Strategic Marketing Analysis

Alexander Chernev

Kellogg School of Management
Northwestern University

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Chapter Three

Identifying Target Customers

Deciding how to segment the market and which customers to target is one of the most important marketing tasks. Even though the general concept of segmentation and targeting is relatively simple, there is a great deal of confusion about when and how to segment and target the market. To address this issue, this chapter offers an overview of the segmentation and targeting processes in strategic marketing analysis.

Segmentation

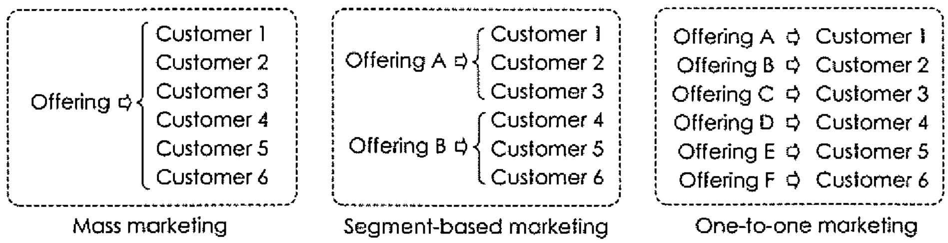
Segmentation is the process of dividing customers into groups with similar characteristics. The process of segmentation is based on the idea that the effectiveness and efficiency of a company's marketing activities can be improved by ignoring the nonessential differences among customers within each segment and treating these customers as if they were a single entity. Thus, through segmentation, the company can reduce the heterogeneity (i.e., diversity) in the marketplace and deal with a relatively small number of customer segments.

Grouping customers into segments serves two main functions: (1) It optimizes the effectiveness of the offering by identifying the key differences among customers in order to develop a customized offering for each segment, and (2) It optimizes the cost efficiency of the offering by identifying the irrelevant differences among customers in order to deliver the same offering to customers within each segment. Thus, the key benefit of segmentation is in allowing the company to optimize marketing expenditures by grouping customers who are likely to respond in a similar fashion to the company's offerings. The key disadvantage of segmentation is that grouping customers into segments does not take into account potentially important differences that may exist among customers within each segment.

Segmentation, Mass Marketing, and One-to-One Marketing

The concept of segmentation can be better understood when considered in the context of two alternative marketing approaches: mass marketing and one-to-one marketing. Mass marketing refers to a scenario in which the same offering is given to all customers. A classic example of mass marketing is the strategy adopted by Ford's Model T, in which a single type of car was offered to all customers. In contrast, in one-to-one marketing, the company's offering is customized for each individual customer. In this context, segmentation can be viewed as a compromise between the mass-marketing approach and the one-to-one approach (Figure 1). By recognizing the diversity of customer needs, segmentation allows the company to design offerings that meet the needs of its customers better than the mass-marketing approach. The downside of segmentation vis-à-vis mass-marketing is that developing different offerings for each segment could potentially lead to higher costs for creating, communicating, and delivering the offering.

Figure 1. Segmentation, Mass Marketing, and One-to-One Marketing.



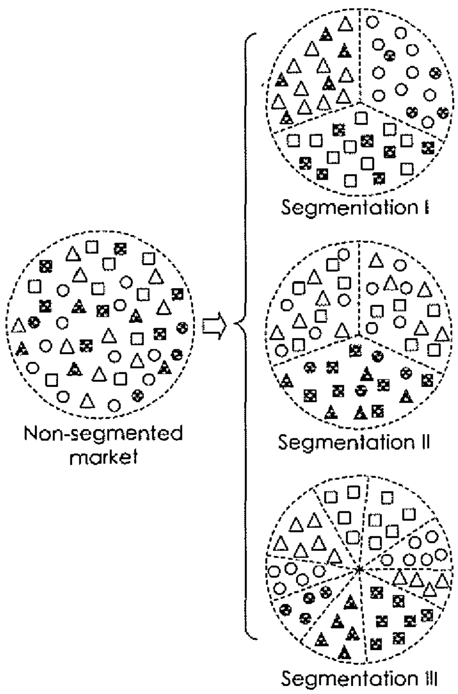
Because in most cases, it is not cost efficient to develop an individual offering for each customer as advocated by the one-to-one approach, segmentation allows companies to effectively reduce the number of its offerings by developing offerings for groups of customers with similar needs. However, because grouping customers inevitably ignores some of the differences within each group, segmentation may decrease the effectiveness of the company's offering by not fully customizing the offering to fit the needs of individual customers.

An important issue in segmenting markets is determining the extent to which a market should be segmented and how large each segment should be. Segment size could potentially vary, between a single segment encompassing the entire market (mass marketing) and multiple segments of one customer each (one-to-one marketing). As a general rule, segmentation is beneficial when the incremental value from more effectively meeting the needs of resulting segments and from optimizing the communications and distribution strategies outweighs the costs of developing separate offerings for each segment. To illustrate, when the cost of customization is relatively high (e.g., durable goods manufacturing), companies tend to develop offerings that serve relatively large segments, whereas in industries where the cost of customization is low (e.g., online information delivery), segmentation can yield relatively small segments.

The process of segmentation can be illustrated as shown in Figure 2, in which customers vary on two factors represented by color and shape. Because each of these two factors has three levels, the maximum number of potential segments is nine. In this context, there are three possible segmentation strategies: by color, by shape, and by color and shape. The choice of a particular segmentation criterion is a function of the degree to which this criterion captures strategically important aspects of customer reaction to the company's offering.

An important characteristic of a given segmentation is its depth, which is determined by the degree of heterogeneity among customers. In general, the greater the segmentation depth, the greater the number of resulting segments and the lower the heterogeneity across customers within each segment. For example, the three scenarios shown in Figure 2 vary in the depth of the underlying segmentation: Compared with Segmentations I and II, the depth of Segmentation III is greater, as evidenced by the larger number of segments and the lower within-segment heterogeneity.

Figure 2. Market Segmentation Strategies



Criteria for Segmentation

As a general rule, a good segmentation should yield segments that are mutually exclusive and collectively exhaustive: they should be sufficiently different from one another so that they do not overlap; at the same time, identified segments should include all customers in a given market. This can be achieved by using well-defined criteria to segment the market.

When segmenting the market, the company's goal is to produce segments that differ in ways that are meaningful for marketing purposes. Thus, segmentation should yield groups of customers that vary in their response to the company's offering: Customers in the same segment should react in a similar fashion to the offering, while customers in different segments should vary in their response. Such segmentation is referred to as *actionable* because it can be used to guide the company's marketing activities. An actionable segmentation can be readily used to select and identify target markets.

▸ Value-Based vs. Profile-Based Segmentation

Two main factors are used to divide customers into distinct segments: value factors and profile factors. These segmentation criteria and the corresponding segmentation strategies are outlined below.

- *Value-based segmentation* groups customers based on their needs and the benefits they seek from the company's offerings. Value-based segmentation criteria can include three different types of factors: (1) functional factors, such as quality, performance, aesthetics, reliability, durability, safety; (2) monetary factors, such as willingness to pay, financing preferences, promotion preferences; and (3) psychological factors, such as image and social status.

- *Profile-based segmentation* captures some of the observable customer characteristics. In consumer marketing, four types of such characteristics are commonly used: demographic, geographic, psychographic, and behavioral. Each of these characteristics comprises one dimension of the customer profile:

  - *Demographic profile* includes factors such as age, gender, income, education, social status, and stage in the life cycle.
  - *Geographic profile* includes location identifiers such as country, region, postal codes, and area code.
  - *Psychographic profile* includes relatively stable individual traits, such as personality, moral values, and lifestyle.
  - *Behavioral profile* captures customers' actions related to the company's offering, such as user status, distribution channel, volume purchased, frequency of repurchase, price sensitivity, promotion sensitivity, and loyalty.

  In business marketing, profile-based segmentation, referred to as *firmographics*, is based on factors such as location, size of company, industry, purchasing process, growth, and profitability.

User-Based vs. Occasion-Based Segmentation

Depending on the nature of the segmentation criterion, most segmentations fall into one of two categories: *user-based* and *occasion-based*. User-based segmentation groups customers based on their relatively stable individual characteristics, which are likely to determine their needs and/or behavior across different purchase and consumption occasions. To illustrate, a customer may have a strong preference for fast food (e.g., burgers and fries) across different consumption occasions.

In contrast, occasion-based segmentation groups customers based on purchase and consumption occasions. By focusing on usage occasions rather than on the individual characteristics of the customer, occasion-based segmentation implicitly assumes that the same customer is likely to display different needs depending on the occasion. For example, when buying wine, a customer's preference may vary as a function of the occasion (for cooking, for daily consumption, for a special occasion, or for a gift).

In general, user-based segmentation is more useful in settings in which customers' needs are relatively stable across purchase occasions and, hence, can be used as a reliable predictor of their behavior on any particular purchase occasion. In contrast, occasion-based segmentation is more useful in cases in which customer needs vary across purchase occasions and the same customer is likely to fall into different usage-based segments. To illustrate, the preference for regular versus light (diet) soft drinks is relatively stable across individuals and is relatively well captured by a user-based segmentation. In contrast, because the preference for a particular soft drink flavor is likely to vary over time for each individual depending on the usage occasion, in this case, occasion-based segmentation is more appropriate.

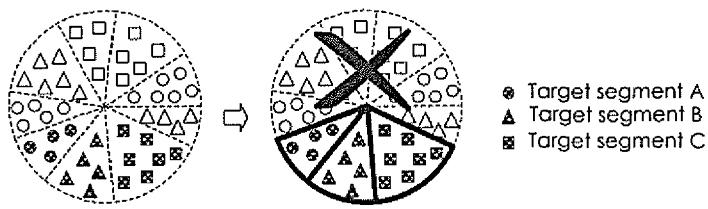
Targeting

The concept of targeting is used in two different contexts: (1) as a process of selecting which customers to serve and which to ignore and (2) as a process of identifying the actionable characteristics describing customers that the company wishes to serve. These two aspects of targeting are discussed in more detail below.

Strategic Targeting: Selecting Customer Segments

The strategic aspect of a company's targeting decision involves identifying which customers (segments) to serve and which to ignore (Figure 3). Thus, strategic targeting reflects a company's decision to develop an offering that matches the needs of a particular set of customers, as well as customized communication and/or distribution activities to reach these customers. Because it is guided by the company's ability to fulfill customer needs better than the competition, strategic targeting is typically derived from value-based segmentation rather than from profile-based segmentation.

Figure 3. Strategic Targeting



One of the key issues in strategic targeting analysis is identifying which criteria to use in selecting target customers. In general, three types of targeting criteria can be distinguished: (1) the inherent attractiveness of the customers in a given segment, (2) the segment's compatibility with the company's strategic goals, competencies, and assets, and (3) a company's ability to serve the segment better than the competition. These three criteria are discussed in more detail below.

- *Segment attractiveness* reflects the ability of a particular segment to deliver value to the company and its collaborators. In general, segment attractiveness is a function of two key factors: (1) the long-term *revenue potential* of the customers in this segment and (2) the *cost of reaching* these customers. More specifically, the revenue potential of the segment is typically determined by factors such as segment size, growth, buying power, and inherent loyalty. The cost of reaching customers in the segment is a function of the company's ability to effectively and cost-efficiently communicate and deliver the offering to these customers.

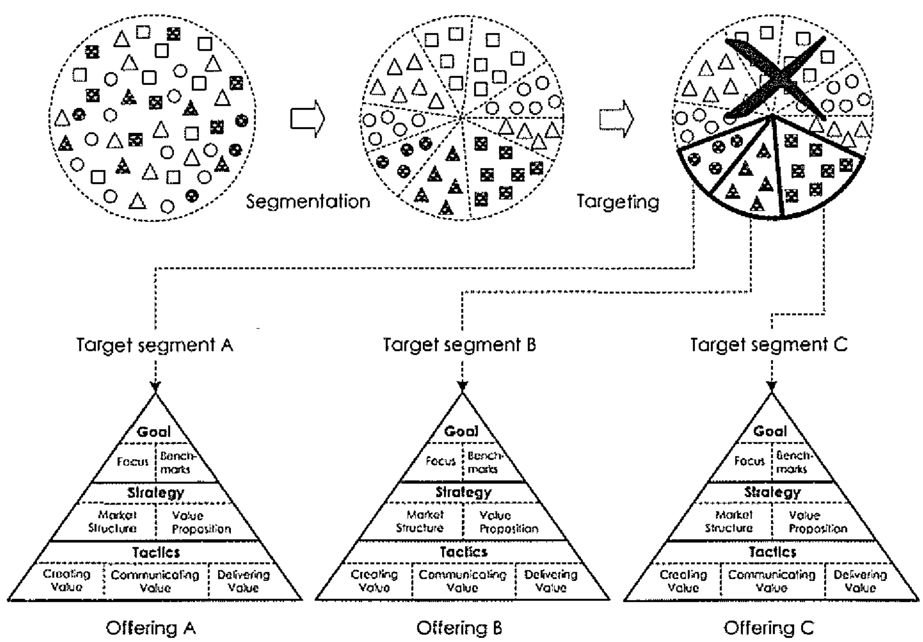
- *Segment compatibility* reflects the ability of the company to deliver value to the target customers in a way that enables the company and its collaborators to achieve their strategic goals. In general, segment compatibility is a function of two key factors: (1) the degree to which serving this segment is consistent with the company's strategic *goals* and (2) the degree to which the company has the *resources* (i.e., competencies and assets) necessary to serve this segment.

- *Competitive advantage* reflects the company's ability to fulfill the needs of target customers better than the competition. A company's competitive advantage is, to a large degree, a function of the extent to which the competencies and assets necessary to deliver value to the target segment are unique and difficult to imitate by competitors.

A segment has to meet all of these criteria to be selected; failure to meet even one criterion will impede the company's ability to be successful in delivering superior value to target customers in a way that benefits the company and its collaborators. To illustrate, the fact that a particular segment is inherently attractive is not a sufficient reason to target this segment; it is also imperative that serving this segment is consistent with the company's goals and that the company has the resources to deliver value to this segment in a way that cannot be matched by competitors.

It is important to note that because different target segments vary in their needs, they often have a different set of competitors and collaborators, rely on different core competencies and strategic assets of the company, and are influenced by different aspects of the overall context in which the company operates. Furthermore, from a company perspective, different segments are often associated with goals that vary in terms of their focus (e.g., monetary or functional) as well as in terms of their quantitative and temporal benchmarks. As a result, each individual segment requires its own strategic analysis, as illustrated in Figure 4. The process of managing multiple offerings comprising a company's product line is discussed in more detail in Chapter 18.

Figure 4. Targeting Multiple Segments: Product-Line Perspective



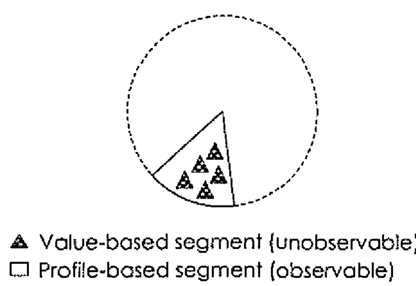
Tactical Targeting: Reaching Already Selected Customer Segments

Unlike strategic targeting, which involves deciding which customers to target and which to ignore, tactical targeting involves developing strategies to communicate and deliver the offering's value to the already selected target customers.

Because of its focus on identifying customers whose needs the company can satisfy better than the competition, strategic targeting is typically derived from a value-based segmentation that groups customers based on their needs. The problem with this approach, however, is that customer needs are not readily observable to the company—a fact that complicates the company's ability to communicate and deliver its offering to target customers in an effective and cost-efficient manner.

Without direct contact with its target customers, the company will need to communicate the value proposition of its offering and make it available to everyone, so that its target customers are aware of the offering and are able to obtain it. The problem with this approach is that it often is not cost effective, especially when the targeted customer segment is relatively small. In cases of multiple offerings by the same company, there is also a risk of customer confusion and/or sales cannibalization if all offerings are made available to all potential customers. To address this issue, companies often use the readily observable profile characteristics to identify the value-based target segments. For example, airlines tend to identify customers' price sensitivity based on their observable purchase behavior, such as advance purchase, flexibility of travel plans, and length of travel. This process of identifying the value-based segments by linking them to certain observable and actionable characteristics is the essence of tactical targeting (Figure 5).

Figure 5. Tactical Targeting

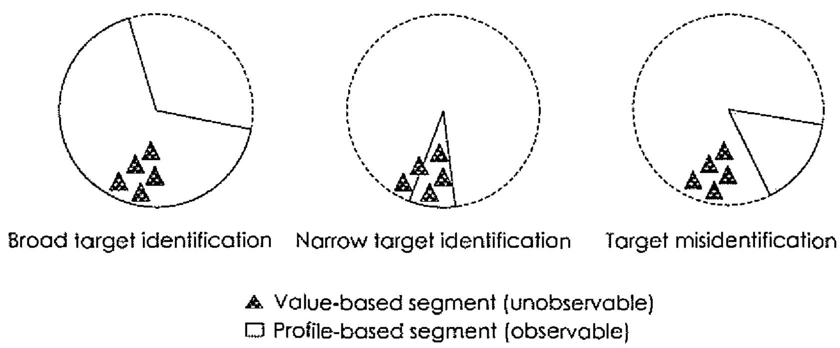


The efficiency of tactical targeting is a function of the fit between the value-based target segment (customers that share a particular need) and the readily identifiable target segment (customers that share certain identifiable profile characteristics). Thus, on a tactical level, the efficiency of a company's targeting strategy can be expressed as the ratio of the size of the value-based target segment (identified in the process of strategic targeting) and the size of the identifiable profile-based segment. The closer the efficiency ratio is to 1, the more efficient the company's targeting approach.

In the ideal scenario, the identifiable segment will perfectly match the value-based segment. In reality, however, achieving such an ideal fit is a challenging task. In this context, there are three types of errors that can be made in tactical targeting: Identification of the value-based target segment could be too broad, the target segment may be identified too narrowly, or the target segment may be misidentified

(Figure 6). The first type of error, often referred to as a "shotgun approach," leads to inefficient targeting because the company will likely spend significant resources reaching customers who are not interested in its offering. In contrast, the second type of error, often referred to as "oversegmentation," leads to inefficient targeting because the company will likely overlook customers interested in the offering. The decision as to which of the two types of errors the company should accept is a function of the relative benefits and costs and should be consistent with the company's overall goals and strategy. Finally, the third type of error involves misidentifying target customers—a scenario in which the company's communication and distribution efforts are directed to a segment that does not include its target customers.

Figure 6. Common Targeting Errors



Relevant Concepts

Baby Boomers: Age-defined market segment most often used in reference to consumers born between 1946 and 1964.

Generation X: Age-defined market segment most often used in reference to consumers born between 1964 and 1975.

Generation Y: Age-defined market segment most often used in reference to consumers born between 1976 and 1999 (other commonly used ranges are 1981–1995 and 1979–1994). Nearly 60 million Americans belong to this group, which is three times the size of Generation X and is the largest age-derived segment.

Heterogeneous Market: Market comprised of customers that vary in their response to a company's offering.

Homogeneous Market: Market comprised of customers that are likely to react in a similar manner to the company's offering (e.g., they seek the same benefits, have similar financial resources, can be reached through the same communication means, and have access to the offering through the same distribution channels).

Niche Strategy: Marketing strategy aimed at a distinct and relatively small customer segment.

Relevant Frameworks: S-T-P

The Segmentation-Targeting-Positioning (S-T-P) framework is a relatively simple and very popular approach that offers an insight into the process by which a company selects its "ideal" customers and develops the offering's unique value proposition. The S-T-P framework implies that the process of delivering customer value involves three key decisions: segmentation, targeting, and positioning. Segmenting the market, identifying target customers, and positioning the offering is an iterative process in which the company attempts to identify the customers who are most likely to benefit from its offering and develops a distinct image of the offering in the minds of these customers.

The S-T-P framework outlines the three key steps in the process of selecting the "ideal" customers and developing the offering's value proposition to these customers. The S-T-P approach does not imply a specific algorithm for dividing the market into segments, identifying which segments to target, and developing a value proposition and a positioning strategy for these customers. Instead, it simply identifies segmentation, targeting, and positioning as key processes in developing an offering's strategy and suggests a particular order in which these processes are to be implemented.

Despite its popularity and intuitive appeal, the S-T-P framework has a number of limitations. One potential limitation of the S-T-P framework is that one of its key components—positioning—reflects only one aspect of an offering's value proposition. Whereas the value proposition captures *all* of the benefits and costs associated with a given offering, positioning captures only the *most distinct aspects* of a company's value proposition. By focusing solely on the most distinct aspects of a given offering rather than on its entire value proposition, the S-T-P approach fails to offer a comprehensive view of customer value. Another potential limitation is that the S-T-P framework focuses only on the customer side of the marketing process and excludes the company and its collaborators from the value equation. As a result, the S-T-P framework does not readily address the process of optimizing the value of the offering to the company and its collaborators.

Additional Readings

McDonald, Malcolm and Ian Dunbar (2004), *Market Segmentation: How to Do It, How to Profit from It.* Amsterdam: Elsevier.

Weinstein, Art (2004), *Handbook of Market Segmentation: Strategic Targeting for Business and Technology Firms* (3rd ed.). New York, NY: Haworth Press.

Gordon, Ian (2002), *Competitor Targeting: Winning the Battle for Market and Customer Share.* New York, NY: John Wiley & Sons.

Appendix: The Algorithm for Segmentation and Targeting

The process of segmentation and targeting can be formalized in an algorithm that outlines a sequence of steps a company should undertake in order to select and identify its target customers. These steps are outlined below.

Step 1: Identify the relevant attributes used by customers to evaluate the offering (e.g., performance, reliability, and price). These attributes should be specific rather than overall performance evaluations (e.g., quality, which typically subsumes all nonprice attributes). It is also important that the selected attributes are uncorrelated (i.e., orthogonal) to ensure that each factor is counted only once. Finally, it is useful to incorporate attributes by which the company's offering is differentiated from competitive offerings. This will help ensure that the resulting segmentation is actionable and can be used to identify target segments to which the company's offering can deliver superior value relative to the competition.

Step 2: Group customers with similar preferences into segments in such a way that (1) customers in each segment are likely to act in a similar manner with respect to the company's offering and (2) across segments, customers differ in their reaction to the company's offering.

Step 3: Define the value profile of each customer segment. This can be achieved by identifying the relative importance of each relevant attribute (identified in Step 1) for each of the segments (identified in Step 2). This step also offers an opportunity to check the appropriateness of the underlying segmentation. If the segments are indeed distinct with respect to their reaction to the company's offering, they should have distinct value profiles. The customer value analysis performed at this step can be summarized as shown in Table 1.

Table 1. Customer Value Analysis

Attributes	**Customer segments**		
	Segment A	Segment B	Segment C
Attribute 1	...	...	...
Attribute 2	...	...	...
Attribute 3	...	...	...
Attribute 4	...	...	...
Attribute 5	...	...	...

Step 4: Identify the relevant set of competitive offerings (i.e., offerings that target the same customers and aim to satisfy the same need) and evaluate the performance of the company's offering and the competitive offerings on each of the relevant attributes (identified in Step 1). Because it explicitly compares the company's offering against competitors' offerings, this step is also referred to as competitive benchmarking. The competitive analysis performed at this step can be summarized as shown in Table 2. Note that unlike the customer value analysis, which evaluates the relative *importance* of product attributes for each customer segment (Table 1), competitive benchmarking identifies a particular offering's *performance* on these attributes.

Table 2. Competitive Benchmarking

Attributes	Company offering	Competitive offerings		
		Offering X	Offering Y	Offering Z
Attribute 1	...	...	...	...
Attribute 2	...	...	...	...
Attribute 3	...	...	...	...
Attribute 4	...	...	...	...
Attribute 5	...	...	...	...

Step 5: Decide whether to serve or ignore each of the evaluated segments. To accomplish this, rate (1) each segment's inherent attractiveness (i.e., the degree to which serving this segment can help the company achieve its goals), (2) each segment's compatibility with the company's assets and competencies (i.e., the degree to which the company can fulfill the needs of the customers in each segment), and (3) each segment's competitiveness (i.e., the competitive intensity in each segment). This analysis is summarized in Table 3.

Table 3. Target Segment Selection

Segments	Targeting Criteria			Targeting decision
	Segment attractiveness	Segment compatibility	Competitive advantage	
Segment A	...	...	...	Serve/Ignore
Segment B	...	...	...	Serve/Ignore
Segment C	...	...	...	Serve/Ignore

Step 6: Link the target segments to actionable characteristics that will be used to communicate and deliver the offering. The goal here is to identify actionable (profile-based) characteristics of the value-based target segments and develop the most efficient strategy to reach these segments (Table 4).

Table 4. Identifying Value-Based Target Customers

Segments	Value Proposition	Communication	Distribution
Segment A	...	...	...
Segment B	...	...	...

At this point, the process of segmentation and targeting is complete. It is usually followed by defining the offering's value for each segment and positioning the offerings vis-à-vis customer needs and competitive offerings. Although it is not part of the segmentation and targeting process, positioning is a logical sequel to these processes and involves identifying the company's strategy to create a distinct image of its offering in the minds of target customers. The key aspects of an offering's positioning strategy are discussed in more detail in Chapter 4.