GENERAL STRATEGY

SEGMENT AND RULE!

Segmentation is an important device for understanding your industry and choosing the best business strategy within it. **Jo Whitehead** gives a step-by-step guide to how it works.

The ability to know which business you are in today and to define the opportunities for the business you want to be in tomorrow, is a fundamental skill for any strategist. This skill more commonly goes under the strategist's buzzword, 'segmentation' – the art of defining what rules different parts of the industry are playing by, the boundaries of those different games and where the trend is heading.

Consider the example of the insurance industry. In the 1980s, general insurance companies thought they were in the underwriting business – effectively, pricing insurance policies. They organised into divisions such as property and car insurance. These business units were often headed by former underwriters. Policies were often sold to the mass market via brokers. Then came the insight that the business could be thought of not as a set of products but a set of channels. Policies could be sold through a range of types of insurance broker (large companies, independent financial advisors) or through a direct sales force. The value of this view of the business was that it revealed that some agents were profitable, others highly loss-making, and that direct selling could be even more profitable. A new view of the business emerged, one emphasising skills in managing and developing channels to market.

Direct Line was one of the first to have this insight, and turned the industry on its head by redefining it as selling directly to the mass market from a centralised telephone service (actually, the idea originated in the US). This development of the idea of insurance as a 'channels' business allowed Direct Line to grow from nothing to being one of the major players in the market place – cutting out the middle man and eventually selling a range of financial products to its customers.

More recently, companies like Sheila's Wheels and Saga have redefined the industry again as selling to particular niches – women and older people respectively. Finally, the industry has turned full circle and the development of internet sites such as gocompare.com is re-establishing the business definition of general insurers as underwriting and pricing policies – sold through others' internet sites.

Changes in how industries are defined

This is not an isolated example. Most industries go through such changes in how they are defined. The definition of the business in which an automotive company operates has evolved from 'low cost production' (Henry Ford) to 'managing brands' (GM) to 'lean manufacturing' (Toyota) and 'engine manufacturing' (Honda) to 'global platforms' (Volkswagen). Where next? Try 'electronics systems' (Continental), 'low cost production' (Tata) or 'luxury goods' (Mercedes).

Each definition of the business and its boundaries defines a new set of skills required. It's the organisations that spot these changes in business definition that have a head start and can emerge as winners. But despite its fundamentality to strategy-making, segmentation can be difficult and many organisations get it wrong (see Box 1 below, 'How VW took a wrong turn on segmentation').

How best to segment a business

Intuitively, segmentation is quite an obvious idea. But coming up with an innovative and insightful segmentation is a complex art. So how can you maximise your chances of getting it right? As Figure 1 (following page) suggests, it involves an iterative process.

Step one: Brainstorm alternative ways to segment.

There are normally three ways to segment an industry:
• market/customer;
• product/service; and
• value chain.

These can be summed up in the more memorable phrase: 'Who? What? How?'

A useful first step when segmenting is to brainstorm alternative ways to segment on these dimensions. Taking the example of the insurance industry again, this would work as follows.

Market/customer

Market segmentations can be in terms of geography (eg England, UK, Europe), customer type (eg age or income), channel (eg agents vs direct sales) or

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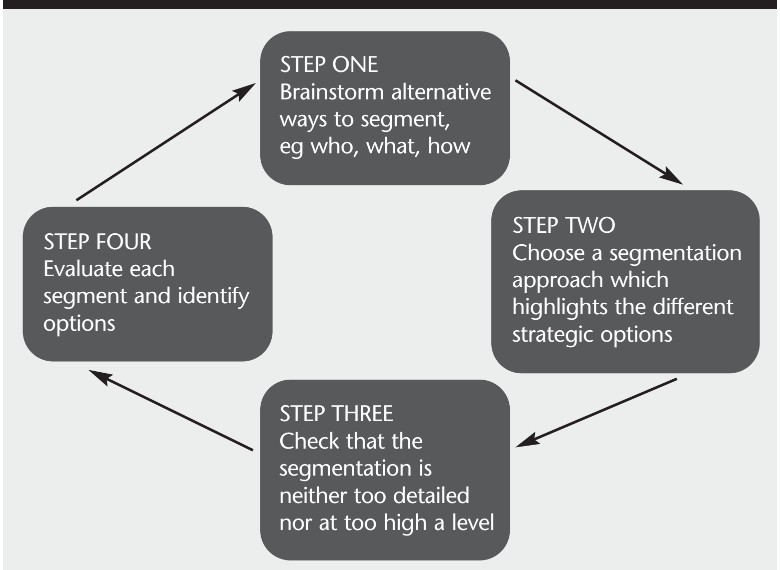
Box 1 HOW VW TOOK A WRONG TURN ON SEGMENTATION

Volkswagen was the undisputed early leader in the Chinese auto market: in the mid 1990s it had a 50% market share. Its management segmented the market according to products – designing their strategy around choices about which type of vehicles to sell. But this segmentation failed to take account of the major changes in the market during the late 1990s. Early on its main customers were state-owned enterprises, who could be marketed to the contacts held by Volkswagen's joint venture partner, Shanghai Automobile Industry Corporation. However, as China's economy burgeoned, retail customers became a more important part of the market. Accessing these customers required a completely different marketing approach and sales and service network. Segmenting the market by product rather than customer, Volkswagen missed this change, allowing its rivals to build stronger positions.

‘Despite its fundamentality to strategy-making, segmentation can be difficult and many organisations get it wrong’

Figure 1 CHOOSING A SEGMENTATION APPROACH



customer needs (eg range of insurance required or importance attached to customer service).

Alternative market segmentations can be derived from changing the level at which the segmentation is made. For example, ‘direct’ versus ‘via agents’ might be a high level way to segment the business – one that is appropriate for discussing major strategy alternatives. To develop a more detailed strategy it would be worth segmenting more finely – for example, by type of agent, or by region.

Product/service

Product segmentations can also be done in various ways. This could be by type of insurance but also by the number of risks covered. As with customer needs, the segmentation could be kept at this level for a strategic debate about the overall strategy but broken down into a finer level of detail – for example a more detailed segmentation of different car insurance products, such as ‘third party only’ versus ‘fully comprehensive’.

Value chain

While customer and product segmentation are the most common bases for segmentation, sometimes it is appropriate to segment in terms of the business model used: for example what parts of the industry value chain to compete in – including underwriting, reinsurance, marketing, sales, claims management and customer service.

So, segmenting on these three dimensions can lead to any number of potential segmentations. It certainly highlights the choices that can be made about where to compete – but there may be thousands of options! The next step is to pick the most useful strategy for segmentation.

Step two: Pick a useful segmentation

The choice of segmentation should support the strategic decision to be made. (If there is no decision, then there is no strategy required!) Strategic decisions seek to position organisations in attractive parts of the market where they can best compete – therefore a segmentation should be chosen which allows you to identify those parts of the industry which are most attractive due to a combination of:

1. high growth rate – all else being equal, you want to choose parts of the market that have high growth rates. Your segmentation should separate out parts of the market undergoing particularly high or low growth;
2. high inherent profitability – your segmentation needs to highlight parts of the market where profits are high for most competitors;
3. potential for winning – you want to segment the market in a way that highlights where you have competitive advantage and are likely to be successful; and
4. sufficient size – ideally, these attractive segments will also be large.

The segmentation also needs to be at a level appropriate to the choice that you are making. For example, assume that you are the head of a UK based insurance business and need to make decisions about your overall UK strategy over the next three to seven years. This involves high-level choices about which customers, products, channels and parts of the value chain to focus on. Therefore you need a high-level segmentation that highlights differences in size, growth, inherent profitability and what it takes to win, for example:

- customer segments – choices about which demographic groups to focus on and which channels will make significant differences in size, growth, profitability and what it takes to win;
- product segments – different types of general insurance but also related financial products eg loans, life insurance also differ on these factors; and
- value chain segments – underwriting, sales and marketing and claims management all have different profitability levels and criteria for what it takes to win.

Suppose the outcome of this UK strategy process is a decision to focus on selling household and car insurance to middle income families, focusing on

'Segmentation is often done iteratively, with a mix of intuition and analysis, trial and error'

underwriting and advertising the brand and selling through other intermediary channels. Your segmentation has enabled you to make this high level choice, but you now need to create a more detailed strategy to roll out this overall UK strategy.

Now that the range of options is narrower and more detailed (for example, which types of household policy do you want to sell?), you will need to come up with a more detailed segmentation to help you make more detailed choices. So, for example, you might segment customers between those living in different regions of the UK, income level, or on the basis of the types of car they drive.

The point is that the level and nature of the segmentation needs to be adjusted to support the decisions you are making. You need a high level segmentation for a high level strategy and a more detailed segmentation for a more detailed roll-out strategy.

Step three: Check your segmentation

If you feel unsure or lack experience in segmentation, check to ensure that the segments that you have created are neither too detailed nor at too high a level. The questions shown in Figure 2 (right), 'Segmentation check', can help you assess the degree of difference between two segments. This will give you a general sense of whether to treat them as one segment, or split them into two.

If the segments you have created do not differ significantly on these dimensions, you might consider consolidating them in order to simplify your strategy. For example, you could start by segmenting England by region but then decide that this need only be done in terms of 'North' versus 'South' – because differences within these regions are not significant enough to warrant a more detailed analysis.

Step four: Evaluate each segment and identify options

Once you have segmented the market you can do your strategic analysis of each segment. This involves the traditional strategic analysis of evaluating the external environment, your competitive position and the options available. In the process of doing so you may well come up with new ways to segment the business – or decide that your segmentation can be somehow simplified.

In seeking to understand the particular needs of middle income families you may decide to segment them in some new way. For example, you may find that families who have not switched energy supplier are also more loyal to their insurance provider and decide that you should focus on such customers – perhaps using some joint marketing with energy companies.

Figure 2 SEGMENTATION CHECK

Do the segments:

1. have very different growth rates?
2. vary significantly in the average profitability of all competitors?
3. have major differences in industry structure? For example:
   - Are customers different in the two segments?
   - Do they have very different purchasing criteria – eg, are customers in one segment more focused on price while others are more focused on brand or product design?
   - Are the suppliers different in the two segments?
   - Are there different potential substitutes for the products in each segment? and
4. have different 'ways to win' or sources of competitive advantage? For example:
   - Do they have different competitors?
   - Is your market share or that of competitors in each segment very different?
   - Are the assets and capabilities required to compete in each setgment very different?
   - Are the cost structures in the two segments different?
   - Are there significant barriers preventing a competitor in one segment entering the other?
   - Is your profitability and market share very variable across the two segments?

Note: there is a catch 22 situation involved in coming up with an insightful segmentation. You need to segment the market before you can truly understand its growth rate, inherent profitability and the way to win – but you must first understand what drives attractiveness and what it takes to win before you can come up with a sensible segmentation. For this reason, segmentation is often done iteratively, with a mix of intuition and analysis, trial and error. It is one of the hardest topics to learn and requires plenty of practice.

Conclusion

By following the four box process suggested above you are more likely to come up with a robust and insightful segmentation. Although there will always be an art to segmentation – and strategy in general – it is also a skill that can be learnt and improved upon, with reflection, and practice.