

Ensuring Segmentation Has Bottom-Line Impact

Practice #3

Customer Segmentation Rules of Engagement



- **Company Profiled:** Air Products and Chemicals
- **2003 Revenue:** \$6.3 billion
- **2003 Employees:** 18,500

Situation

Air Products' Chemicals business finds that the large majority of its operating income is derived from less than 10% of customers, yet, due to an outdated segmentation model, its resources are focused disproportionately on low-return, low-margin customers that account for little, or in some cases negative, cash flow for the firm.

Action

As a critical work process tool in its strategy development and execution process, Air Products segments its customers using a granular scorecard it co-developed with its customers to rigorously assess the potential and strategic fit of each customer opportunity. Upon completing the segmentation process for more than 3,000 customers within the Chemicals business and identifying three distinct customer segments, the firm deploys explicit rules of engagement to guide interactions with each segment. The rules cover a wide range of activities, with the goal being not only to increase margin in each segment but ultimately to make all customers profitable.

Result

By reallocating resources around the most profitable customers while reducing cost-to-serve for the rest of the customer base, Air Products' Chemicals division triples overall business profits in only two years. Overhead costs were reduced by 3% and margins increased by more than 20% in all three segments. Additionally, the process uncovers segment-specific product opportunities and has led to the launch of several products that quickly became the most profitable in the Air Product portfolio.

Customer Profitability

Using the Pareto Principle (the 80/20 rule), Air Products' Chemicals division works backward from operating income to determine what percentage of its contribution margin, revenue, and overall customer-base are responsible for 80% of operating income. Rather than finding the traditional ratio of 20% of its customers driving 80% of its income, Air Products discovers that only 8% are responsible for 80% of operating income, with 73% of customers contributing nothing to operating income at all. Furthermore, 23% of customers have a cash negative impact on the business.

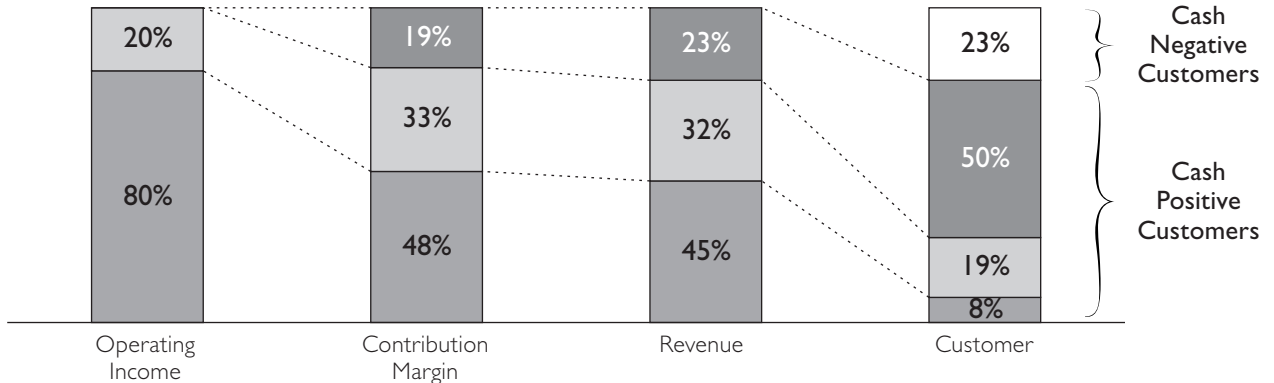
An Inefficient Allocation

Learning that so few customers are contributing to the majority of operating income, Air Products reviews its customer investments to understand why such investments are not consistently translating into profits. The initial analysis of its customer investments identifies a clear disconnect between the most valuable customers and Air Products' customer-level resource allocation, as the most profitable customers are in many cases receiving less attention and internal resources than the cash negative customers.

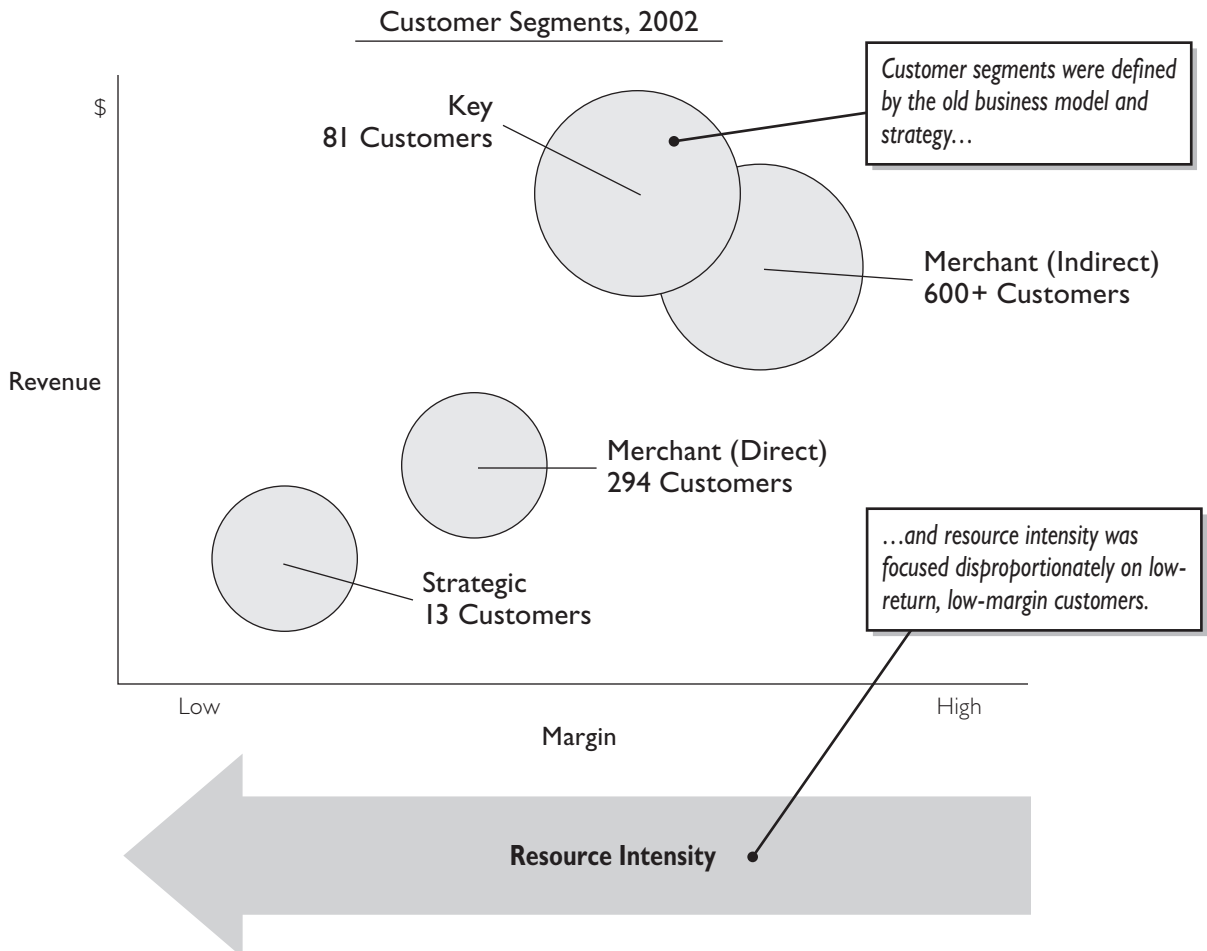
FOCUSED ON THE WRONG CUSTOMERS

Only a handful of customers were driving the majority of operating income...

Customer Distribution in Air Products and Chemicals, Chemicals Business, Pre-2002



...in part due to an outdated segmentation strategy that resulted in inefficient resource allocation



Source: Air Products and Chemicals.

A Means to an End

Based upon customer analysis, Air Products prioritizes the reallocation of customer investments in its strategy review process. Prior to reallocating resources, the firm must first identify specific customer segments in which to focus its investments. As a result, the firm implements a customer segmentation exercise within its overall strategy process. It is important to note that Air Products strongly believes that customer segmentation is not an end goal, but merely one of several linked work process tools that enable the execution of an overarching strategy.

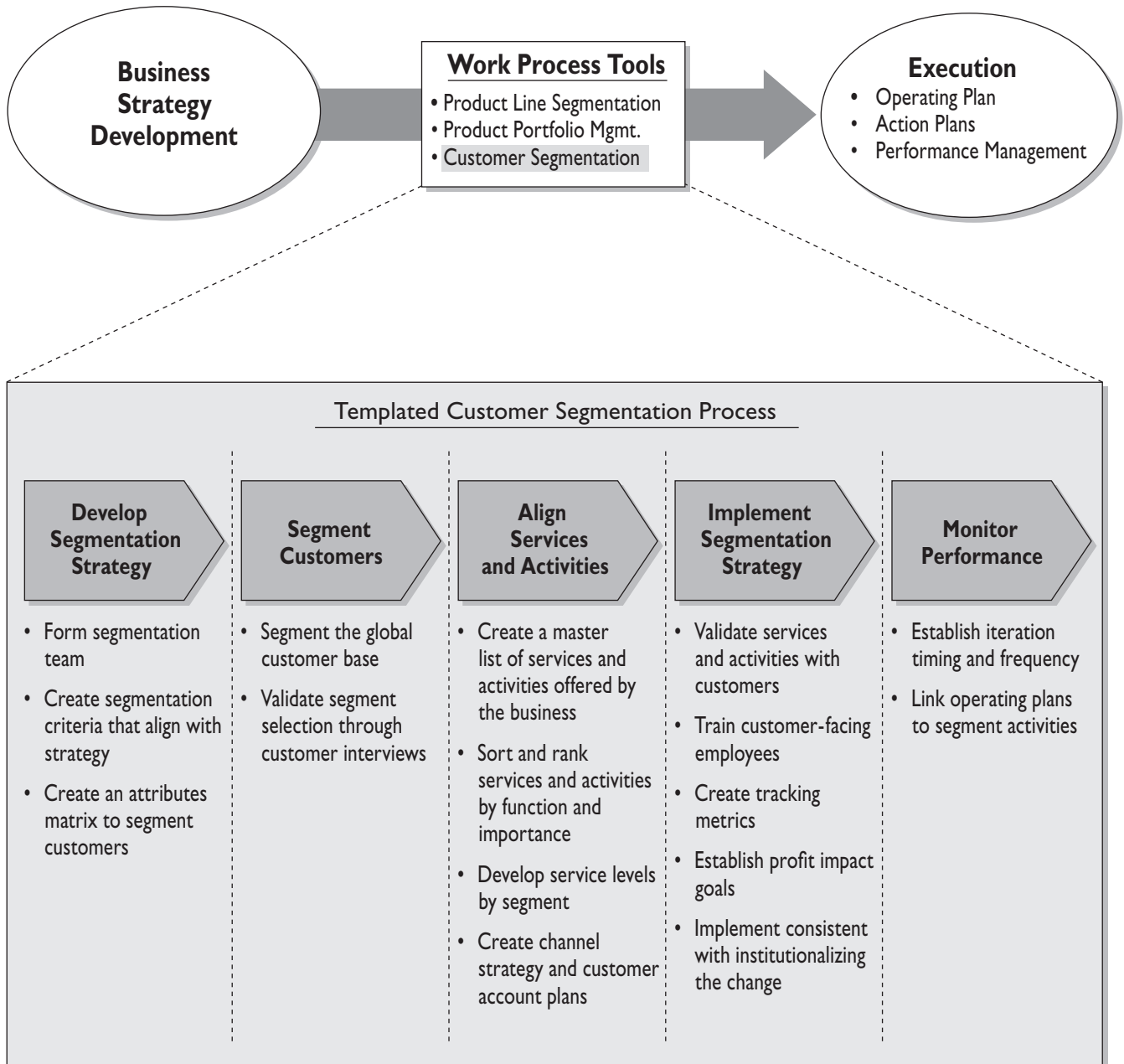
Beyond Just Segmentation

Air Products' Chemicals division sets out to create a customer segmentation process that is customized to its specific business yet also exportable to other divisions within the company. To do so, the Chemicals division pilots a templated segmentation process. The five-step process is intended to take three months to complete, as each business follows the same process from beginning to end, with many of the components of the five steps being customized (e.g., creating an attributes matrix to segment customers).

SEGMENTATION AS A TOOL TO EXECUTE STRATEGY

Templated Process to Improve Customer Segmentation Is Piloted in Chemicals Business

Air Products and Chemicals' Strategy Deployment Process



A Detailed Scoring System

The pilot team brings together all customer-facing employees to determine specific criteria by which customers should be segmented. After multiple deliberation sessions, the team agrees upon nine key criteria against which each customer should be measured. Acknowledging that all nine criteria are not equally important, the team creates a weighted scoring system in which more points are attributed to the most critical attributes (e.g., profitability, market share, and growth rate) than less important ones (e.g., customer partnerships and contracts and position with customers).

Prior to scoring customers, the team conducts two exercises: first, it tests the nine attributes with customers to ensure it is using the correct segmentation criteria, and second, it groups performance criteria for each attribute into three categories.

Natural Break Points

Upon receiving validation from its customers, Air Products analyzes and scores each of its 3,000+ customers individually against the nine criteria. The final point scores across all customers are tabulated, and the firm finds clear natural break points in the continuum of scores. The break points, are used to determine which customers fall into each of the three customer segments.



A GRANULAR, CUSTOMER-BY-CUSTOMER ANALYSIS

The Scorecard Provided Weighted Analysis of Each Customer's Importance to the Business

Air Products and Chemicals' Customer Evaluation Form

Performance Level Criteria						Example	
Category	Attribute	Definition	Focus	Key	Merchant	Customer A	Score
Potential	Market Share	Position in market segment	Top 5 50 pts	Top 10 30 pts	Top 20 10 pts	7	30
	Growth Rate	Growth rate in market segment	2x 50 pts	1x 30 pts	<1x 10 pts	2.7x	50
	Market Growth Rate	Does customer participate in at least one segment with high growth rates?	Yes (multiple) 25 pts	Yes (one) 15 pts	No 5 pts	Yes (3)	25
	Customer Partnerships & Contracts	Does the customer have contracts/partnerships with competitors?	No 15 pts	Few 10 pts	Many 5 pts	Few	10
Profitability	Profitability	% of the total contribution margin on an absolute \$ basis per region	1% 50 pts	0.5%–1.0% 30 pts	<0.5% 10 pts	2.3%	50
	Position with Customer	Profit potential from identified opportunities over 2 years	2X 15 pts	1X–2X 10 pts	<1X 5 pts	\$307M	15
Strategic Fit	Technical Focus	The value of Air Products' technology to the customer: % by volume of non-commodity products sold to customer	55%+ 25 pts	40%–54% 15 pts	<40% 5 pts	41%	15
	Innovation	% of customers' sales from and planned to be from products introduced in the last 5 years using all available technologies	10%+ 25 pts	5–10% 15 pts	<5% 5 pts	13%	25
	Global Presence	Customer scale in at least two regions: contribution margin on an absolute basis globally	1% 25 pts	0.5%–1.0% 15 pts	<0.5% 5 pts	0.3%	5
TOTAL SCORE						225	



Segment	Scoring Range	# of Customers
Focus	> 190	27
Key	150–190	44
Merchant	< 150	3,000+

Scoring ranges determined by natural breaks in continuum of scores.

The vast majority of merchant customers scored below 50 points.

Segment-Based Rules of Engagement

While the customer scoring was a useful exercise, Air Products realizes that it is not truly valuable unless those segments are actually treated differently in day-to-day operations. As a result, Air Products implements explicit rules of engagement against all customer-facing activities for each segment. All customer-facing employees—in technical services, sales, and commercial services—are required to follow the new admittedly prescriptive rules, that govern activities as simple as holiday gifts and business meals and as complex as customized product development activities and specialized pricing.

Organizational Push-Back

The new rules of engagement were met with a significant amount of organizational push-back. Indeed, in its first iteration of the segmentation process, Air Products had to engage in performance review discussions with some employees because those employees did not adopt the new rules. Air Products found that engaging business leaders—those employees truly responsible for driving the change—early in the process was critical to the successful cascading and adoption of the rules.

SETTING CLEAR GROUND RULES

Greater, Proscriptive Rules Govern All Customer Activities to Ensure Segmentation Strategy has Intended Impact

Air Products and Chemicals' Service Activity Guidelines

Technical Services			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Visits by technology	Target 2 minimum	Target 2 maximum	Only as justified by volume and/or revenue targets
Response time	Within 24 hours	Within 48 hours	Product Information Center call within 48 hours
Custom Product Development	Yes if the opportunity will provide X profit within the next 24 months	Yes if the opportunity will provide X profit within the next 24 months	Yes if the opportunity will provide X profit within the next 24 months and up-front cost recovery commitment is in place

Sales			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Face-to-face sales representative visit	1 every 6 weeks per contact; Document at least 4 times per year in CRM system	1 every 6 to 10 weeks; Document at least 2 times per year in CRM system	1 to 2 per year; Document at least once per year in CRM system
Internal documentation	Account plan required and updated quarterly	Account plan required and updated annually	No requirements
Sales training	Individual custom training	Standard training	Electronic training

Services and activities are ranked based on perceived importance to the customer, validated through customer visits and surveys, and then established by segment.

Commercial Services			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Off-list special pricing	Available based on competitive situation: no minimum contribution margin above cash break-even	Available based on competitive situation: minimum contribution margin of X%	Available based on competitive situation: minimum contribution margin of Y%
Claim resolution policy	Field resolution if less than 2.5x	Field resolution if less than X	Full investigation required for payment

Predicting Impact

Upon creating the new rules of engagement, Air Products conducts a line-by-line analysis of each rule to analyze the potential financial impact—revenue opportunities and cost reductions—within each segment. The analysis is then rolled-up into segment-specific financial goals, which are immediately worked into each business's operating plan.

Making Every Customer Profitable

While many segmentation strategies result in the shedding of unprofitable customers, Air Products' goal is to use the segment-driven rules of engagement to make every customer profitable without losing any customers. The line-by-line analysis finds that by improving margins from both sides—cost and revenue—through explicit rules regarding cost-to-serve, it is indeed possible to migrate all customers to profitability.

Furthermore, Air Products finds that traditionally low-margin customers—its merchant system—can indeed be profitable, as the new rules, coupled with new products developed strictly for that segment, enhance the margins among customers in that segment.



LINE-BY-LINE ANALYSIS INFORMS FINANCIAL GOALS

Air Products analyzes the potential economic impact of all new rules...

Air Products and Chemicals' Economic Analysis of Segments

Technical Services			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Visits by technology	Target 2 minimum	Target 2 maximum	Only as justified by volume and/or revenue targets
Response time	Within 24 hours	Within 48 hours	Product Information Center call within 48 hours
Custom Product Development	Yes if the opportunity will provide X profit within the next 24 months	Yes if the opportunity will provide X profit within the next 24 months	Yes if the opportunity will provide X profit within the next 24 months and up-front cost recovery commitment is in place

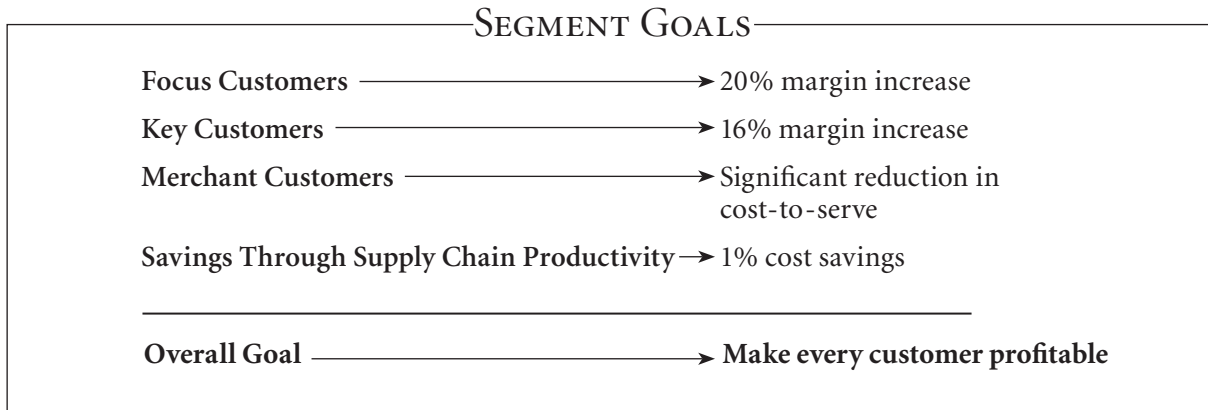
Air Products conducts a line-by-line analysis of potential cost reductions and revenue opportunities from the newly created segment rules.

Sales			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Face-to-face sales representative visit	1 every 6 weeks per contact; Document at least 4 times per year in CRM system	1 every 6 to 10 weeks; Document at least 2 times per year in CRM system	1 to 2 per year; Document at least once per year in CRM system
Internal documentation	Account plan required and updated quarterly	Account plan required and updated annually	No requirements
Sales training	Individual custom training	Standard training	Electronic training

Service/Activity	Focus Customers	Key Customers	Merchant Customers
Face-to-face sales representative visit	Revenue Impact: \$x Cost Impact: (\$y)	Revenue Impact: \$z Cost Impact: (\$c)	Revenue Impact: \$d Cost Impact: (\$r)

Commercial Services			
Service/Activity	Focus Customers	Key Customers	Merchant Customers
Off-list special pricing	Available based on competitive situation: no minimum contribution margin above cash break-even	Available based on competitive situation: minimum contribution margin of X%	Available based on competitive situation: minimum contribution margin of Y%
Claim resolution policy	Field resolution if less than 2.5x	Field resolution if less than X	Full investigation required for payment

...to set growth goals for all customer segments



Economic Success

Financially, Air Products' Chemicals business has reaped tremendous rewards from the segmentation exercise. Not only have all three segments seen margin growth between 20 and 30% in the first two years of the new rules, but overhead cost has declined by 3%. All together, the business has tripled its profits in only two years and attributes the vast majority of this improvement specifically to this process.

Tighter Rules Translate into Better Economics

An example of the effect of the new rules of engagement is in custom projects, which Air Products used to do for all customers. By limiting custom projects using segment-specific criteria and instilling guidelines about project specifications, the firm has halved the cost per project while increasing project adoption rates and reducing project breakeven from three years to only four months.

New Products for New Segments

An additional benefit of the segmentation process comes in product development, where Air Products now introduces products targeted at specific segments. Two products that would never have been introduced if not for the segmentation exercise are now significantly beating growth and profitability expectations.

Firmwide Adoption

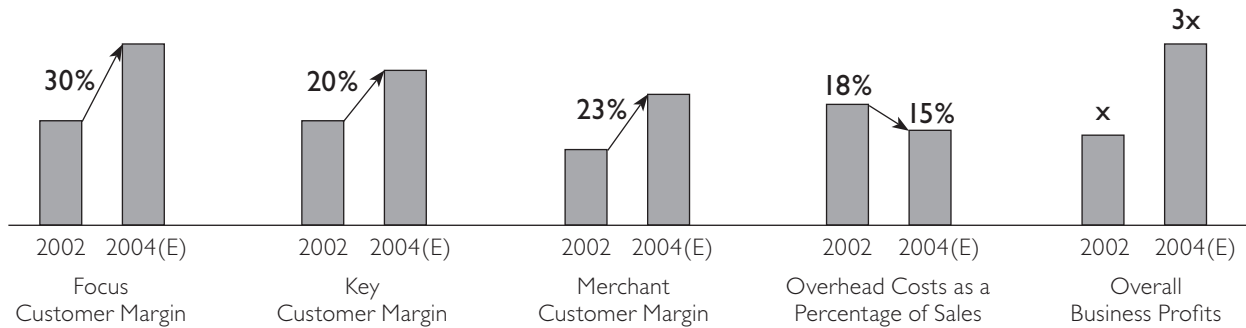
The tremendous financial success of the segmentation strategy within the Chemicals division has sparked interest throughout the rest of the Air Products businesses. The firm is currently in the process of rolling out the segmentation process to the rest of the company.

CASE RESULTS

SUCCESS DEFINED

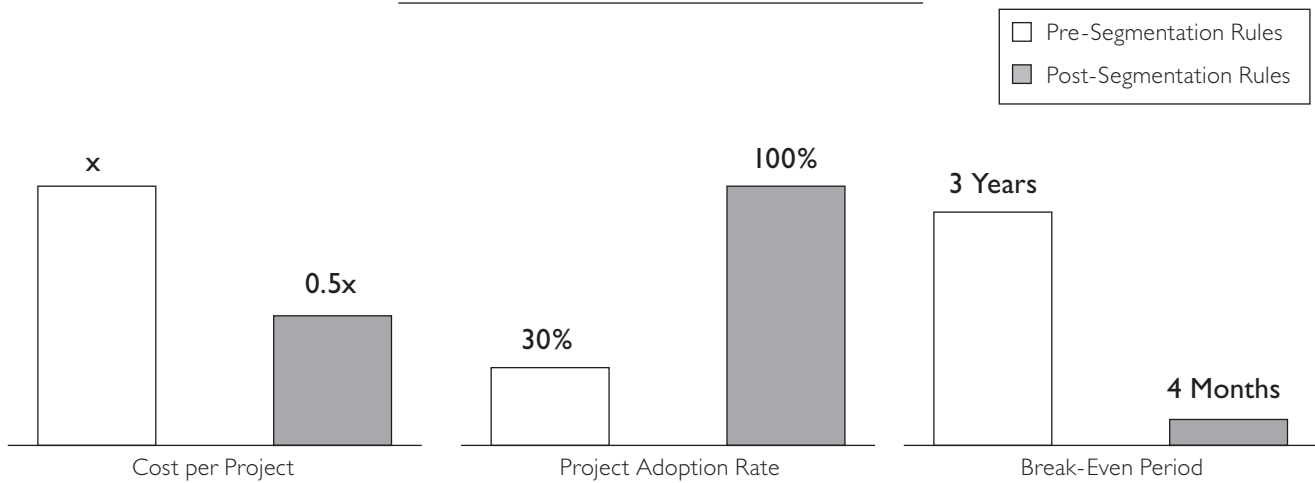
Customer segmentation has served as a key tool to triple profits...

Financial Performance, 2002–2004



...through significant economic improvements...

Changes in Custom Product Economics



...and segment-focused product and pricing enhancements

Select Air Products and Chemicals' New Products Since Segmentation Implementation

