Slice and Dice!

A view on customer segmentation in paper and packaging

By Ralf Moebus and Joachim Klein

The industry is still lacking behind in terms of customer insight and value-based customer relationship management. Segmentation is a powerful tool to differentiate customer service and improve margins.

According to Austrian - born American economist Peter Drucker (1909 - 2005), there is only one valid definition of business purpose: "to create a customer!" In order to benefit from the "created customers", companies can use a powerful method: Customer Segmentation.

From Peter Drucker's definition of the purpose of a business, he derived the following: "Find out what needs your customers want fulfilled today. Determine how well your products are meeting the needs of your customers. That is the purpose of business." This implies that, if a business finds out what their customers want, it will generate enough monetary returns in order to establish a sustainable business model.

While this in itself may not be groundbreaking news, the complexity for companies in everyday life is to deal with the multitude of different wants and needs of their customers and at the same time keep an eye on their profitability. In fact a customer may find different product attributes or services appealing but if he is not willing to pay a premium they need to be stripped in order to keep a product or service competitive.

Due to the nature of product and service evolution a producer or service provider often needs to identify opportunities to make services part of the package at competitive costs once former premium services have become standard services. In this case it may be lethal to try to charge for such services or strip a product of these characteristics if competitors offer them for free.

An approach to combine customer needs with the necessity to make money is the concept of customer segmentation which still has a high potential for the paper & packaging industry. The concept has been around for quite some time and almost has a boring and "unsexy" connotation to it, possibly because of its perceived mechanical approach. Nevertheless, if applied in a mindful way it can be very beneficial for companies and for their customers.

This article will outline some of the most vital elements that need to be considered in order to make customer segmentation a successful journey and a compelling operating model for the company that applies it. By outlining the elements, also common pitfalls are touched which have made many segmentation activities fail in the past.

Short overview of customer segmentation

Generally customer segmentation considers the fact that not all customers are equally profitable to a company and also do not require and value the same services. The definition of a segment is important to understand. A segment is a group of customers with similar (homogenous) characteristics along a list of criteria but with as little commonality as possible to the next segment (homogeneity within a segment heterogeneity between segments). The idea is that these homogenous segments can be serviced with similar service packages. Statistically the method of cluster analysis is used to identify segments.

Segmenting the customer base into groups of similar profitability and similar needs enables a company to tailor service packages to these customer clusters which are appreciated on the one hand and deserved or paid for on the other. These services can be differentiated across the customer segments and are documented on a service level matrix.

While new technologies have enabled companies especially in the FMCG industry to move towards a "segment of one" approach, targeting every single (private) consumer with a fully customized offering – the business customers usually have less diverse customer needs.

Nevertheless, even if a lot of products are commodities or are being commoditized as in many areas of paper and packaging, the concept of a differentiated customer approach still is highly valuable. In the paper and packaging landscape a multitude of different services are offered to the customer base: logistic services such as part loads, express orders or dedicated inventories or supply chain planning services (production priority or e.g. acceptance of "crash orders") or financial services such as special payment terms, financing and credit risk cover.

Sector examples:

+ *A corrugated packaging producer only considered their largest, profitable and growth customers for new board requests.*
+ *A European producer of publication paper integrated customer segmentation into their planning process in order to ensure that enough capacity is allocated to the most profitable customers in times of bottlenecks.*
+ *A paper merchant introduced premium service level customer service for top customers in order to improve customer loyalty in this segment specifically.*
+ *A paper producer linked the total customer value to the commission of their European sales agents.*
- *A fine paper company withdrew their segmentation initiative completely after failing to involve the salesforce from the beginning and subsequently achieve the necessary buy-in.*
- *Still, most of "ABC-classifications" in the paper industry are volume based only.*
- *A fiber based consumer products producer does not know the profitability of the key product segments*

The important take away is, that most of the customers will gladly accept these services, but just a fraction of them would also be willing to pay a premium – or to put it the other way around: If the customer would realize a price benefit, they would happily sacrifice unnecessary services.

"Services are necessary only if they are valued by the customer, otherwise they are a costly waste of resources"

The StepChange Margin Wheel below demonstrates where customer segmentation and service offerings are located in the logic of margin management and pricing. Before customers can be segmented, a solid view on customer profitability needs to be established.

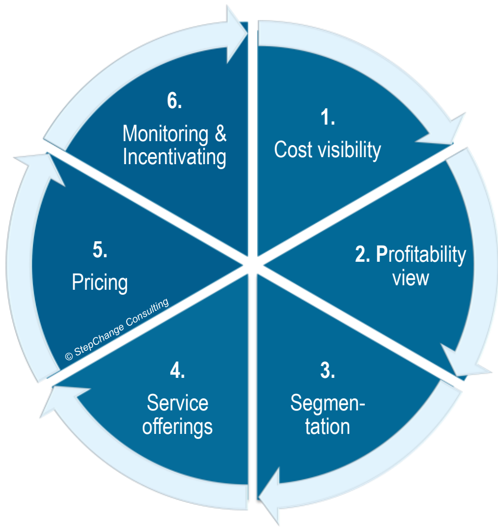


Figure 1 – StepChange Margin Wheel

If services are segmented and the value add of services has become transparent, they can also more easily be integrated into pricing decisions, avoiding margin leakages and accidental delivery of "wanted but unvalued" services.

Once a cost view and profitability calculation on customer level exists and customer needs are transparent to the company, customer segments can be defined and differentiated services can be linked to the customer clusters.

It is not about "taking something away"!

…yes it is... on occasions …but it is the wrong perspective to deliver to the sales force who has to implement the new service levels. While costly services are stripped from the offering or priced separately, the focus needs to be on raising competitiveness in order to stay in business at clients who do not value these services.

Many segmentation efforts already fail in the early stages and do not achieve buy-in from the salesforce as segmentation and service models are perceived as taking something away from the existing customer base. Instead, the message to the stakeholders needs to be: "We want to identify and provide services to customers according to the value they add to a company" – those customers that do provide lower value need to be served in a more cost efficient way while customers with a high value-add need to potentially receive a much higher service level. In essence the segmentation prioritizes and balances the service efforts based on customer value. This can easily be compared with the mileage programs of many airlines.

"The message to the stakeholders is: we are customizing our service model to the needs of our customers!"

Understand the true value of the customer base

There are many ways to segment the customer base. As stated above it is essential to identify similar clusters of customers that value the same service offerings and provide similar contribution to the business. Typically segmentation criteria consider:

- Customer needs – "What does the customer want?"
- Current customer profitability "What does the customer pay for?"
- Future customer potential/profitability - "What may the customer pay for in the future?"

In order for the sales force to be able to manage the customer segments it needs be transparent what the segmentation criteria are that determine a customer's mapping.

"The customer classification has to be transparent in order to derive the right actions for each customer"

Avoid complexity!

The biggest show stopper of an actionable and successful segmentation is complexity. While reviewing existing services, it will be found that all services currently provided can be segmented into different levels according to customer value and needs. The imperative is to focus on just a few services in the beginning for the following reasons:

- To introduce and manage a comprehensive set of service levels from the beginning will cause complexity and make it more difficult to communicate the concept and thus reduce buy-in from the organization.
- The focus on just a few relevant and easy to manage services will allow for a learning curve in administrating the segmentation. Furthermore it will allow for a transition- testing- and learning-period. Otherwise the risk of failure increases drastically.
- Transition Period: It may be essential to have a transition period especially in cases where services will be stripped down dramatically or charges will be applied.
- Drivers of success need to be isolated and it will be easier to determine the variables of success if not all variables are changed at the same time.

"Start with just a few but relevant services - focus on completeness later"

While the organization learns to work with the new service model, new services can be introduced over time and transitory services can be excluded from the service level matrix.

Name the segments

Most of the existing segmentations in the industry are using segment descriptions "A, B, C" or more creatively "Green, Amber, Red". The trouble is that these descriptions already carry implicit meanings with them. In the mind of most sales people "red" customers will be interpreted as negative. "C" clients can be associated with small and negligible. It can also be harmful for the customer relationship if a customer finds out, that they are considered "red" or "C" customers. In B2C often less technical terms are used such as "Platinum, Gold, and Silver".

An option for paper and packaging is to name the segments according to what they are, e.g. A="full service", B="selective service", C="paid service".

Think about what the customer wants and values=pays!

The company needs to identify the "sweet spot" of every customer segment. Everything which is not considered "sweet" needs to undergo a thorough revision whether it should still be part of the offering. Models like the "Kano-Model" offer suitable frameworks to support decision making and qualification of customer preferences.

A customer who does not value short lead times will happily sacrifice safety stocks in order to realize a price advantage or avoid a price increase. As stated above – the perspective is, not to take service away from the customer, but to ensure that they will have a competitive offering.

The approach of testing potential services for their value add to the different segments will ensure that customers won't be over-served while the company is being underpaid.

Introduce only what you intend to enforce

As a general rule, services should not prematurely be introduced to the service level matrix just in order to test their acceptance by the sales force or the customer. If too many services fail or are corrupted by too many exceptions, the organization will lose confidence in the concept which will ultimately put it at risk.

If testing is necessary, management needs to think about a more isolated and secure approach of testing it and equally needs to be firm and determined to keep the service on the service level matrix against initial resistances.

"Qualifying a service for the service level matrix needs to be done prior to introducing it"

Testing of service levels needs to be completed prior to introducing the service on the service level matrix. Developing new service levels together with the sales force ensures early buy-in. Testing customer behavior can be done via customer interviews, panels or surveys or in an isolated setting selectively via new customers.

Measure the success

As for any change initiative, progress and success need to be measured in order to find out, if (1) the program is progressing as planned, (2) targeted benefits materialize or (3) any unwanted effects occur.

For the first element, it makes sense to measure the "service level adherence rate" of orders, for example: How many orders are not in accordance to the service levels defined for each segment. This KPI will provide insight into the degree of implementation of the concept.

Benefits achieved will be measured based on the targets defined for each segment and may include surcharge elements of services that can be measured easily. Also growth and profitability achievements can be measured against the targets defined.

To identify undesired effects, it is necessary to consider negative impacts a new service could potentially have on the customer base and to ensure that potential results are measured. (e.g. customer losses in a specific cluster). Maintaining an even closer communication link with the sales force during the time of transition is essential to identify other potential negative impacts early on – e.g. through task force telephone conferences and status updates. Controlling the efforts through an overall project management is advisable.

"Measuring provides security, acting on measurement provides success"

Having the right metrics in place does not prevent organizations from delivering bad results. Equally important to measure the right things is to take action on negative trends if they pass certain thresholds. For example – if the adherence rate of new orders shows that the level of service level compliance is too low, actions need to be taken: After understanding the root cause of the trend, the countermeasures can be defined which may result in fine-tuning of the service level, further training of the internal sales force, or even a change in the system logic of the ERP system. As you only get what you measure (and incentivize) it is important to provide not only incentives to the customers with the new service levels but also to ensure that the sales organization is incentivized according to the targets of the customer segments.

Conclusion

Segmenting the customer base and offering valued services to the customer segments ultimately will inherently improve margins. Segmentation based service models also support the consistency of service delivery across complex sales organizations. Major elements to consider when implementing customer segmentation models are:

- Understand the value of the customer base ("What's in it for us?")
- Review customer services on their value proposition to the customers and customer clusters ("What's in it for the customer?")
- Involve organization and communicate early and proactively to the sales force about the intention of the initiative: It is not about taking something away, it is about delivering the right service to each segment and making all customers profitable
- Use meaningful names for the segments in order to avoid pre-set associations
- Avoid complexity – segmentation initiatives fail if they are too complex, especially in the beginning. Rather start small and with service offerings that have been tested before implementation.
- Introduce only what will be enforced – reversing too many services after roll-out will undermine confidence in the concept, buy-in and ultimately will put the whole initiative at risk

- Measure the implementation progress and success of the service model to be able to judge on the effectiveness and potentially define improvement actions
- Act on the measurements
- Align (sales) incentives to profit targets of customer segments

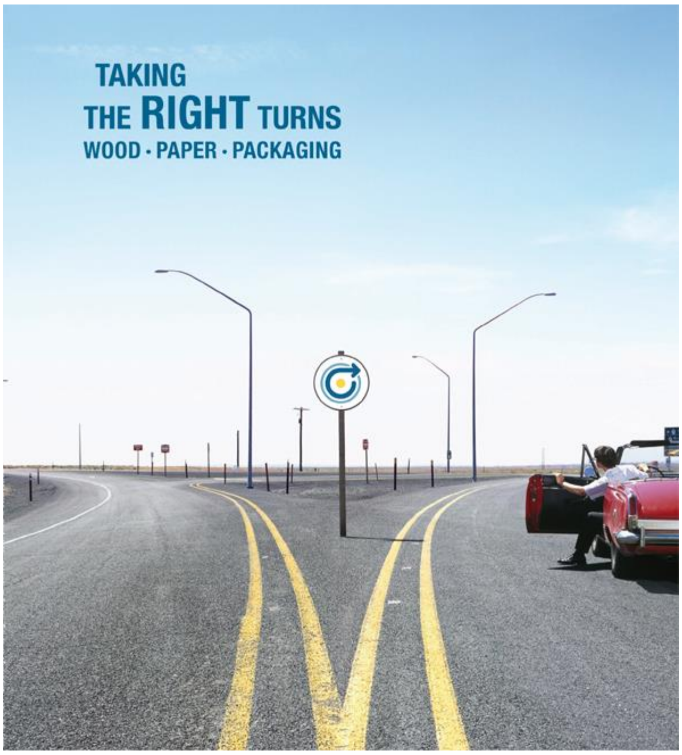
Both the segmentation concept and its implementation require a coordinated approach. Significant conceptual work is required to identify the right customer segments and to build the service level matrix. The implementation needs to be robust and rigid and yet done with care. Significant pitfalls of failure exists.

It is recommended to conduct such efforts through projects as it typically requires an outside view to identify improvement opportunities.

Done right the segmentation model lays the foundation to improving top-line profitability and creating a happy and satisfied customer base.

Ralf Möbus (ralf.moebus@stepchange.com) is Principal at StepChange Consulting and specializes on performance improvement with focus on sales & margin management and supply chain transformation.

Joachim Klein (joachim.klein@stepchange.com) is founder and Managing Director of StepChange Consulting advising global companies in the paper value chain in strategy development, M&A, and overall profit and performance improvement.



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