

Predictive Customer Segmentation for B2B Markets

In fast-changing markets, greater confidence in the best next move

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In the world of consumer sales and marketing, sophisticated companies have used advanced segmentation techniques to build great competitive advantage. Capital One has done this in credit cards, Harrah's Entertainment in casinos, and Coach in fashion retailing. These and other companies have learned how to hone their product and market strategies to specific sets of customer needs, identify profitable pricing strategies, organize their sales forces efficiently, and design effective marketing communications.

Yet for most companies in fast-moving business-to-business (B2B) markets, attempts to achieve deeper customer understanding and move segmentation beyond traditional industry, size, and geographic views of customers have largely fallen short. In a recent study by the Institute for the Study of Business Markets, which surveyed the top business marketers in the United States, the most pressing concern identified by respondents was "finding a better way to expand understanding of their customer needs, market segments, and the key drivers of customer value."

Many executives in B2B businesses—particularly those who have traditionally relied on technological innovation to secure competitive advantage—have come to realize that new technology or new product features are not enough to attract more customers or increase revenues from existing customers. Creating new avenues of sustained growth hinges instead on deeper understanding of customers’ most pressing needs, such as reducing costs, mitigating risks, and improving productivity.

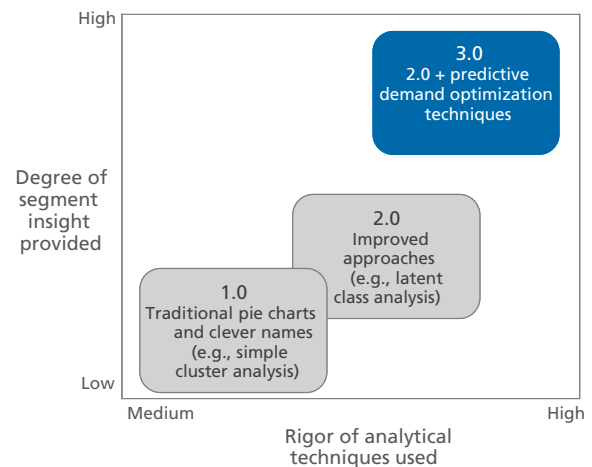
Improving B2B segmentation techniques is especially relevant now, for two reasons. First, many suppliers that have primarily served large enterprises now aspire to serve mid-sized and small businesses. One-to-one marketing approaches generally are too expensive for these smaller accounts, and customer priorities vary widely across accounts. For example, there are huge differences in trying to sell software to a dry-cleaning franchise, a landscaping business, and a small law firm. Second, B2B suppliers have come under pressure to lower their selling, general, and administration (SG&A) costs, thanks to long-term price declines that have driven such costs to unacceptable levels as a percentage of sales. Suppliers have little choice but to focus on serving customer segments that are most likely to yield profitable sales as well as standardizing their approaches to promotions and discounting.

Evolving to a Higher Order

The introduction of advanced modeling and other new statistical techniques into mainstream market research over the past decade—what might be termed the second generation of segmentation—enhanced the analytical rigor behind segmentation. Using these techniques, companies have been better able to at least identify customer segments based on attitudes and behaviors rather than simply on industry, size, or geography. Yet executives at most B2B firms still lack segmentation schemes that will give them a deep understanding of exactly which elements of the product or service offer actually drive customer behavior.

Fortunately, an emerging third-generation approach—what we call *predictive segmentation*—is proving highly effective in fast-moving B2B markets.

Exhibit 1 The evolution of customer segmentation



Whereas prior approaches to segmentation were entirely archeological in nature—looking at past customer choices and behavior—the predictive approach also looks forward. Specifically, it examines how customers might respond to changes that a business might make to its offering, channels, pricing, and so forth. It uses the market’s response to these forward-looking moves, in combination with past behaviors, as the basis for segmenting.

The predictive approach not only produces forward-looking segments; it also gives users a high degree of confidence in their decisions about what to do differently for each segment. The reason? Potential moves have been “pre-tested” and were factored into building the segment definitions. These departures from past approaches make predictive segmentation ideal for fast-moving sectors such as high-technology and communications, where historic behaviors are not necessarily good predictors of future behaviors. And since users of this approach typically test a number of different forward-looking moves, they see the potential impact of a full set of possible moves. This insight allows executives to identify which moves to implement, and which to discard, by segment.

Specific Benefits

The forward-looking aspect of predictive segmentation thus provides three benefits that were not possible through more traditional forms of segmentation:

Predictive segmentation scientifically tests how customers might respond to future offerings, channels, and pricing. It gives managers greater confidence in decision making.

- You can define the segments in a way that reflects reaction to both past and potential future offer elements. This is particularly important in rapidly evolving business markets such as the technology sector.
- You can prioritize which high-impact moves to make, at a segment level.
- You can see the real impact or benefit, in terms of market share gain or revenue increase, of making individual moves. Thus, you more easily gain senior executive approval and support.

At a more detailed level, predictive segmentation allows executives to derive more accurate answers to questions in three interrelated areas:

- *Channel requirements.* Which customers require high-touch, tailored treatment?
- *Value proposition.* Which customers want feature-rich offerings and are willing to pay for them? Which are more interested in basic functionality? What are the specific forward-looking capabilities that each segment will value and pay for?
- *Price sensitivity.* Which customers actually make purchasing decisions based on price? And what is the likelihood of influencing their decisions by adjusting pricing? How much of a price change is required to tip the scale from “no” to “yes” for these customers?

How It Worked at Hill-Rom

One such case is medical-equipment supplier

Hill-Rom, which worked with Oliver Wyman to employ predictive segmentation techniques and reorganize its sales force in a way that put the new segmentation approach to good use. Hill-Rom’s revenue growth had begun to slow, and its traditional tactics (including product-line extensions and acquisitions) weren’t enough to secure desired levels of future growth. Competition had intensified as well.

The company implemented a new segmented approach to its North American customer base that included distinguishing between those who wanted to invest in leading-edge technology and those who valued standard, “good enough” products. The new model paid big dividends in the form of a 6 percent rise in overall customer satisfaction in a two-year period, and a doubling of the revenue growth rate over two years in Hill-Rom’s North American business.

Challenges of B2B Markets

Even with the advent of new technical tools to improve segmentation, this area remains far more challenging in B2B than in consumer markets. Sales cycles are long, and offerings are complex. Moreover, many customers care less about initial product costs and more about the total costs of ownership, including service, maintenance, upgrades, and other factors. Competitors’ offerings and strategies shift so quickly that managers cannot reliably compare the impact of changes in a given marketing lever over more than one quarter of business. In addition, customer relationship management systems cannot easily capture the decisions and actions that led to success or failure with any particular account, because such information is largely anecdotal, not quantitative. Rare is the account executive who takes the time to document these cause-and-effect links.

There’s a final challenge: Many of the criteria that managers may want to use to improve segmentation are related to business designs with which the firm has meager experience. For instance, a company may want to move toward a managed-services or hosted-solution business design. But if its experience lies largely in product sales, the firm will lack the data needed to understand customer behaviors and priorities associated with the new business design.

New Principles

To address these concerns and create a truly effective segmentation approach, our experience in a range of B2B industries suggests that executives should be guided by four principles:

- Focus the segmentation effort on one business problem.
- Conduct “what if” simulations to explore the impact of potential business moves on the problem you have identified.
- Demand both insights and targetability from the segmentation scheme.
- Refresh the segmentation scheme to reflect evolutions in your business design.

Let’s consider each principle in depth.

Focus on a specific business problem.

The most effective segmentations we have observed do not start as top-down, high-level initiatives to improve understanding about customers in a general sense. Rather, they begin as attempts to solve a particular business problem, whether it’s increasing sales-force productivity, redefining channel strategy, rolling out new types of products or solutions, or overcoming a competitive threat. By centering the effort on a specific business objective, executives can better assess the segmentation effort’s potential value before actually implementing it, which makes for a less risky investment.

To make this work in practice, the team responsible for that objective must own the segmentation initiative. Marketing scientists, research specialists, and organizational design experts all play a role, but the business owners must lead the effort to keep it on track right from the start.

The segmentation project must be run not as a stand-alone exercise but rather as part of a broader set of initiatives required to solve the identified problem. This larger set of initiatives may include pricing, offer design, go-to-market strategy, and

detailed plans for getting the most value from the segmentation.

One large software provider that we worked with focused on a business problem that surfaced in the form of complaints from channel partners and the internal sales organization that the company was generating too many special promotions. The sales organizations had no way of discerning when to use which offer. Meanwhile, the promotions-development teams did not know which offers were being used with which customers. The company was planning a major product release, and executives worried that the firm would not achieve the targeted level of market adoption or that too many promotional offers around the release would erode profitability. The organization employed a predictive segmentation approach to test potential future offers through a simulated buying exercise. This exercise generated insights into which types of customers responded to which offers, allowing managers to narrow the total number of offers to a select few per segment.

The software firm dramatically reduced the number of offers in the market and provided clear offer-targeting guidelines to the field organization. These results helped channel partners as well, and the firm hit its revenue targets without sacrificing profitability.

Define segments by testing business moves that could solve the selected problem.

It’s critical to directly test and measure customers’ reactions to changes intended to address the defined business problem. The changes could include lowering or raising price, developing a new channel, increasing or decreasing time to deliver a service, or adding a new feature to a product. Measuring the impact of potential changes allows managers to identify which ones to implement for which segment. You can also use the results of customers’ responses to these potential moves to determine more useful segment definitions (see the sidebar, “The Science Behind Predictive Segmentation”).

Consider the case of a major software company that was reorienting its offers around an emerging, potentially game-changing technology called

The Science Behind Predictive Segmentation

To reap economic value from segmentation, it's not sufficient to define customer segments and understand how each behaves differently. Senior executives must also determine what to do differently as a result of the new segmentation, and then convince key people within the company that the different segments will in fact react differently to these moves.

Predictive segmentation builds in the opportunity to rigorously "pre-test" each segment's reactions to potential changes in business levers, therefore, one can define segments based not just on their past behaviors, but also on how they will react to changes the firm might make.

This forward-looking perspective comes from putting representative customers from the target markets through a simulated buying exercise, presenting them with fully described offerings from all the relevant suppliers in the marketplace. Elements of the offerings are varied using a specific sampling approach called experimental design, which allows a marketer to project the impact of many stimuli by testing just a few of them. Using mathematical formulas to select and test a subset of combinations of variables that represent the complexity of all the original variables, marketers can model hundreds or even thousands of stimuli accurately and efficiently.

The next step is to build Bayesian models to combine the experimental design data with traditional survey data on customer needs, attitudes, and behaviors. This gives marketers both forward- and backward-looking data with which to construct or define their segments. In the exhibit below, drawn from the IT industry, the segment definitions were based on customer input on backward-looking variables (for example, "How much do you spend on software annually?") as well as

forward-looking variables (customer reaction to the simulated moves by the company).

As one example, in the exhibit below, look at the reaction to price changes by segment. Moving the price from \$55 to \$40 per software license causes minimal gain in segments 1 and 3 but huge gains in segment 2. Given a reliable sizing of the market potential in each segment, you can clearly discern whether the price change is prudent before implementing it. And providing you can find ways to change the pricing equation for segment 2 only (say, through discount programs), you could optimize profitability across all segments—since all of the gain from a price reduction comes from that segment.

Predictive segmentation entails pre-testing other business moves as well. While segment 1 barely reacted to a potential price change in software license, it responded vigorously to a change in the availability timeframe (from 14 days to 3 days). In fact, the model demonstrated that customers in segment 1 were willing to pay up to \$5 per license more for the better availability, without any negative impact on market share. Armed with this insight, the software firm could now create a new offer that was higher priced but that reflected the faster availability. Executives could know in advance that demand from segment 1 was sufficient to justify yet another new offer. Equally important, the sales force could determine exactly which segment to target with this new offer.

This more scientific approach takes the guesswork out of deciding how to treat each segment differently. It also wins management support for proposed changes, because people who can better anticipate the results of proposed business moves feel more confident in their decisions.

Base case

	Segment 1	Segment 2	Segment 3
List price per license	\$55	\$55	\$55
Discount/promotion	5%	5%	5%
Availability	14 days	14 days	14 days
Upgrade	Monthly, 5% list	Monthly, 5% list	Monthly, 5% list
Customization	Yes	Yes	Yes
Pre-loaded on PC	No	No	No
Resulting share	12%	7%	28%

Reaction to price change

	Segment 1	Segment 2	Segment 3
List price per license	\$40	\$40	\$40
Discount/promotion	5%	5%	5%
Availability	14 days	14 days	14 days
Upgrade	Monthly, 5% list	Monthly, 5% list	Monthly, 5% list
Customization	Yes	Yes	Yes
Pre-loaded on PC	No	No	No
Resulting share	15%	29%	30%

Service-Oriented Architecture (SOA). This technical redefinition would profoundly affect the functionality of the company's offerings. Executives wanted to understand how to segment customers based on a new set of SOA capabilities in combination with the firm's traditional capabilities. They tested customers' reactions to these new SOA capabilities and helped generate answers to several key questions:

- Which groups of customers ascribe a high degree of value to these new capabilities and are willing to pay a premium for them?
- How large are these segments of opportunity, and where do they exist?
- Where should we focus our scarce supply of internal sales teams that have expertise in the new technology?
- With which groups of customers should we avoid talking up the new technology and its capabilities, given that it has little perceived value to these groups?

By refreshing the way these executives viewed and segmented the market, this testing approach generated valuable insights into how customers would react to new technical capabilities the firm had not yet launched in the market.

Treat the objectives of deep customer insight and easy customer identification as complementary, not as tradeoffs.

Marketing executives commonly assume that segmentation can either provide deep customer insight or help the field organization easily identify and target desired segments—but not both. This belief often stems from hard experience. Segmentations that hinge on industry, geography, or company size generally underperform behavioral approaches in providing real insight. By contrast, attempts to distinguish segments based on customer needs, attitudes, and behaviors lead to the definition of segments that are intuitively compelling but hard to observe and impossible to find using the limited data available to the channel.

Consequently, B2B companies tend to strike an awkward compromise. They create one segmentation model for the sales and service organization, whose members prefer highly targetable segments, even at the cost of reduced insight. They devise another segmentation model for the product development and marketing communications groups, to whom customer understanding is crucial, even if they cannot easily identify individual segment members.

Predictive segmentation makes this tradeoff unnecessary. It is possible—indeed, it is increasingly critical—to segment customers in ways that provide both deep insight and easy identification. This better balance comes from focusing segmentation efforts on solving a particular business problem rather than treating segmentation as a catch-all tool.

One technology company that put this principle into practice had been struggling with a field marketing organization structured around the variable “size of company served.” The company was attempting to adopt a more sophisticated segmentation approach by factoring in an industry variable, which also was highly observable. However, for the business problem this firm was trying to solve—reaching small-business customers more effectively—the variables of channel preference and decision-making process best determined how to segment the market. Because this data was not available to the field organization, members of the segmentation team identified a few proxy variables (such as industry, company ownership struc-

Principles of Successful Segmentation

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ture, and type of software license)—data that were in the existing systems and that correlated with the key variables of interest.

This tactic allowed the field organization to identify members of desired segments without overhauling existing data systems or restructuring any parts of the organization. As a result, the company could reach the desired customer segments with new offers without having to rebuild its customer data.

Once you gain insight into customers' priorities, there are various ways to take action. Oliver Wyman recently worked with Purolator Courier, Canada's largest courier company, to bring the segmentation to life. From dozens of interviews with Purolator's clients, it became clear that they had needs far beyond the delivery of packages, including reducing inventory costs, tracking and tracing packages, and managing returns. When the research was completed, we helped transfer the resulting strategy from marketing to the sales force.

The first initiative was to rationalize Purolator's pricing. We also introduced value-based sales training that focused on the higher-order needs uncovered during the research. Based on the data, Purolator developed a customer compass, which included different questions to ask clients depending on which department the sales reps were selling to. Strengthening the linkage among marketing, inside sales (which qualified the customers), and the sales force helped to focus Purolator's effort on high-value customers.

Make segmentation a dynamic, ongoing process.

Too many segmentation efforts start with bold and broad ambitions but quickly become underused and

go stale, until another segmentation scheme starts three or five years later. The most effective segmentation programs have the reverse dynamic: They start with a sharp focus on a specific business problem and then extend more broadly across the organization.

To do this right requires embedding the new thinking about segmentation in your core business processes. If the business problem you've defined is "improve sales productivity," the firm must make the segmentation effort part of the sales execution process. This means that each segmentation effort must be tailored to the needs of different parts of the organization, as each addresses different business problems. Similarly, the segmentation effort must be refreshed as the overall business process or strategy it serves is updated.

The point is illustrated by the case of a business-services company that used segmentation to better align its broad services portfolio to customer needs and ultimately to improve sales-force productivity. To continue satisfying customers, the company had to evolve its services portfolio over time. Accordingly, executives realized they had to refresh the firm's segmentation to reflect the new portfolio and ensure that the segmentation continued to add value as a sales-productivity and account-planning tool.

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For companies that operate in complex, rapidly evolving B2B markets, predictive segmentation has injected an old concept with new science and fresh thinking, generating impressive business results along the way. Thoughtful implementation of this new form of segmentation will help managers improve their odds of generating measurable value as well as surmount their immediate business problems.❖

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