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Identifying Your Most Profitable Customers:

# An Introduction to Customer Segmentation

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Segmenting your customers can help you focus your marketing efforts, so you can increase profits and overall customer satisfaction. Learn steps and strategies to help you get started.

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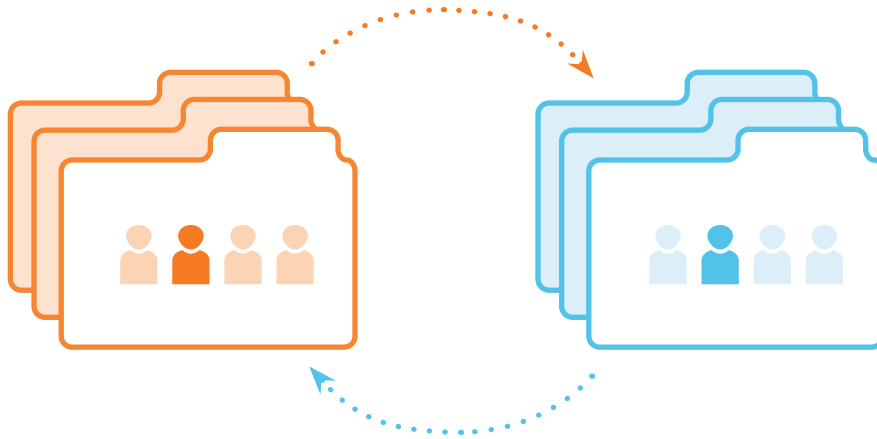
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# Introduction

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# What is Customer Segmentation?

Customer segmentation (also called market segmentation) is the practice of dividing customers into groups that share similar characteristics.



Think of an online pet supply store as an example: Its customers are very diverse, with very different needs and preferences. What they buy is highly dependent on the type of pets they own; their pets' ages and dietary needs; their lifestyles and income; and how they interact with their pets. From a marketing perspective, it wouldn't make sense for a pet supply store to communicate to its entire customer base in the same way.

But customer segmentation is about more than matching customers with appropriate product offers. It's also about changing the way you communicate with your customers based on what you know about them. It's also about identifying your most profitable customers and tailoring your products and services to meet their specific needs. Ultimately, customer segmentation is about creating relevant shopping experiences that build brand loyalty.

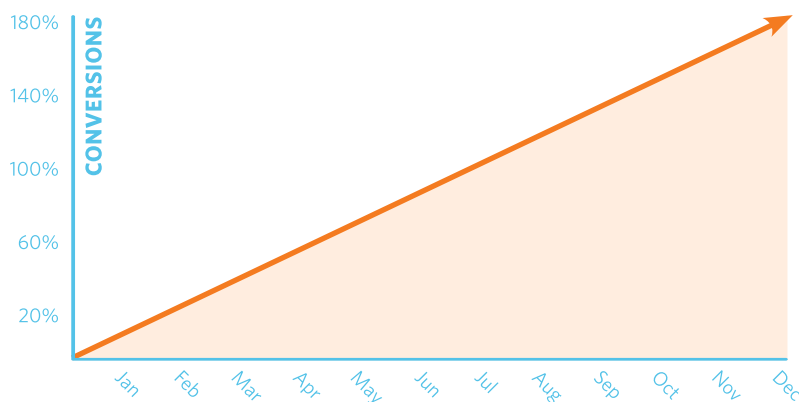
# Why is it Important to Retailers?

Not so long ago, many online retailers focused their marketing efforts around appealing to the “average” customer and attracting as many site visitors to their stores as possible.

But customers are becoming more sophisticated in how they navigate their myriad shopping choices, and online retailers are discovering that one-size-fits-all marketing approaches aren't so effective any more.

In fact, targeting the wrong customers can cost you—not just in wasted marketing dollars, but in higher operational costs associated with processing product returns, handling customer service calls, and responding to lackluster customer reviews. Conversely, targeting the right customers (with the right messages at the right time) can pay off in terms of higher conversion rates, higher average order values, and increased profits. Targeting the right customers can also lead to brand advocacy and word-of-mouth advertising; valuable product insights; and greater overall customer satisfaction.

## TARGETING THE RIGHT CUSTOMERS



# Putting Segmentation into Practice

Segmenting your customers can help you figure out which customers to target, and how to best communicate with those customers.



In many cases, you can segment customers dynamically based on pre-set conditions such as items in a customer's shopping cart, items previously purchased, or recently viewed items. Such on-the-fly segmentation might customize what banner ads a particular customer sees, for example, or automatically suggest products that might be of interest to that customer. Or trigger an email containing a specific promotional offer. The result can be a more engaging customer experience.

More powerful results can be achieved by segmenting customers based on customer needs and specific marketing objectives. For example: a bank might segment its customers based on age, marital status, and checking or savings account balances to identify young couples who may be considering buying a house and thus looking for a home loan. Or a sporting goods store might segment customers based on geographic location, age, income level, and lifestyle data to identify customers living in coastal regions who may be interested in buying wetsuits, paddle boards, and surf gear.

## Examples of dynamic segmentation:

1. Customers from a specific city or state with a shopping cart value of more than X
2. Customers who have spent more than X on previous purchases
3. Customers who have viewed the same product more than twice and have bought similar products in the past

# Defining Customer Variables

Chances are you've already collected a wealth of data from your store's customer registrations, purchase history, and other sources.

This data can be used to segment customers based on almost limitless geographic, demographic, behavioral, and lifestyle variables. The key to meaningful segmentation is to define customer variables and attributes that are relevant to your unique business.

**Here are some of the variables used most often to segment customers:**



## **Geographic**

Region of the world or country, population density, climate



## **Behavioral**

Page views, previous purchases, product benefits sought (i.e., price, quality, prestige), product attributes, shipping/payment methods used, reward program participation



## **Demographic**

Age, gender, household size, marital status, income, education level, occupation, ethnicity



## **Lifestyle**

Recreational and entertainment activities, social values, cultural practices, community affiliations (professional, military, religious, educational)



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Steps to Successful

# Segmentation

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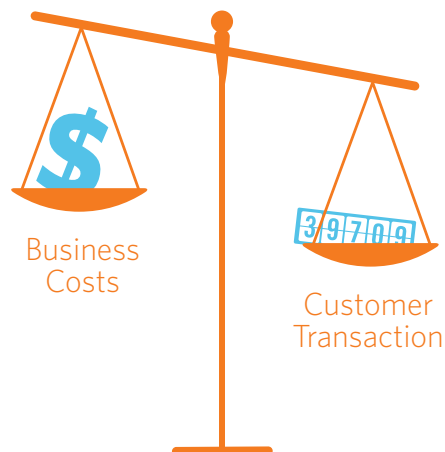


## 1

# Understand Your Business Costs

Before you start segmenting your customers, you should have a good idea of not just your overall business costs, but your costs associated with each customer transaction.

What are your advertising and [customer acquisition costs](#)? How much do you spend on shipping and order processing? On customer service? Knowing your business costs will help you determine how much you need to earn from each customer transaction to be profitable. More importantly, you'll be able to start linking customer behaviors to profits. This is essential to helping you identify which customers are worth targeting—and which ones are not. Dell Computer, for example, [made the decision](#) to drop its lowest priced computers from its product line since customer segmentation data revealed that the company couldn't make money from the extremely price-conscious customers who bought those computers.



In addition to understanding your business costs, you'll want to begin assessing your customers' profit potential, or customer lifetime values (CLV).

Customer lifetime value is the average net profit (revenues minus expenses) that can be attributed to a company's relationship with a customer over time. It can be a useful tool in segmenting your customers. Here's how to calculate it:

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$$\begin{array}{ccccccc} \text{AVERAGE} & & \text{NUMBER OF} & & \text{AVERAGE RETENTION} & & \text{LIFETIME} \\ \text{VALUE} & \times & \text{REPEAT} & \times & \text{TIME FOR A} & = & \text{CUSTOMER} \\ \text{OF A SALE} & & \text{TRANSACTIONS} & & \text{TYPICAL CUSTOMER} & & \text{VALUE} \end{array}$$

Knowing your customer lifetime values can give you a good idea of how much repeat business you can expect from individual customers. You can use these values—in conjunction with your customer acquisition costs—to determine how much you're willing to spend to cultivate ongoing relationships with these customers.

# 2

## Identify Your Best Customers

The [80/20 rule of marketing](#) says that 80% of a business' sales come from 20% of its customers.

By that same rule, 20% of a business' products can be expected to make up 80% of its total sales. A quick analysis of your purchase history data can offer a wealth of information about who your best customers are, and which customers are buying your top-selling products.

**Look for your most profitable customers and those with high profit potential, such as:**



### Frequent Shoppers

Repeat customers and frequent shoppers  
([According to marketing experts](#), repeat customers respond 40% to 60% better than one-time customers.)



### High Average Order Values

Customers with high average order values



### Few Returns

Customers who have made few or no returns



### Provide Reviews

Customers who regularly leave product reviews and use social media to tell friends about their purchases



### Responsive Customers

Customers who regularly respond to special offers and promotions.

Analyze these top-tier customers to see what other characteristics they might have in common. What is the average price range for the products they buy?

How often do they make a purchase? Where do they live? What payment or shipping options do they prefer? What is their age range or gender? The idea is to learn as much as you can about these customers so you can tailor your marketing efforts to attract similar customers in the future.

Next, take a look at your top-selling products. Who is the intended buyer for these products? What characteristics (demographic and behavioral) do these people share? Do you offer related products that might appeal to this same audience? Likewise, you'll want to learn as much as you can about these customers so you can tailor your products and services accordingly.

You may also want to try to identify your worst, "bottom-tier" customers, so you can minimize unprofitable attempts to convert these customers in the future. These customers would be those that are consistently unprofitable based on your cost per transaction analyses. Look for customers that have a high rate of product returns, low average order values, and a high rate of customer service calls or inquiries. Typically, unprofitable customers are those looking for the lowest priced deals, and are therefore usually not the most loyal customers. Knowing who these customers are can give you the flexibility to include or exclude them in your targeted marketing initiatives.

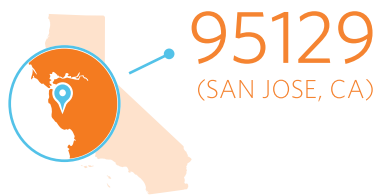
### Identify:

1. Your best (and worst) customers
2. Customers who buy your best selling products
3. Behaviors and characteristics associated with profit

# 3

## Collect Data from External Sources

The more you know about your customers, the more effectively you'll be able to meet their needs and create targeted, relevant shopping experiences. Beyond your transaction database there are a number of external sources you can tap to collect data about your customers.



### Census Data

With a little extra research you can collect a range of useful demographic information based on your customers' zip codes. Through [ZIPSkinny](#), for example, you can access statistics on marital status, income level, education level, ethnicity, and occupations for a particular area. Factors related to local climates might also be useful to collect—especially for clothing retailers and merchants that sell products for outdoor use.



### Browsing Devices

Another way to collect useful customer data is by detecting browsing devices used to access your store site. While a few years ago most retailers assumed consumers were accessing their sites from desktop or laptop computers, that assumption is clearly no longer accurate. Mobile eCommerce sales are now growing faster than traditional eCommerce sales, with tablet computers being the [preferred shopping device](#).



### Surveys and Market Research

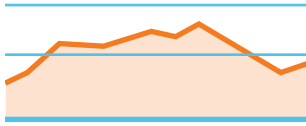
Consider conducting independent market research or surveying your customers to collect richer data—such as information about your customers’ lifestyles, attitudes, activities, shopping preferences, etc. For example, a site selling jewelry could survey their customers to find out which metals and stones they prefer, how often they purchase or wear jewelry, whether they give jewelry as gifts, and how price sensitive they are.



### Cookies

Using cookies to track customers’ behaviors as they shop your store site is another popular method merchants use to collect information about their customers. Cookies collect data such as browsing history, page views, even income, age range, and education level (depending on information customers have previously entered to complete online forms).

However, using cookies to track and profile consumer behavior is raising significant [privacy concerns](#). And many consumers are choosing to opt-out of cookie collection whenever possible. Asking customers to login to your site, register, or sign up to join a rewards program might present more reliable and consumer-acceptable ways to collect the same information. And often, the information you collect is uniquely relevant to your business.



### Web Analytics

Most web analytics packages provide retail site owners with information about the device used to access their site, including vendor and model name. Web analytics packages can also provide information on your customers' geographic location, times and days of the week they visited your site, and the pages they viewed.

As a merchant, you can use this information to draw conclusions about your customers based on the associated demographics. For instance, customers using the latest smart phones might be seen as younger shoppers willing to spend more on a product, since demographics show that approximately 50% of iPhone and Android users are [under the age of 34](#). Customers using the latest tablets might be seen as older shoppers concerned with comparing prices, since demographics reveal 38% of iPad and Nook users to be [50 - 64 year-old leisure users](#).



### Data Aggregator Services

For a fee, data services such as [Rapleaf](#) and [Spearmint](#) will provide you with a range of information about your customers based on their email addresses. These services work by scouring public records, census data, website analytics and even social media sites to estimate your customers' average potential values, average purchase frequency, and average social influence, for example. Rapleaf, which builds customer profiles that include estimated age and income levels, claims have at least one data point tied to more than 80% of all U.S. consumer email addresses.

# 4

## Create Customer Profiles

Once you know a bit about your customers' lifestyles, behaviors, and purchasing habits, you can begin to build profiles to help you zero in on your customers' needs, mindset, and challenges.



A good customer profile leverages demographic, lifestyle, and behavioral characteristics to reveal important differences that you, as a merchant, can target. A good profile can also help you refine how you communicate—in terms of word choice, tone, and calls to action—with your various customers, so that your messages and calls to action resonate.

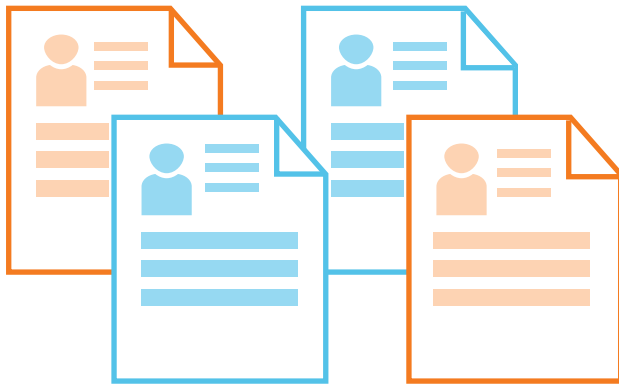
For example, a mattress retailer might build very different profiles for its customers, even though everyone is essentially buying the same thing (a mattress). The difference is that Joan, a lawyer living in an urban area who values organic and sustainably made products, may be interested in a very different selection of mattresses than Joel, a construction worker and musician who suffers from occasional back pain. The email offers each customer receives would be radically different.



Creating detailed customer profiles can also help you identify new sub-segments for existing products, or tailor existing products to meet the needs of a particular customer segment.

Lego is a great example of a retailer that creates detailed customer profiles for its various customer segments: preschoolers; 5 to 14 year olds; and adult hobbyists. Each profile describes the customer's approach to playing with Legos—whether it's to create free-form objects and shapes, pretend and role play, or create large-scale replicas of known buildings and structures.

The more specific and lifelike your customer profiles the better, although profiles shouldn't be based on an actual individual. Aside from incorporating basic demographic information, profiles should include hobbies, interests, concerns, needs, desires, and frustrations. It's also helpful to include first-person statements to reveal personality and communication clues.



### Use customer profiles to:

1. Zero in on customer needs and challenges
2. Identify new segments and sub-segments
3. Create products or product features to appeal to a new customer segment

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# Conclusions

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# Conclusions: Keeping Segmentation Fresh

You'll want to regularly review and refine your customer segments, since customer behaviors, perceptions, and demographics change over time.

Avoid forming segments based on factors that quickly change (such as technology products or clothing styles). Instead, use factors such as lifestyle values or personality traits that change less frequently. It's also a good idea to conduct periodic surveys and market research to update and expand your customer data.

## 01

**Avoid adding customers to more than one segment** at a time, so that the customer gets consistent marketing messages that lead to a positive overall experience. Bombarding customers with multiple offers aimed at overlapping customer segments can lead to dissatisfaction and disengagement.

## 02

**Make sure segments are large enough to generate** planned sales volume, and that the customers in each segment have clear and defined product preferences. Measure the success of your segmentation through A/B testing of segments against the larger customer population.

## 03

**Look for opportunities to tailor products, services,** and offers to meet the needs of specific customer segments. The more you can anticipate and identify customers' changing needs, the more likely you are to keep your customers coming back.

## Quick Guide to Segmentation Strategies

Once you've collected and analyzed your transaction data and learned all you can about your customers, you can start experimenting with different segmentation strategies. Try grouping customers according to:

- 1 **Profit potential**
  - Transaction frequency
  - Date of last purchase
  - Average order value
  - Lifetime customer value
  
- 2 **Past Purchases**
  - Product type / attributes
  - Product price
  - Payment / shipping method used
  - Product benefits sought (i.e., price, quality, prestige)
  - Product satisfaction
  
- 3 **Demographics**
  - Geographic location (city, state, country, or region)
  - Age, gender, household size, income, occupation, education, ethnicity
  - Browsing device (laptop, PC, tablet, smart phone) and type (vendor and model)
  - Traffic source (organic search, banner link, referral site)
  
- 4 **Psychographics**
  - Hobbies and interests
  - Leisure and recreational activities
  - Affiliations (religious, professional, cultural, political, institutional)
  - Personality traits (social vs. private; modern vs. traditional; spontaneous vs. cautious)
  
- 5 **Behaviors**
  - Pages viewed
  - Response to offers and promotions
  - Reward program participation
  - Channels of engagement (mobile, social, in-store, online)

## Maximize Your Segmentation Success with Magento's All-in-One eCommerce Solution

Magento can help you personalize the customer experience so you can increase customer satisfaction, order values, and overall sales. Powerful customer segmentation features let you group customers based on purchase or browsing history, items in wish lists or shopping carts, demographics, and more.

Merchants who use Magento to run their online stores gain numerous benefits:



Attract & Retain  
More Customers



Make Buying  
Easy



Grow & Scale  
with Confidence



Cultivate Brand  
Loyalty



Customize & Refine  
Your Site

## About Magento

Magento offers flexible, scalable eCommerce solutions designed to help businesses grow and succeed online. The Magento platform is trusted by more than 150,000 businesses, including some of the world's leading brands. Customers choose Magento because our cost-effective solutions enable businesses of all sizes to control and customize the look and feel, content, and functionality of their online stores.

Magento is part of eBay Inc., a global leader in commerce technology. Our relationship enables us to offer our customers, partners, and community members a wealth of experience and resources in commerce-related technologies, as well as access to world-class, branded capabilities from eBay Marketplaces, PayPal, eBay Enterprise, and others.

To learn more about how Magento Enterprise Edition is helping merchants grow their online businesses, visit:

[www.magento.com/enterprise](http://www.magento.com/enterprise)