Measuring Variability Factors in Consumer Value for Profit Optimization in a Firm—A Framework for Analysis

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Consumer value may be defined as a tool to measure the prolonged satisfaction and the on-going propensity to buy products and services. Though there are many issues floating in current debates about consumer value, it may be argued that the importance of consumer value in terms of the level of satisfaction is evident in providing a revenue stream to companies, and thereby repeat purchase behavior is of strategic importance to management. The consumer value concept is used to assess product performance and eventually to determine the competitive market structure and the product-market boundaries. Consumer value may be measured as product efficiency viewed from the consumer’s perspective, i.e., as a ratio of outputs (e.g., resale value, reliability, safety, or comfort) that consumers obtain from a product relative to inputs (price, running costs, and so on) that consumers have to deliver in exchange. The efficiency value derived can be understood as the return on the consumer’s investment. Products offering a maximum consumer value relative to all other alternatives in the market are characterized as efficient. This paper develops the framework for measuring consumer value with reference to establishing the long-run relationship with the firm and optimizing its profit levels. The discussions in this paper address the core issues of consumer value in retailing products and services: how to conceptualize it, how to measure it, and how to manage it.

Keywords: consumer behavior, value measurement, consumer satisfaction, model construction and estimation, profitability of firm

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1 Introduction

Developing consumer value through retailing lies at the heart of the marketing concept. The pursuit of this goal implies that a company is not only interested in making the sale or achieving trial purchase at any cost but is also aiming to develop strategies to achieve long-term profitability through repeat buying and consumer retention. Such an approach builds loyalty on the one hand and enriches the consumer value of products, services, and related factors on the other. The consumer value companies attempt to build and maintain are supplemented by brand managers with mass-media advertising and more direct and interactive methods, such as internet communications and other innovative channels of distribution (Pearson, 1996; Peppers and Martha, 1997; Barwise and Hammond, 1998).

Consumer value may be defined as a tool to measure the prolonged satisfaction and the on-going propensity to buy products and services. While there are continuing discussions on consumer value, it may be argued that consumer value is of strategic importance to management as it highlights the manifest nature of consumer satisfaction in providing a revenue stream to the company through sustained involvement and repeat purchase behavior.

Individual value to the consumer may be estimated as a base value, and changes in this value are affected by corresponding changes in measures of specific value drivers. The base value is tied to the most important of all complements, which may be determined as the consumer’s needs. The base value may be estimated with reference to the price that a consumer is already paying for obtaining similar utility or from the size of the savings that the product brings.

It is challenging to predict the base value in the distant future because new discoveries and applications are often unexpected. Additionally, estimating value drivers for a new product can be tricky because there are no direct historical data. However, we can assume that the impact from changes in price or availability of
The concept of consumer satisfaction has a long history in marketing. Studies of consumer behavior emphasize consumer satisfaction as the core of the post-purchase period. Because consumer satisfaction presumably leads to repeat purchases and favorable word-of-mouth publicity, the concept is essential to marketers. In saturated markets, consumer satisfaction is thought to be one of the most valuable assets of a firm. Consumer satisfaction serves as an exit barrier, thereby helping the firm to retain its consumers. The impact of loyal consumers is considerable; for many industries, the profitability of a firm increases proportionally with the number of loyal consumers, and high sales to new consumers can be attributed to word-of-mouth referrals. Several contributions have been made in relation to various mechanisms for improving and using consumer satisfaction.

Barsky and Labagh (1992) propose a consumer-satisfaction matrix as a tool for evaluating customer information and attitudes and for identifying related strengths and weaknesses. Dube et al. (1994) describe how consumer satisfaction data can be used for positioning strategies that help the business carve a niche, whereas Morgan (1993) investigates the consumer value of benefits offered in mid-scale restaurant chains. Several contributions in the marketing literature suggest that there are very high expectations for these loyalty-building initiatives (Reichheld and Sasser, 1990; Nalebuff and Brandenburger, 1996; Reichheld, 1996). Academics, consultants, and business people
have speculated that marketing in the new century will be very different from the time when much of the pioneering work on consumer loyalty was undertaken (e.g., Churchill, 1942; Brown 1953; Cunningham, 1956 and 1961; Tucker, 1964; Frank, 1967). Yet the potential for improving applied concepts is evidenced by the numerous changes over conventional ideologies achieved to date.

The well-known disconfirmation of the expectations model of satisfaction suggests that consumer satisfaction is a result of a comparison between company performance and consumer expectations (Oliver, 1980 and 1981). Disconfirmation models are usually focused on performance of specific attributes and expectations (Bearden and Teel, 1983; Churchill and Surprenant, 1982; Tse and Wilton, 1988; Oliver, 1993). However, there is a gap in our current understanding of satisfaction in the context of channels, where relationship-building rather than transactional exchange assumes importance. The comparison process between actual performance and expectations may be moderated by the presence of firm and environmental variables such as consumer power, consumer size, rivalry, channel configuration, product line growth rate, supplier flexibility, and consumer service. The relationship between consumer service and satisfaction has been investigated to a limited extent in the logistics literature. Mentzer et al. (1989) call for a formal analysis of logistics and marketing consumer service items in order to establish certain general dimensions of consumer service and to investigate their impact on consumer satisfaction. Further, Mentzer et al. (1989) and Emerson and Grimm (1996) find that the performance of certain logistics and marketing consumer service dimensions directly contributes to consumer satisfaction in a channels setting.

The key marketing variables such as price, brand name, and product attributes affect consumers’ judgment processes and permit inference on quality dimensions leading to consumer satisfaction. The experimental study conducted by Brucks et al. (2000) indicates that consumers use price and brand name differently to judge quality
dimensions and measure the degree of satisfaction. Zeithaml (2000) synthesizes contemporary evidence and identifies the direct effects of service quality on profits. He also discusses the links between perceived service quality and purchase intentions, between customer and segment profitability, and among key drivers of service quality, customer retention, and profitability. Lam et al. (2004) discuss the interrelationships among customer value, satisfaction, loyalty, and switching costs by developing a conceptual framework linking all these constructs in a business-to-business service setting. On the basis of the cognition-affect-behavior model, the authors hypothesize that customer satisfaction mediates the relationship between customer value and customer loyalty and that customer satisfaction and loyalty have significant reciprocal effects on each other.

The consumer value concept is used to assess product performance and to determine the competitive market structure and the product-market boundaries. Consumer value may be measured as the product efficiency viewed from the consumer’s perspective, i.e., as a ratio of outputs (e.g., resale value, reliability, safety, or comfort) that consumers obtain from a product relative to inputs (price, running costs, and so on) that consumers have to deliver in exchange. The efficiency value derived can be understood as the return on the consumer’s investment. Products offering a maximum consumer value relative to all other alternatives in the market are characterized as efficient. Different efficient products may create value in different ways using different strategies (input-output combinations). Each efficient product can be viewed as a benchmark for a distinct sub-market. Jointly, these products form the efficient frontier, which serves as a reference function for inefficient products. This ensures that only products with similar input-output structures are partitioned into the same sub-market. As a result, a sub-market consists of highly substitutable products. In addition, value-creating strategies to improve product performance (i.e., policies of how to vary inputs and outputs) in order to offer maximum consumer value are provided. The
impact of each performance parameter on consumer value may be determined along with the value drivers among them.

Based on the interplay between potential value and realized value, managers can devise consumer specific strategies. Bliss (1988), after surveying existing models of retailing, discusses the idea that the retailer saves its consumers time and money by assembling goods in one place. This introduces an essential non-convexity and importantly affects the conditions under which shops compete with each other and the constraints on their value attributes. The value of a consumer may be defined with reference to a firm using expected performance measures based on key assumptions concerning the retention rate and profit margin, and the consumer value also tracks the market value of these firms over time. The value of all consumers is determined by the acquisition rate and cost of acquiring new consumers as discussed by Gupta et al. (2003).

It is necessary to develop a strong approach to measure consumer value since it is a key factor influencing the process of profit optimization in a firm. The previous research contributions discussed above largely argue towards building consumer value by measuring levels of satisfaction. There exists the potential for deriving consumer value by measuring the intangible factors in retail transactions, transitional movements in the value of non-conventional products, promotional appeals, and dynamics of retail consumption. The framework for measuring consumer value discussed in this paper help to determine exit-voice-loyalty based on the interplay between the potential value and realized value, which may lead managers to develop appropriate strategies to augment consumer satisfaction. Hirschman (1970) initiates this concept to measure the value among marketing channels. The analytical framework in this text is also discussed with reference to the prospect theory developed by Tversky and Kahnman (1981) towards framing decisions and understanding the dynamics of choices that consumers may exercise in order to optimize their satisfaction and ultimate value.
3 Framework for Analysis

A retail chain is modeled as a dummy control center (CC) that helps in evolving strategies, marketing designs, and building corporate image. The CC is an integrated part of the corporate headquarters that is instrumental in making most of the business decisions. Let us assume that there are \( L \) networks and \( D_m \) spatially spread markets. Let \( \Delta_j \subseteq \{1,\ldots,D_m\} \) denote the set of markets served by the \( j \)th chain and \( \phi_h \subseteq \{1,\ldots,L\} \) denote the set of chains serving the \( h \)th market. The operations of the \( j \)th chain in market \( h \) in period \( t \) are fully described by the \( N \)-dimensional vector \( Z^{j,h}(t) \equiv (Z_1^{j,h}(t),\ldots,Z_N^{j,h}(t)) \) \( \in \{1,\ldots,R\}^N \), where \( Z_k^{j,h}(t) \) is the practice for the \( k \)th dimension of store operations. There are then \( R \) feasible practices for each dimension. The store operations of chain \( j \) is represented by an element of \( \{1,\ldots,R\}^{N|\phi_h|} \).

3.1 Measuring consumer value

Consumer values for goods and services are largely associated with retail store brands and consumer services offered therein. The beginning of consumer preferences is the basic discrete time point that helps consumers make buying decisions and maximize product value. Ofek (2002) discusses the idea that the values of a product or service are not always the same and are subject to a value life cycle that governs consumer preferences in the long run. If consumers prefer a product or service for \( N \) periods and \( Q \) denotes the value perceived by the consumer, then this value satisfies \( Q > N \), where \( Q \) and \( N \) are both exogenous variables. If every consumer receives higher perceived values for each purchase, the value-added product satisfies \( q \geq Q \), where \( q \) refers to the change in the quality brought about by an innovation or up-graded technology. The consumer may refrain from buying the product or service if \( q \leq Q \). However, a strong referral may influence the consumer value with an advantage factor \( \beta \) that may be
explained by price or quality factors. In view of the above discussion it may be assumed that consumer preferences have high variability that inflates value factors in retail purchasing decisions:

\[
E \left[ \sum_{t=1}^{N} \beta' t (C_t, \tilde{Z}) + \beta^{N+1} Q_{N+1} (V_{N+1}) \right]
\]

where \( C_t \) represents consumption, \( \tilde{Z} \) is a vector of consumer attributes (i.e., preferential variables), \( Q_t \) is the value perceived by the consumer, and \( V_{N+1} \) denotes the value perceived by the consumer that maximizes \( Q_t \) and also enhances values for future purchases when the influence of referrals is not negative (i.e., when \( V_{N+1} \geq 0 \)).

Consumer value is a dynamic attribute that plays a key role in purchases and is an intangible factor to be considered in all marketing and selling functions. Consumer satisfaction may be expressed as a function of all value drivers in which each driver contains parameters that directly or indirectly offer competitive advantages to the consumers and enhance the consumer value:

\[
V' = K_s, K_m, K_d, K_c \prod \{ V(x, t, q, p) \}.
\]

In the above equation \( V' \) is a specific consumer value driver and supplies (\( K_s \)), margins (\( K_m \)), distribution (\( K_d \)), and costs to customers (\( K_c \)) are constants; here, \( x \) is volume, \( t \) time, \( q \) quality, and \( p \) price.

The total utility for conventional products goes up due to economy of scale as quality is increased (\( \frac{\partial V}{\partial q} > 0 \)). In addition, consumer value is enhanced by offering a larger volume of products at a competitive price in a given time (\( \frac{\partial V}{\partial x} > 0 \)). Conventional products create lower value for consumers while innovative products, irrespective of price advantages, enhance consumer value. The value addition in conventional products provides a lesser enhancement to consumer satisfaction compared with innovative products. Such
changes in consumer value due to shifts in production may be expressed as:

\[ V'_{hj} = a \left[ \sum \frac{T_p}{(1+V_p)^{j+j+1}} \right] + b(X_j). \]  

(3)

In this equation \( V'_{hj} \) represents enhancements in consumer value over the transition from conventional to innovative products, \( a \) and \( b \) are constants, \( T_p \) denotes high-tech and high-value products, \( V_p \) represents the value of product performance that leads to enhanced consumer value, and \( j \) is the period during which consumer value is measured.

In addition to high-tech and high-value products, consumers and companies may also find potential for enhancing value with appropriate promotional strategies. Consumer values are often enhanced by offering better buying opportunities that reflect short- and long-term gains. Let us assume that the competitive advantage in existing products over time that offers the \( j \)th level of satisfaction through various sales promotion approaches adopted by the company is \( G_x \). Such a market situation may be explained as:

\[ G_x = [r_1m_1; r_2m_2; r_3m_3; \ldots; r_nm_n] \]  

(4)

where \( r_j \) denotes the \( j \)th level of satisfaction \( (j = 1, \ldots, n) \) and \( m_j \) is the number of consumers attracted to buying the product. Given the scope of retail networks, a feasible value structure for consumers may be reflected in repeat buying behavior \( (R) \) that explains the relationship between consumer value derived from a product and its associated marketing strategies. The impact of such consumer value attributes in a given situation may be described as:

\[ \sum_{j=1}^{n} r_jm_j = R, \]  

(5)
The prospect theory laid by Tversky and Kahnman (1981) proposes that the intensity of gains plays a strategic role in value enhancement as $G_{it} = g_{pt} = \frac{\partial G}{\partial p}$. In this situation $t$ represents the period in which promotional strategies are implemented to enhance consumer value with reference to product-specific gains ($g_{pt}$). However, in order to measure the relationship (variability) between repeat buying behavior and consumer value, it is appropriate to determine the cumulative decision weights ($w$); substituting into the equations (1), (4), and (5) shows that:

$$G_{it} = w \sum_{k=1}^{jm} g_{pt}(r|m_j) + \beta^{n+1}Q_{N+1}(V_{n+1})$$.

Consumer value, however, may be the driver function of gains on buying decisions and influence variables such as perceived use value and referrals.

Value measurements have been used as one of the principal tools to assess trends of consumer behavior for non-conventional products. The value syndrome influences individual and group decisions in retail and bulk deals and conditionalizes the decision process of consumers. Conditional consumption behavior suggests that consumption depends heavily on the utility function and on the source of uncertainty (Carroll and Kimball, 1996; Deaton, 1992). The dynamics of retail consumption behavior may be expressed as:

$$c_i = \alpha_0 + \alpha_1 y_i + \alpha_2 w_i + u_i$$, \hspace{1cm} (6)

where $c_i$ is the log of real per capita total consumption, $y_i$ is the log of real per capita disposal income, $w_i$ is per capita expenditure, and $u_i$ denotes a random error term. Under these assumptions $c_i$, $y_i$, and $w_i$ are co-integrated, and $u_i$ is non-positive. In the process of measuring consumer behavior with reference to preference variables leading to price and non-price determinants, the dependent factor is the rate of change in consumption ($\Delta c_i$). In view of the above discussion, the dynamic consumption function that reflects the retail
consumer behavior for particular products may be estimated using equation (6) as:

$$\Delta_{ct} = \beta_0 + \beta_1(L)u_{t-1} + \beta_2(L)\Delta_{yt} + \beta_3(L)\Delta_{wt} + \beta_4(L)\Delta_{rt} + \epsilon_i,$$

where $\Delta$ is the change factor, $r$ is the concentration ratio of retail stores in a given location, and $\epsilon_i$ is a random error term. The test of this model requires time series data to be analyzed for trend values, taking $L$ as a polynomial log operator. It has been observed in previous studies that value-to-expenditure ratios increase consumer sensitivity in terms of purchase volumes and drive repeat buying decisions for regular and high-tech products (Carroll and Dunn, 1997). Belessiotis (1996) explains that the consumer confidence index, derived using value factors, forecasts more than changing expectations.

### 3.2 Consumer preference rationale and market demand

Each market operates in a predetermined consumer segment, defined by a vector of ideal store practices and referred to as a consumer’s type. A consumer’s type is a random draw from a distribution which is parameterized by his core benefit value, which is an element of a proper subset of $\{1, \ldots, R\}$. If a consumer’s core benefit value is $s$ then his type is a random draw from $\{s-E, \ldots, s+E\} \subset \{1, \ldots, R\}$ according to a uniform distribution where $E$ is a parameter discussed in greater detail below. The seeds for consumers in market $h$ are distributed according to a triangular density function over $\{s_h-G, \ldots, s_h+G\} \subset \{1, \ldots, R\}$. This construction of the distribution of consumer types is performed independently for each market. By this specification, markets differ according to the single parameter $s_h$, and the heterogeneity between markets $h'$ and $h''$ is measured as $|s_h - s_{h'}|$.

The parameter $E$ controls the degree of correlation in a consumer’s preferences—that is, the degree to which preferring particular values for one dimension implies that similar values tend to be preferred for other dimensions. If $E = 0$ then the consumer’s ideal
vector of store practices is an element of \{\{(1, ..., 1), ..., (R, ..., R)\}\}, so that consumers assign the same value to all dimensions. More generally, the lower \(E\) the greater is the correlation across dimensions. The reason for such a correlation is the presence of a few consumer traits—such as income, parents’ traits, and education—which influence preferences over a large set of dimensions. For example, people with higher income may not incur greater search costs (due to their higher valuation of time), so they would prefer everyday low prices with fewer sales. From the retailer’s perspective, fewer product lines and larger inventories reduce the chances of being out-of-stock of a product, causing the consumer to make another trip to the store or purchasing elsewhere.

Consumer decision-making with respect to which store to buy from and how much to buy from that store is assumed to depend only on the distance between the consumer’s ideal store practices and the actual store practices. We use Euclidean distance, which takes the form \(\sqrt{\sum(z_k - w_k)^2}\) for a consumer of type \(w \equiv (w_1, ..., w_N)\) and a store with practices \(z \equiv (z_1, ..., z_N)\). A consumer ranks stores according to this metric. Furthermore, it is assumed that the number of units demanded by a consumer equals

\[
A - \sqrt{\sum_{k=1}^{N}(z_k - w_k)^2} > 1 \quad (8)
\]

and such decisions are largely governed by the convenience factor associated with buying the products and services, where \(\sigma > 1\) and \(A \geq \sqrt{N(R-1)^2 + 1}\) so that \(A - \sqrt{\sum_{i}(z_i - w_i)^2} > 1\) for all \((w, z)\).

### 3.3 Consumer positioning

If a market \(h\) is served by the chains in \(\Phi_h\), each consumer has \(|\Phi_h|\) stores from which to choose. In any time period, a consumer shops from exactly one store but, as described below, he can change stores
over time. As stated above, consumers rank buying points according to the convenience of access and proximity to preferences. Thus, a consumer of type $w$ prefers a store with practices $z'$ to a store with practices $z''$ if and only if:

$$\sqrt{\sum_{k=1}^{N}(z'_k - w_k)^2} < \sqrt{\sum_{k=1}^{N}(z''_k - w_k)^2}.$$  \((9)\)

A consumer enters each period with a favorite buying place—that is, the place he currently most prefers. Associated with a favorite store is the consumer’s perception of the distance between the store and the consumer. Suppose chain $j$’s store in market $h$ is the favorite store of a consumer in market $h$. Furthermore, suppose the consumer last visited that store in period $t'$. The consumer’s perception of the distance to the store is specified as $\sqrt{\sum_{k=1}^{N}(z^{j,h}(t')_k - w_k)^2}$, where $z^{j,h}(t')$ is the store’s set of practices as of period $t'$.

The purchasing process proceeds as follows. In each period, a consumer buys from his favorite store with probability $1 - Q$. In that event, his favorite store remains unchanged though the perceived distance from that store is updated to reflect the current practices of the store. With probability $Q$, he engages in a search which involves randomly selecting a store from the rest of the stores in that market and then buying from that store. At the end of the period, the consumer compares the distance to the store just visited with the distance to his favorite store. If the former is larger then the consumer does not change his favorite store (nor the distance assigned to it). If the former is smaller then the consumer changes his favorite store to the store just visited and assigns to that store a distance based on the store’s current practices. It is assumed that the random variable determining whether consumer positioning is appropriate or not depends on the strength of existing consumers and the time interval including the search and purchase. If $Q = |\Phi_e| - 1/|\Phi_e|$, a consumer has no loyalty as the ex ante probability of buying from a predetermined place is the same. If $Q = 0$, the consumer is absolute
loyal as no experimentation occurs. Therefore, it may be assumed that

\[ Q \in [0, \frac{1}{\Phi_h} - 1/\Phi_h]. \]

This framework analyzes optimal portfolio choice and consumption with value management in the triadic firm-supplier-consumer relationship. The value concept in the above relationship governs the consumer portfolio decision in terms of the formulation of recursive utility over time. It shows that the optimal portfolio demand for products under competition varies strongly with the values associated with the brand, industry attractiveness, knowledge management, and ethical issues of the organization. The extent of business values determines the relative risk aversion in terms of functional and logistical efficiency between the organization and supplier, while the switching attitude may influence the consumers if the organizational values are not strong and sustainable in the given competitive environment. The model assumes that a high functional value integrated with the triadic entities raises the market power of the organization, sustains decisions of consumer portfolios, and develops long-run relationships thereof. The consumer value concept is used to assess product performance and to determine the competitive market structure and the product-market boundaries.

The model explains that the value-based consumer portfolios enhance consumer value as it represents product efficiency viewed from the consumer’s perspective, i.e., as a ratio of outputs that consumers obtain from a product relative to inputs that consumers deliver in exchange. The derived efficiency value can be understood as the return on the consumer’s investment. Products offering a maximum consumer value relative to all other alternatives in the market are characterized as efficient. Market partitioning is achieved endogenously by clustering products in one segment that are benchmarked by the same efficient peer(s). This ensures that only products with similar input-output structures are partitioned into the same sub-market. As a result, a sub-market consists of highly substitutable products.
Consumer values reflect competitive gains, perceived use values, purchase volume, and level of identification with the consumer. If these variables do not match consumer preferences, a switching attitude emerges. If the organizational values are low, the supplier relationship may be risk averse due to weak dissemination of values from organization to the suppliers.

4 Application Prospects in Management

The retail sales performance and the consumer value approaches are conceptually and methodically analogous. Both concepts calculate the value of a particular decision unit by analysis of forecasted attributes and risk-adjusted parameters. However, virtually no scholarly attention has been devoted to the question of whether these components of shareholder value could be determined in a more market-oriented way using individual consumer lifetime values. Systematically explored concepts in the field of consumer value and market-driven approaches would be beneficial for a company to derive a long-term profit optimization strategy. Hence, a comprehensive framework for estimating both consumer value and profit optimization needs to be developed.

On a tactical level, managers need to consider the optimum spread matrix of consumers. This requires careful attention and the application of managerial judgment and experience to measure the value-driven performance of the firm. It cannot be prescribed by a text. Managers should also be prepared to vary their management style in response to the analyses they prepare. For example, a different style may well be needed to deal with consumers who do not yield much profit and present high service costs. All of these points suggest that portfolio theory is a useful theoretical approach and that categorization and management of supplier-consumer relationships is valuable. The following applied portfolio attributes may be identified by companies in order to develop an optimal consumer value-profit matrix:
• High-Profitability: Consumers who have high actual and potential value, coupled with relatively low service costs.
• High-Potential: Consumers who have high potential value, medium actual value, and low service costs.
• Underperforming: Consumers who are currently unprofitable.

The consumer portfolio management process should then assist the creation of strategies to maximize returns on consumer relationships, either by portfolio or individual accounts.

5 Conclusion

Consumer value in terms of satisfaction is one of the indicators for building profit-oriented strategies in a firm. The consumer value concept may be applied by firms to evaluate product performance in a given market and to determine the optimal approach using competitive advantages. In order to gain the benefits of comprehensive consumer value, firms need to systematically estimate the profitability associated thereof. The ultimate goal of the firms may be to generate continual revenue streams by maintaining customer value. There appears to be a need for new research that advances consumer satisfaction and value measurement methodologies. The existing theoretical and methodological issues are reviewed in this study and a new framework has been proposed in this paper to measure consumer value. The framework for measuring consumer value discussed in this paper provides analytical dimensions to establish the long-run consumer relationship with the firm and to optimize profit levels.

References


