A Practical Approach to Small Business Segmentation

The small business market in the United States is expected to play a significant role in reviving the economy. There are approximately 27 million small businesses in the U.S., and according to the U.S. Small Business Administration, this segment has generated approximately 70 percent of net new jobs over the past decade. There is no doubt that small businesses represent an attractive, and growing, market segment for financial institutions. However, for many banks and other financial institutions, increasing the share of their small business market *profitably* has proven elusive.

Part of the challenge of serving "the small business market" is the very definition of "small business," which typically refers to businesses with less than $7 million in revenues and/or fewer than 500 employees. That means that your local plumber, mom and pop grocery chain, and boutique graphic design shop all fall under the heading of small business—despite the fact that they have very different needs and expectations for banking services.

Given the breadth of the market, developing a customer segmentation strategy for small businesses should be an important component of a bank's go-to-market strategy. Treating all small business customers the same can risk under-delivering to some and over-delivering to others, as under-served businesses will move their banking needs to the competition, while the over-served will gladly take what's offered, incurring greater costs than the revenue they provide. Subdividing the market allows a financial institution to focus its limited resources—business bankers, support staff, and marketing dollars—on those businesses best aligned with the financial institution's strengths in order to generate an acceptable rate of return.

Deciding to segment small business customers is a relatively easy and straight-forward decision. Determining how and on what basis to segment small business customers is more difficult. In this article, we discuss some of the most common segmentation schemes, together with their pros and cons, and offer our thoughts on the best approach to small business segmentation.

Four Dimensions of Segmentation

Like consumers, small business customers can be grouped together based on any number of common characteristics or needs. Four of the most common segmentation schemes are:

1. Company Demographics and Geography
2. Product Usage
3. Profitability
4. Business Life Cycle

Each of these segmentation schemes has benefits and drawbacks. As a practical matter, most financial institutions will want to use a combination of these factors to target their marketing and sales activities.

Company Demographics and Geography

Segmentation based on company demographics and geography is relatively simple to execute and is fairly inexpensive. Common factors include:

Company Demographics	Geography
▪ Sales size ▪ Number of employees ▪ Company age ▪ Industry ▪ Ownership structure	▪ City, state, zip ▪ Business population density ▪ Calculated values (e.g., distance to the nearest branch or small business office)

Much of this information is available commercially through third-party demographics vendors (e.g., Dun & Bradstreet, Experian, Hoover's, Standard and Poor) or through government agencies such as the U.S. Census Bureau. Beware, however, that some of the information may be self-reported, and values such as sales revenues could be "optimistic estimates" or just plain stale.

Although demographic information can be used to quickly narrow the market, it doesn't necessarily group small businesses with similar buying behaviors. For example, two companies with $1 million in annual sales revenues can have vastly different banking needs. A general contractor might need a line of credit for cash flow purposes, a term loan for equipment, and a basic business checking account. A wholesaler may need wire transfer, foreign exchange, and ACH payment services but not require any credit. Given this, relying exclusively upon basic demographics may not provide the bank with enough meaningful insight to develop a targeted value proposition.

Product Usage

Beyond their business size or location, small businesses can be differentiated on the types of banking products used and/or their frequency of use. This approach is especially valuable for cross-selling other products. The segmentation can be done at a high level—does the small business use credit products, deposit products, cash management services, or investment series? Or it can be driven down to a lower level, e.g., commercial real estate loans, business CDs, international wire transfers, and trust services.

Analysis of usage can bring to light bundles of products that appeal to particular industry groups, allowing business bankers to focus their selling efforts. For example, a clothing wholesaler could benefit from a line of credit to manage cash-flow cycles, international letters of credit to purchase inventory from overseas suppliers, and an online cash management tool to monitor balances and initiate wire transfers.

Product usage information for current customers can be pulled from internal sources – either from a data warehouse or from the core banking systems. For prospects, product usage data for specific small businesses is harder to come by. Public credit filings (e.g., UCCs and mortgages) can be purchased for a given geographic area, which will identify the amount of debt, type of collateral, and the lien holder. Third-party data providers offer statistical data which can provide general guidance on the percentage of businesses using a particular product by sales revenues, industry, and geography. For example, approximately 60 percent of legal and health services companies nationwide use merchant card services.

The downside of segmenting by product usage is two-fold. First, there is a risk building and reinforcing product silos internally. One group focuses on customers using cash-management products, another focuses on customers with credit, etc. While this may optimize delivery from the bank side, to a small business it may appear that the bank is just interested in the next "product sale." Second, products can't necessarily be mapped to business needs. A payment can be made using a check, an ACH payment, or a wire transfer. Product information used in conjunction with other segmentation factors can provide more insights for selling efforts

Profitability

Separating customers into bands by profitability is one of the best ways to align resources with your best customers—once the bank has identified the most profitable customers, they can be targeted for a higher level of service

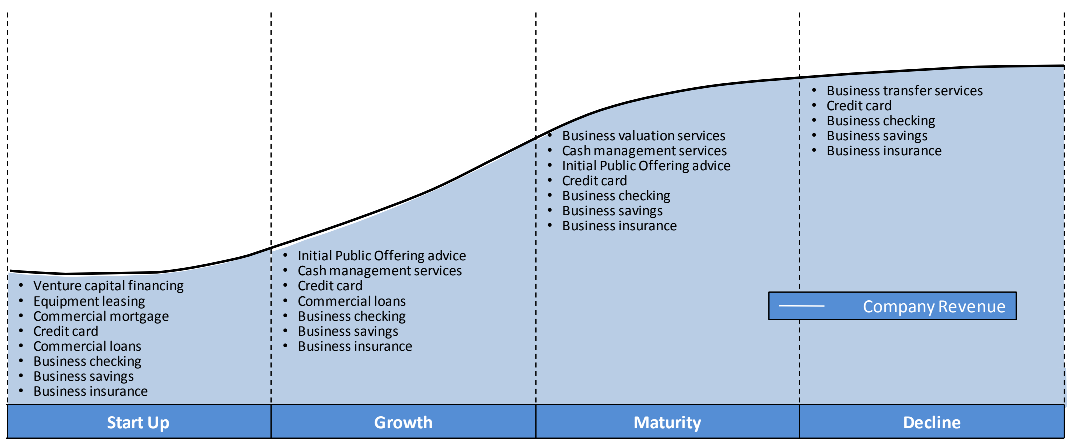
One of the primary drawbacks of this segmentation scheme, however, is the difficulty of calculating customer profitably. Unfortunately, many financial institutions don't know how much profit each customer generates. Calculating the revenue produced is relatively straightforward, but determining the costs requires considerable effort. The financial institution must make decisions on how to calculate interest margins on credit and deposit products, which direct and indirect expenses belong to the small business segment, and how to appropriately allocate these costs to individual products or customers. The number of estimates and assumptions that often need to be made can add considerable complexity to the endeavor and undermine the perceived accuracy of the analysis.

In addition to the difficulty in determining profitability, another drawback with using profitability for segmentation purposes is that it doesn't explain *why* the customer is profitable. Four small-businesses generating the same level per year in profits could have nothing in common – one may have a large loan at market rates, the second carries a smaller loan at a higher interest rate due to risk factors, the third has several jumbo CDs, and the fourth is a heavy user of cash management services with only small deposit and loan balances. The needs of these customers and the treatments applied by the financial institution should be substantially different.

Business Life Cycle

Lastly, banks can derive value from segmenting small business customers based on the business lifecycle. As a business progresses through the typical life cycle phases—start-up, growth, maturity, and decline/transition—its needs can be predicted, as can those of the principals/owners. A small business in the start-up phase tends to be focused heavily on personal and business credit. In the growth phase, the business continues to need credit, but also adds cash management services. As it matures, growth levels off, reducing the need for credit and increasing the need for asset preservation and investment options. In the decline/transition phase the owner looks toward retirement and seeks transition services.

Commercial Needs by Business Lifecycle Stage



Source: Trump Bank; Spectrum Group; Business Banking Board research.

The difficulty in segmenting by lifecycle stage is the lack of commercially available sources for the information. Businesses move through the phases at varying speeds, with a significant percentage never leaving the start-up phase, so the age of the business is not a good predictor. Business bankers will need to review the small business in their portfolio and assign each to a stage based on interviews with the owners/principals and analysis of financial statements, which can be a time-consuming effort.

No one segmentation scheme will provide a full profile of a small business prospect—but used in combination, these four dimensions can provide significant insight about a small business. For example, a business banker can have a focused conversation with a customer if he or she knows that the small business owner is a general contractor (industry) who has a small line of credit (product usage), has grown annual sales revenues significantly for the past 3 years (business lifecycle) and is in the bank's top quartile for profitability. The banker could explore additional credit needs to finance the growth as well as payroll and tax needs to assist with an expanded workforce.

Each financial institution will need to develop its own segmentation scheme based on its objectives. A bank focusing on product expertise, such as SBA financing, may de-emphasize demographic and geographic factors. Another bank catering to specific industry groups may de-emphasize the business lifecycle. The goal is to divide customers and prospects into logical groupings, allowing the bank to selectively target those with the best overall return.

Next Steps

Segmenting the small business market is merely one step in the process. Other key questions to be answered are:

- Which segments should be targeted and why?
- What is our competitive advantage in the targeted segments?
- How large are the targeted segments and are they growing or shrinking?
- How well do current customers match up with the targeted segments?

With the answers to these questions, a financial institution can begin to allocate its resources more intelligently, avoiding the scattershot approach of treating every customer the same regardless of their needs and potential profit to the financial institution.

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