A Conceptual Model to Stratify Customers to Improve Customer Profitability : Diamond Model

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Abstract

Every company tries to know who the best and idealistic customers are and how to identify them by use of the special methods. To solve this problem the diamond model of customer stratification, which is the conceptual model, is introduced in this research. We modified the customer stratification model developed by Narayanan *et al.* (2007). By use of this model we can find out the most profitable customers and then we can plan to improve the profitability of the rest customer groups.

Key Words: Customer Stratification, Customer Profitability, Diamond Model

1. Introduction

One of the key questions senior management always asks is "How do we identify the customer and market segments for the best customer-focused outcomes?" According to the criteria for performance excellence of Baldrige National Quality Program, we can find the appropriate answer to this question in the customer and market focus criteria (Category 3) and customer-focused outcomes (Category 7) (4). Classification of customers into groups based on profitability is the next step to answer this question. In this paper the diamond model to stratify the customers is introduced. It is a heuristic approach to stratify the customers.

This paper is organized as follows. Section 2 describes the customer stratification model. In section 3, the benefits of customer stratification are explained. In section 4 provides the strategic use of customer stratification model.

2. Performing Customer Stratification

2.1 A Brief Note on Customer Stratification

Not all customers are worth equally having. To make a customer be worthwhile, he (she or

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it) must generate profit for the company (7).

Campbell and Cunningham (1983) categorize customers into groups: yesterday's customers, today's regular customers, today's special customers, and tomorrow's customers (2). They base this classification on multiple criteria including sales volume, age of relationship and profitability. The researches at Texas A&M University extended the idea of stratification to customers. It is well known that profits from customers follow Pareto principle-about 20% of a company's customers account for about 80% of its profits (3). It is commonly believed that 20 percent or less of the causes (the vital few) result in 80 percent or more of the effect. This is known as the Pareto principle.

Customer segmentation approaches are widely used in revenue management models in airlines, hotels and retail chains (1). Best Buy, one of the leading electronic retailer in USA, began identifying high spenders in its stores as "angels"-based on its sales records. Best Buy further classified the angels as Barrys (high income men), Jills (suburban moms) and Buzzes (people interested in latest gadgets) based on demographic and buying patterns. This classification helped Best Buy to customize its local stores and train its sales force to assist the right customers. Best Buy also identified unprofitable customers and formulated strategies to avoid them (5). We can also find out many examples in Korean banking, telecommunication, and retail industries.

Narayanan *et al.* (2007) stratify customers into different groups such as core, opportunistic, marginal, and service-drain. To identify these customer groups, they propose a 4-dimensional classification based on sales volume, gross margin, cost to serve and loyalty (6).

Table 1. A brief note on customer stratification

Research	Customer Groups	Classification Criteria
Campbell and Cunningham (1983)	yesterday's customers, today's regular customers, today's special customers, and tomorrow's customers	sales volume, age of relationship and profitability
McWilliams (2004)	angels-Barrys, Jills, and Buzzes	demographic and buying patterns
Narayanan *et al.* (2007)	core customers, opportunistic customers, marginal customers, and service-drain customers	sales volume, gross margin, cost to serve and loyalty

In the customer stratification model by Narayanan *et al.* (2007) there are 4 customer groups and 4 classification criteria as follows.

2.2 Diamond Model

It is time for a new approach to be introduced for segmentation. Segmenting customer base is more effective than segmenting the market for most organizations. But which seg-

Table 2. Customer stratification model by Narayanan *et al.* (2007)

Customer Groups	Contents	Classification Criteria			
		sales volume	gross margin	cost to serve	loyalty
core customers	profitable customers who transact in high volume on a regular basis	High	High	Low	High
opportunistic customers	profitable customers who buy infrequently	Low	High	Low	Low
service-drain customers	high volume customers who consistently require higher levels of service while demanding low prices	High	Low	High	High
marginal customers	buy infrequently in low sales volumes and require either low prices or high service levels	Low	Low	High	Low

Note: measure of each dimension: High-Low

Source: Abstracted from Narayanan *et al.* (2007).

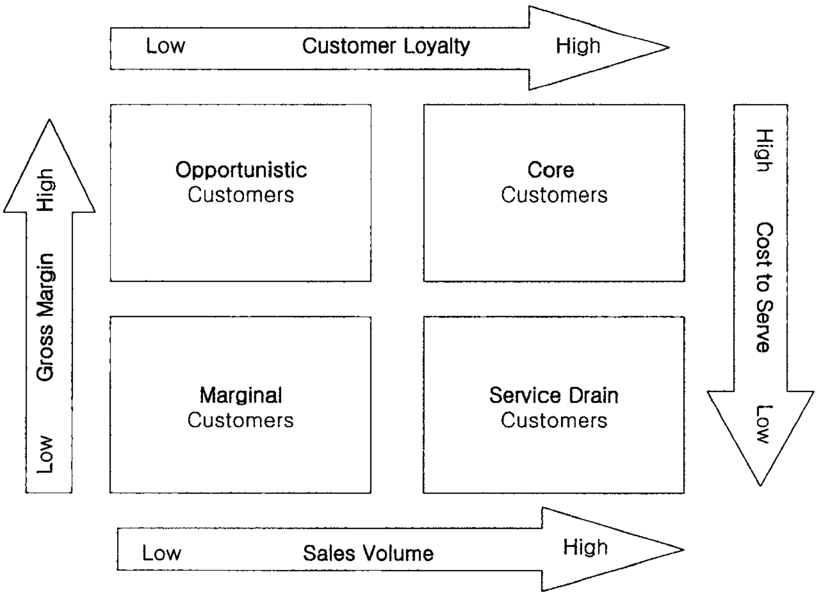


Figure 1. Customer stratification model by Narayanan *et al.* (2007)

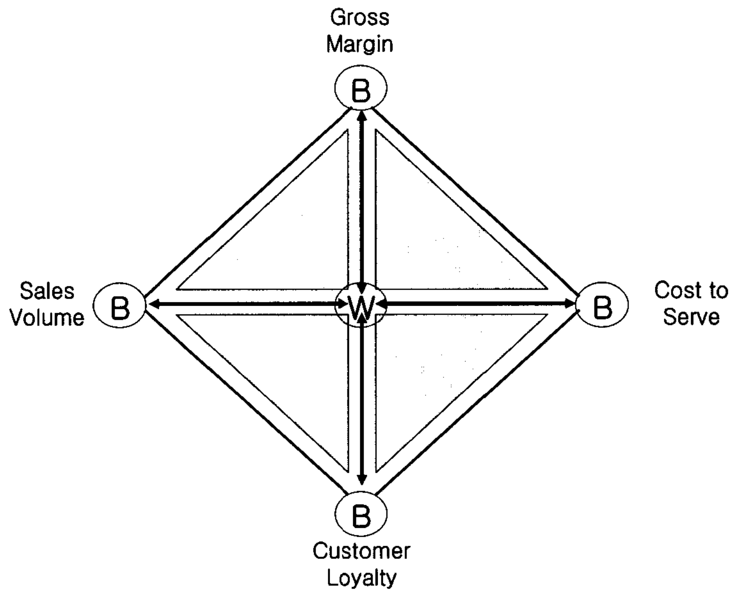
ment is more profitable? The profit comes from greater focus on the right customer relationships to retain. While the introduction of new analytical techniques and technology is useful to identify the right customers, in this research the simple but meaningful customer stratification model is newly introduced.

Table 3. Customer stratification diamond model

Customer Groups		Classification Criteria			
		sales volume	**gross margin**	**cost to serve**	**loyalty**
Old	core customers	Best	Best	Best	Best
	opportunistic customers	Worst	Best	Best	Worst
	service-drain customers	Best	Worst	Worst	Best
	marginal customers	Worst	Worst	Worst	Worst
New	financial-oriented	Best	Best	Worst	Worst
	mass-spot	Best	Worst	Best	Worst
	relation-oriented	Worst	Worst	Best	Best
	niche-long-term	Worst	Best	Worst	Best

Note: measure of each dimension: Best-Worst

The previous researches on customer stratification has focused on single dimensional analysis, but Narayanan *et al.* (2007) and this research introduce the 4 dimension model. In this research customer classification dimensions are similar to those in Narayanan *et al.* (2007), but this research contribution lies in the stratification model which is named the diamond model. There are 8 customer groups including the existing 4 groups (core, opportunistic, service-drain, and marginal customers) and the new 4 groups (financial-oriented, relation-oriented, mass-spot, and niche-long-term customers).



Note: measure of each dimension: B(best) – W(worst)

Figure 2. Customer stratification diamond model framework

In this model, there is only one perfect diamond which is core customer. The other customer groups are 4 triangles (service-drain, opportunistic, financial-oriented, relation-oriented), one horizon (mass-spot), on vertical (niche-long-term) and one point (marginal). Every customer groups except perfect diamond tries to be the perfect diamond. That is the solution to each group.

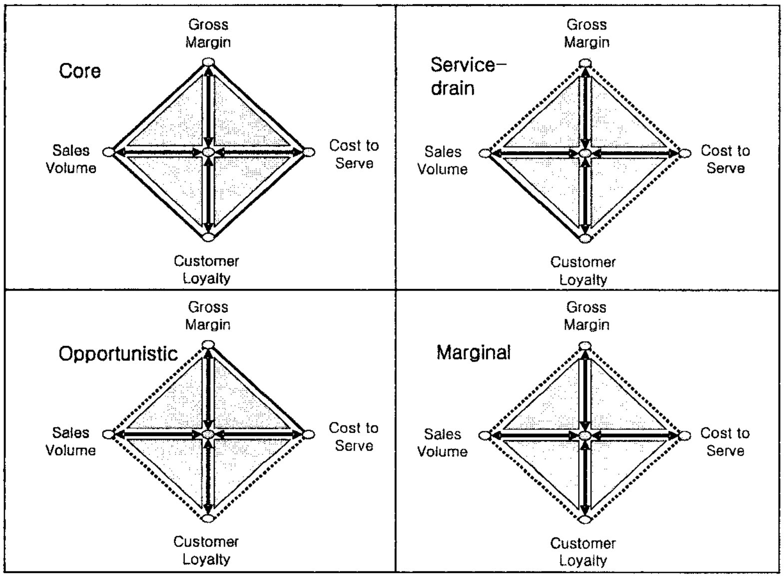


Figure 3. Customer stratification diamond model for old groups

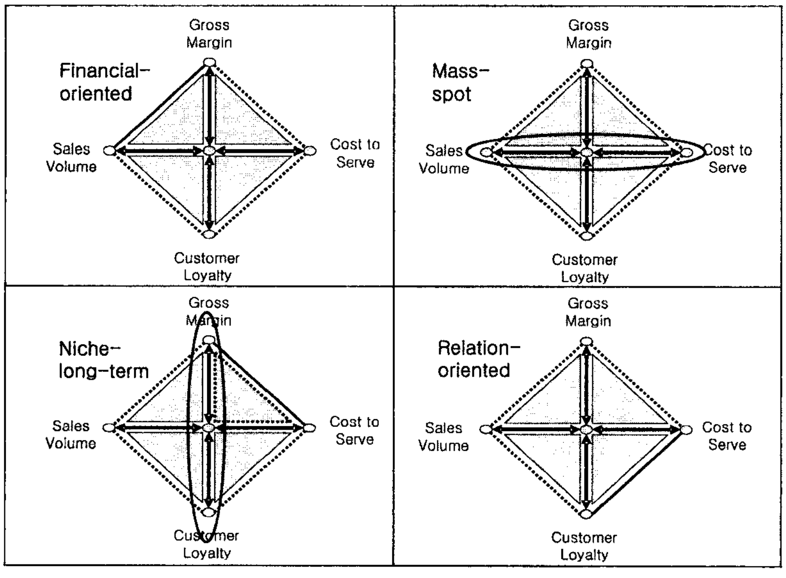


Figure 4. Customer stratification diamond model for new groups

3. Benefits of Customer Stratification

If we can know the customer profile, exactly the profitability of each customer group, we can properly respond the customer requirements. Different customers require different service levels. If we can, we would be the best performer in the market. By use of this model, we can plan to establish the customer strategy to satisfy each customer group.

To improve the company's performance its resources such as sales force and promotion budget can be re-allocated based on customer stratification. If it determine the performance goal, then it's all resources are allocated by the strategic decision.

4. Strategy to Improve Customer Profitability

4.1 Strategy for each group

The customer stratification provides a strategic insight for future business planning as well as distinguishes the right and wrong customers. Table 4 shows how to suggest the strategy for each customer group by use of diamond model. The main strategy is how to find and connect the missing links among 4 dimensions.

Table 4. Strategy for customer groups to be a diamond

Customer Groups		Strategy (example)
Old	core customers	to sustain current position (already diamond)
	opportunistic customers	to increase sales volume by more sales forces
	service-drain customers	to increase gross margin by increasing prices
	marginal customers	to eliminate these long-tail low-volume customers
New	financial-oriented	to increase the customer loyalty by relationship management
	mass-spot	to decrease cost to serve by suggesting more favorable transaction conditions
	relation-oriented	to introduce more valuable product
	niche-long-term	to suggest the volume discount

4.2 Conclusion and Future Research

Diamond model provides the strategic implications for each customer groups to improve the company's overall performance, especially for unprofitable service-drain, marginal, mass-spot, and relation-oriented customers.

Another contribution of this research is to introduce the easy approach to identify customer groups by simple 4 dimensions. According to the company's situation the dimensions can be changed.

To apply this model, the specific data need to be defined and collected. For example, cost to serve is the cost of each transaction beyond the cost of goods sold, that is service calls, special delivery requirements, method of payment, etc. The other challenge is how to determine the customer types. Even though Narayanan *et al.* (2007) suggest the ranking criteria and combination approach, the more systematic approach is needed. In the future research the new approach will be applied to identify the customer groups.

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