

MODERN DISTRIBUTION MANAGEMENT

The Newsletter for the
Wholesale Distribution Channel

How To Segment Customers

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Think of your customer list as an investment portfolio

In building a successful customer-focused distribution business, it's critical to focus on customers with the greatest profit potential. Dividing your customer base into groups or segments is the fastest way to identify them. What is a customer segment? How many segments should you have? How is customer profitability information used to create and use segments? This article is an excerpt from the new book, More to the Bottom Line: Customer Profitability Analysis Tools for Distributors. Go to [NAW Publications](#) for more information and to order.

How many segments should you have?

The right number of customer segments depends in part on the size, but mostly on the complexity, of your business. A meaningful segment is a group of customers that meets three criteria: They are identifiable by common characteristics, they are profitable and they are growing. How much time do you need to spend studying a segment that is too small to bother with, isn't profitable or is deteriorating?

For the sake of simplicity and to maintain focus, it makes sense to keep the number of segments as small as possible. Customer segmentation for wholesaler-distributors presents a multitude of opportunities to analyze customers and to enhance profitability. For example, segmentation can identify ways to better deploy sales representatives.

A foodservice disposables distributor divided its healthcare customers into two groups — hospitals and nursing homes. The buying habits and needs of the rapidly consolidating hospital segment had become highly predictable. Hospitals had moved toward group purchasing, awarding exclusive long-term contracts to prime vendors based on pricing and brand preferences. The hospitals needed service-oriented sales reps equipped with a deep understanding of both products and the unique needs of acute care. Nursing homes tended to choose suppliers based on relationships.

The two segments appeared on the surface to be one segment (healthcare). However, the disposables distributor found that two different types of salespeople could serve the two segments better and more profitably than one salesforce serving all healthcare accounts.

Customer segmentation for distribution customers can help to identify and understand the common threads of customer profitability. Consider Exhibit 1, an example of customer segmentation for a janitorial supplies distribution company.

Segmentation example: Janitorial supplies distributor

	Price sensitivity	Need for attention	Brand loyalty	Extra services
Technicians/ Hands-on	Medium	High	High	High
Buddies/ Loyal	Low	High	High	Medium
Oldtimers/ Convenience	Fairly Low	Medium	Medium	Medium
New wave/ Spreadsheet jockeys	High	Low	Low	Low

Source: Evergreen Consulting, LLC

The janitorial supplies customer groups least sensitive to price were those loyal to the distributor and its sales staff as well as to some of the distributor's preferred product lines and "old-timers" who were most interested in convenience and personal attention. The technically oriented customers were knowledgeable about product details, brand loyal and not too price sensitive, but demanding of time for demonstrations and training programs. The most price-oriented customers were those who were new to the business and had relatively little interest in product differentiation. Their primary interest was in saving money.

What does customer profitability have to do with segmentation?

The ideal jumping-off point for customer segmentation is the customer profitability ranking report. The preliminary step is to identify a list of profitable, growing customers.

Next, identify customers having identifiable, common characteristics. The characteristics might be industry type, frequency of purchase, product assortment purchased, method of order entry, delivery method, loyalty or any other possible clue as to why each customer is profitable and growing. By using trial-and-error to test different possibilities, you can construct customer profitability ranking reports that reveal reliable indicators of potential profitability. For example, an industrial parts distributor analyzed its most profitable accounts using the customer profitability ranking reports for each location.

A distributor of power transmission components tested such customer characteristics as industry type, geographic location and frequency of purchase and product mix. Trial rankings of customer profitability showed that product mix and purchase frequency were stronger indicators of profitability than industry type. Customers who were methodical and organized in their replenishment practices placed larger, more profitable orders. Gross profit per order was the primary indicator of more profitable orders, but the root cause for larger orders was how the customers purchased, not their industry or what they bought.

An especially juicy customer segment, one composed of profitable and growing accounts with common characteristics, took this distributor by surprise.

Redistribution customers, who purchased for resale rather than for their own consumption, had customarily been given second-class status based on their lower gross profit percentages. But the distributor discovered that its redistribution customers were a fast-growing and profitable segment that deserved special attention from management. Common characteristics included large orders, low service requirements, prompt payment and purchase of high-turnover stock merchandise. In addition, redistribution customers used sophisticated inventory management and order entry tools, which

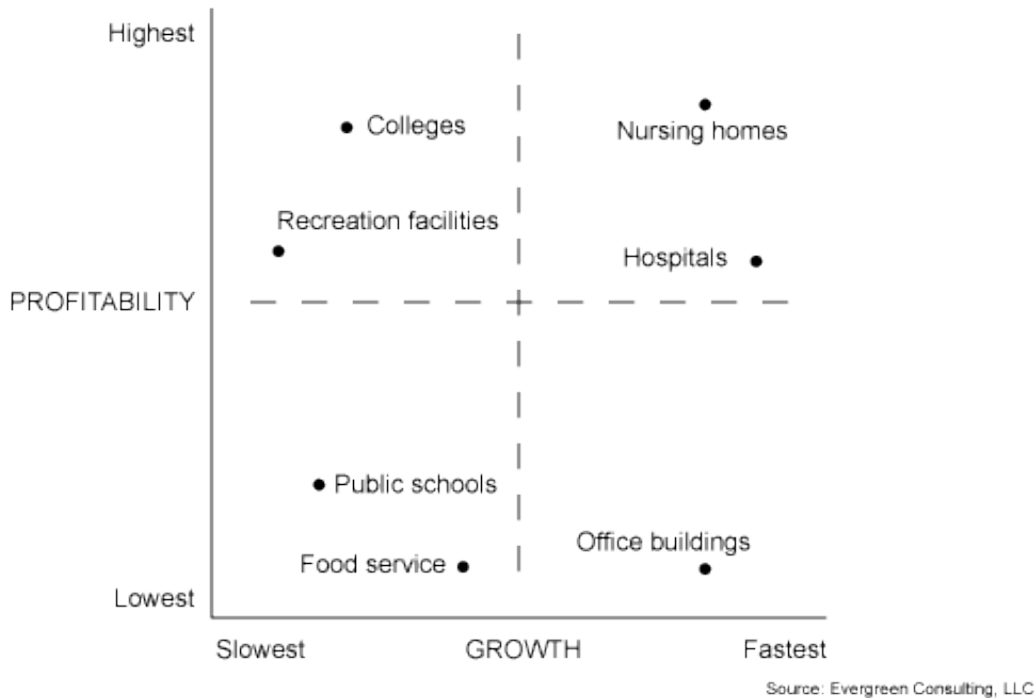
generated relatively few small fill-in orders and low order-entry costs.

Customer segmentation & distributor strategy

Customers within a given industry type often have identifiable, common characteristics. For many distributors, segmenting by industry type—and identifying the most profitable, fastest-growing industry types—is the key to segmentation.

The janitorial supplies distributor divided its customer list up by industry type and ranked them on profitability and sales growth. Exhibit 2 is a graph of the industry types showing the profit/growth quadrants.

Profit/growth segmentation for a sanitary supplies distributor



The sanitary supplies distributor found that the choicest segments—those in the northeast quadrant—were nursing homes, hospitals, colleges and recreational facilities. One of the largest segments, office buildings, was growing but was not profitable. Two other large segments, public schools and foodservice, were neither growing nor profitable. The best strategic move was to deploy sales effort and program development toward the choice segments and away from the sluggish ones.

How managing a customer portfolio is like running an investment portfolio

Operating a distribution business is similar in some important ways to managing an investment portfolio. Like your counterparts in the financial world, you are responsible for making large investments in other companies. Portfolio managers invest in securities of other companies with the expectation of making a profit. Distribution managers such as yourself invest their people's time and money in relationships with other companies, with the expectation of making a profit.

Think about your balance sheet. The two largest assets, accounts receivable and inventory, are tied to specific accounts directly (receivables) or indirectly (inventory). These two assets, related closely to customers, compose up to 80% of total assets for most distributors. Acquisition-minded distributors carry their investment in goodwill as a significant intangible asset, also related indirectly to specific customers.

Business development costs, such as finding and cultivating prospects, although written off as a current period operating expense, represent a significant annual investment of time and money.

The disciplines followed by successful investment portfolio managers apply to the duties of managing a portfolio of distributor customers. The overriding need for making portfolio decisions is information about current—and expected future—profitability resulting from the investment in each customer. Wholesale distribution managers have to work harder than

mutual fund managers to obtain customer-specific profit-and-loss information, but they need the facts to make effective decisions.

The performance of investment portfolio managers is evaluated against peer groups and industry benchmarks. The same degree of accountability can be applied to distribution management by measuring customer profitability, segmenting customers and comparing results against goals, prior performance and industry benchmarks.

The bottom line

Dividing your customer list into segments and identifying the most profitable, fastest-growing customer groups provides clear direction as to where you must invest. Customer profitability data also points out those customers who must be protected at all costs and those who need remedial work in order to justify your continued investment in them. Finally, customer profitability information helps shape business policies to point your company toward increased profits.

Key points:

- By segmenting groups of customers with identifiable, common characteristics, wholesaler-distributors can look for the customer behaviors that determine profitability.
- Distributors can identify the select group of profitable and fast-growing customer segments that are the most attractive investment opportunities.
- Customer profitability is a key factor in customer segmentation, as opposed to simply dividing customers into groups based on industry type.
- A critical strategic decision is which customer segments to focus on, both in selling efforts and in development of value propositions.

Many of the disciplines used by investment portfolio managers are applicable to the decisions distribution managers make when managing and investing in their portfolio of customers.

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