how to formulate the data in such a way to cluster customers. For the Cannondale orders, our hypothesis is that bike shops purchase Cannondale bike models based on features such as Mountain or Road Bikes and price tier (high/premium or low/affordable). Although we will use bike model to cluster on, the bike model features (e.g. price, category, etc) will be used for assessing the preferences of the customer clusters (more on this later).

To start, we'll need a unit of measure to cluster on. We can select quantity purchased or total value of purchases. We'll select quantity purchased because total value can be skewed by the bike unit price. For example, a premium bike can be sold for 10X more than an affordable bike, which can mask the quantity buying habits.

Step 1: Data preprocessing

- First, you will load all three dataset (products, orders, and customers) and merge them together into one single data frame for further analysis. Remember, you can link three dataset together by using the product.id and customer.id in the orders table.
- Next, convert the unit price to categorical high/low variables. To do this, you can divide the unit prices into two halves using the median as the split point.
- Spread the customers by quantity of bike models purchased. To do this, you can group the data by model & model features (bikeshop.name', 'model', 'category1', 'category2', 'frame', 'price') and summarize by quantity purchased. Then, you can use a pivot table to spread the aggregated data across different bikeshops.
- Last, we need to scale the quantity data. Unadjusted quantities presents a problem to the k-means algorithm. Some customers are larger than others meaning they purchase higher volumes. Fortunately, we can resolve this issue by converting the customer order quantities to proportion of the total bikes purchased by a customer.

Step 2: Perform K-Means Clustering

Now you are ready to perform k-means clustering to segment our customer-base. Think of clusters as groups in the customer-base. Prior to starting we will need to choose the number of customer groups, k , that are to be detected. The best way to do this is to think about the customer-base and our hypothesis. We believe that there are most likely to be at least four customer groups because of mountain bike vs road bike and premium vs affordable preferences. We also believe there could be more as some customers may not care about price but may still prefer a specific bike category. However, we'll limit the clusters to eight as more is likely to overfit the segments.

- Fit a k-means Clustering model on preprocessed data. You can use the k-means package from the scikit-learn library in python. Refer to external resources if you need more information on the scikit-learn library.
- Clearly state your choice of the parameter k and your assumption behind choosing a specific k parameter. How many clusters do you think there should be and why?

Step 3: Analyze the result

Now that you have clustered the data, you can inspect the groups find out which customers are grouped together.

- Print out customer names that are in each segment
- Determine the preferences of the customer segments by by inspecting factors related to the model ((e.g. price point, category of bike, etc). To do this, you need to combine cluster centroids with bike models for feature inspection. Then for each cluster, arrange top 10 bike models by cluster in descending order and print out this information.

What to submit

Save your .ipynb as a html file and submit it to Canvas. Remember to run all your cells and display the output in readable format before submitting your code!

External Resources

<http://www.business-science.io/business/2016/08/07/CustomerSegmentationPt1.html>

<http://scikit-learn.org/stable/modules/generated/sklearn.cluster.KMeans.html>