

AN INTRODUCTION TO SEGMENTATION



About GrowthCap

Over the past few years FSDK has been at the forefront of SME banking development through conducting market assessments and studies in areas such as trade finance and SME equity funds, as well as supporting development of the credit reference bureau. Through its partnerships with its Action Research Partners (ARPs), FSDK's GrowthCap initiative is supporting adoption of SME best practices by individual financial service providers.

This paper is part of a series of Technical Notes and Resource kits that are being developed out of work with the ARPs. These provide detailed information about the best practices and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

Abstract

Segmentation breaks the SME market into smaller groupings so that like customers may be served with products, staff, and processes that meet their needs, and the bank can prioritise target SME markets. This Technical Note describes the different ways the SME market may be segmented and shows the steps for making segmentation choices.

> INTRODUCTION

Segmentation is a process of breaking the SME market into smaller like pieces, grouping customers with similar or common behaviours, so that they can be better approached and served, with products, staff, and processes that are appropriate for business needs and at appropriate price points.

These varying products and approaches will be reflected in:

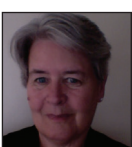
- Product design;
- Communications media;
- Pricing; and
- Distribution design.

Each of these factors will be tailored to address the needs and wants of the segment, with the aim of providing

efficient and cost-effective service, for both the benefit of the customer and the profitability of the bank.

A bank that has already established an SME department nominally has already done some segmentation – SMEs have been recognised as a segment separate from corporate and retail clients. In some cases however this segmentation is based only on loan size, and as such ignores businesses that are non-borrowing.

An appropriate segmentation is key to SME business strategy because all choices about products, staffing, credit process, delivery channels, and other aspects of strategy in reaching SMEs will be based on the segmentation. Regarding SMEs as a unique segment by themselves is not an adequately refined approach. A bank needs to seriously consider how the SME segment breaks down, and how it will serve all or part of that market.



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> DEFINING SMALL AND MEDIUM SIZED BUSINESSES



It is unlikely, that a single product at a single price point would equally meet the need of any business that falls into the SME category.

What constitutes an SME? The category is quite broad, and per the Kenyan government definition from the MSE (micro and small) Act of 2012, ranges as follows:

Micro enterprise:	1 – 9 employees Turnover not exceeding KES 500,000
Small enterprise:	10 – 49 employees Turnover between KES 500,000 and 5 million
Medium enterprise:	50 – 99 employees Turnover between KES 5 million and 800 million

SME does not include microenterprise, but larger micro businesses, called very small enterprises (VSEs) might be characterised as on the larger end of micro, and likely to become formalised and become small businesses. Many banks will count VSEs as part of their SME portfolio.

Whether VSEs are included or not, the SME range is clearly huge, with the only commonality that these are for-profit businesses. It is unlikely, however, that there would be a single product at a single price point that would equally meet the need of any business that falls into this SME category. The need to sub-divide this market explains the need for segmentation, breaking the market into smaller target groups that can be better served.

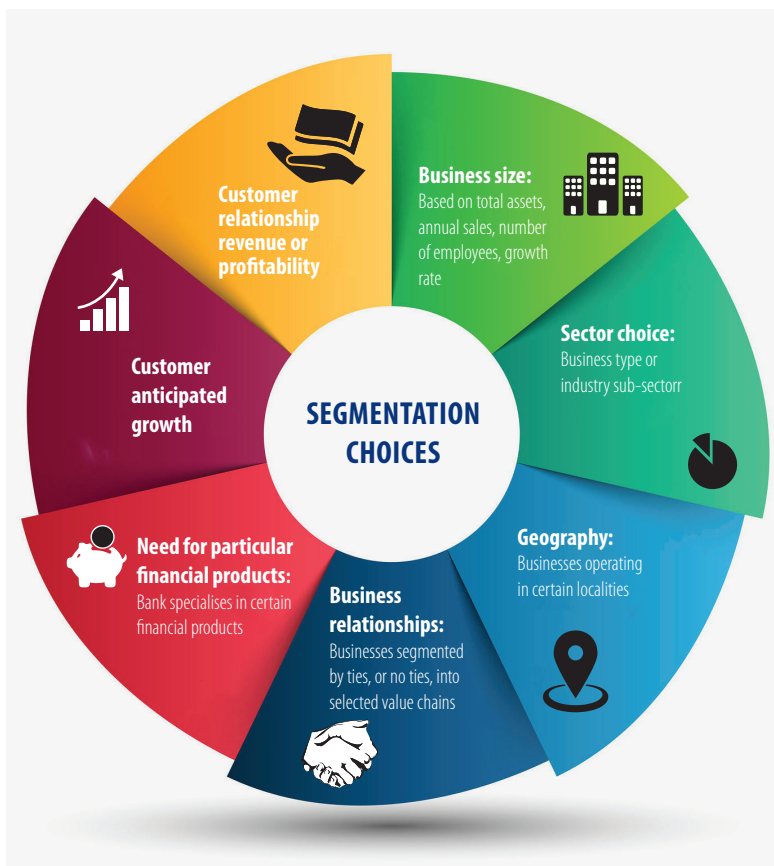
Before the more recent increase interest in serving SMEs as a group, banks did little segmentation. Within the Retail division they may have differentiated between consumer accounts and high net worth individuals. There are retail products, for example, that have been designed to cater to sub-segments of the retail population, such as loans available only to salaried persons. The Corporate division may do some segmentation based on industry, but businesses are large enough to receive a customised offer, so customers are not approached as members of a class or group with common characteristics that can be addressed with standardised products that are intended to be sold in volume.

Worldwide an increasingly common practice in banking is to separately provide for small and medium businesses, generally with small businesses served through mass-market products and medium-sized businesses served with a more customised package of services.

> SEGMENTATION CHOICES

Segmentation can be done for SMEs in a variety of ways. Some segmentation choices which may be combined include:

- **Business size** – based on total assets, annual sales, number of employees, growth rate – most segmentation choices will have some element of size associated with them;
- **Sector choice** – segmentation focuses on sector (e.g. manufacturing, wholesale trade) or more specifically on sub-sector (e.g., food processing, furniture manufacture);
- **Geography** – businesses operating in certain localities
- **Business relationships** – businesses segmented by ties, or no ties, into selected value chains
- **Need for particular financial products** – bank specialises in certain financial products (e.g. equipment leasing, foreign exchange) and prioritises serving businesses that use that financial product;



- Customer anticipated growth;
- Customer relationship revenue or profitability.

The **segmentation choice will depend on the bank's current portfolio, the market, and the bank's goals**. For instance, a larger bank that already has a value proposition for SMEs may segment on business size and sharpen up the offer for each segment. If a bank is a new entrant to a competitive SME market, or is a relatively smaller market participant, it is likely to seek out niche segments that are underserved, or where the bank has some expertise. A segmentation based on the profitability of customer relationships is an attractive choice, but does require a lot of data and information on revenue and costs.

In all cases the bank will have a limited amount of capital that it can devote to SME banking. Segmentation should prioritise service to the most important segments, and then select second and third-ranked segments until capital is fully allocated. For instance, a bank may decide that it prioritises business-to-business (B2B) SME suppliers to its corporate clients, followed by B2B suppliers in selected industries, followed by all other SMEs¹ (no SME walk-in business is turned away, but only business in the first, then the second, sectors are targets for marketing). If the bank's capital limits the amount of SME credit that it can provide, it may simply not provide any loans at all to the "other" category, and may limit products available to the second sector. The relative importance of the SME line of business in the bank is also significant – does the bank consider this a "leading edge" department, or is the bank more focused on its retail or corporate portfolios, and SME products are simply offered to fill out a full market line, but business not really pursued.

The bank's goals are also an important factor in segmentation. For many banks, profitability, at least in the short term, is not a priority – "first strike" and capture of market share may be more important in some markets for SMEs in general if they are unserved or underserved, but more commonly for certain market niches. These factors will affect the choices made and resources that the bank is willing to devote to its segmentation strategy.

Banks may also choose to serve what they regard as 'niche markets' as separate segments. In many countries both in the west and in emerging markets women-owned businesses are served as a separate segment, and non-financial services such as training programmes and advisory services are offered both as inducements to the businesses and as services designed

¹ ICICI Bank of India is well-known for selecting this approach to segmentation.



to support elevation of business performance to a bankable level. In many Asian and African countries there is a "Chinese banking" department which is characterised by staff being the same ethnicity as the customers. In Kenya and elsewhere this is "Asian banking". Another important segment found in East African banks is Islamic Banking, which will offer a set of products that comply with Islamic principles.

Other factors that influence segmentation choice include:

- Legacy business – what is the bank already known for, what are its specialties;
- Market potential in branch areas;
- Risk appetite;
- Competitor focus – rather than compete head-on a bank may choose to focus on markets that competitors have not prioritised.

➤ EVALUATING AND SELECTING SEGMENTS

In an ideal world a bank will go through three steps to assess the market and make its segment choices. These steps comprise²:

1. Conduct **market research** to determine the size of the SME market, its components (industries, number of employees, geographic concentrations, and constraints – particularly those that can be addressed with well-

² GrowthCap has published Technical Notes on all three of these topics.

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In an ideal world a bank should conduct market research, use data mining techniques and estimate the profitability of each segment to assess the market and make its segment choices



designed financial services) and growth rate of different parts of the market. This study will show where the greatest opportunities lie. To date this type of market research has been weak in Kenya.

2. Use **data mining techniques** to assess the bank's current portfolio, to understand what customers are already in the bank, including their industry concentrations, number of employees, geographical concentrations, and use of financial products. If possible this also should include evaluating SME customers who are not currently classified as such, particularly large sole proprietorships that use the owner's account for business transactions. Again, to date this type of data mining of existing customer data has been weak in Kenya.
3. Determine potential segments and estimate potential market capture; quantify choices by **estimating profitability from each segment**. This can be used to rank target segments, although the ranking would be tempered by other factors such as legacy business and competitor focus. Estimating the profitability of different groups of SMEs is an area of weakness in many banks in Kenya.

In practice a bank will use short cuts rather than fully going through all these steps. Initial market research for instance may not be conducted if the bank is already in the market and has some SME business. However the bank should review all the publicly available market research to better inform its choices. The internal data mining is important, whether it is done before or after the segmentation choices have been developed – the bank needs to know what customer base it already has and

how those businesses have performed. Existing customers are also by far the best prospects, because they already know the bank and calls to them will not be "cold". For banks that have a robust Customer Relationship Management (CRM) system this data mining will be relatively easy. This type of customer review would be needed to populate a new CRM system, so one way or the other it is worth putting in the time and effort that this task will take.

The step that is missed by most banks is the quantification of projected market capture and the estimation of profitability from those segments. In addition to providing a good basis for prioritising segments to market to, this analysis is useful because it establishes a benchmark for performance, and can be a strong argument for justifying additional allocation of resources. Conversely, this analysis, particularly as applied to the bank's current portfolio, will also identify the segments that are generating losses, and these then can be managed.

There are two important cautions that should be considered in making successful segmentation choices. These are:

Segments should not be too small. In general a bank wants the segments to be manageable as SME portfolios, characterized by numbers and volume. It will not be feasible to develop value propositions, much less to manage distinctive service to a great many segments, so the maximum number of segments should be three or four. The bank may choose to give special attention to certain sub-segments (e.g., have all the customers in one particular industry specialty serviced by a single office that knows the industry).

Segment rules need to be enforced. In developing the products and delivery systems for particular segments the bank will be making decisions about how the segment can best be served, and should be realistic about the value proposition created for the segment. As customers change, however, they should be handled differently, in accordance with the segment standards. This is often particularly a problem with relationship officers or branches keeping customers that they originally solicited, even if the customer does not meet qualifications or grows out of the segment that the originator represents. Similarly SME clients build relationships with particular officers and branches and can themselves be reluctant to being moved onto another part of the bank even though it might better placed for serving their business needs. Nevertheless businesses over a certain size, for instance, should be handled by the corporate division and offered suitable products and service. There is a disservice to the rest of the SME segment if such a customer is retained in the SME portfolio, as a larger customer like this tends to suck away the time and attention that should be going to SMEs.



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> OTHER CONSIDERATIONS

Once the bank has decided on its priority segments it will then make process and related changes to serving these segments, including development of appropriate financial products and

bundles, selection and training of staff, and development of alternative delivery channels as appropriate. The practical implementation of an SME segmentation approach in a bank is not discussed in this introductory note but is addressed in a separate GrowthCap Technical Guide, 'A Guide to Implementing Segmentation for SME Banking'.

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The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation.



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