

# Growth without profit: explaining the internet transaction profitability paradox

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## Abstract

It has been frequently reported that a major problem of Internet business models is that they lack transaction profitability. The difficulty does not appear to be with the number of transactions (i.e. growth) but the problem of transaction profitability with low returns to online retailers. This paper explores the root causes of weak profitability on two levels. The first suggests an explanation derived from strategic level analysis. Within this analysis two models are used. The first is an explanation of how Internet businesses in general can lose bargaining power to other industry stakeholders. How this relative loss of bargaining power translates into reduced returns for Internet business models is discussed. The second strategic model is unique to this paper and seeks to explore a basis for mapping strategic positions that may yield superior returns for various generic Internet business models. In this way the strategic section of the paper provides both an analysis of the causes of the transaction profitability problem and then goes on to propose a generic strategic solution. The second level of theoretical analysis is operational. Here the paper develops two further models. The first links the unique attributes of the Internet to service outcomes and customer loyalty through a framework of “order winning” and “order qualifying” criteria. This theoretical framework provides a dynamic explanation of transaction profitability. The second operational model (called “the leaky bucket theory”) analyses transaction cycles to seek out both opportunities and risks to Internet based customer value creation. The theoretical section is illustrated by case data including EasyJet, Sainsbury’s and Mercedes Benz amongst others. The paper concludes with specific suggestions for Internet business managers that are designed to help them address the problem of low transaction profitability. This article draws on the early results of doctoral research being conducted at Templeton College and Said Business School, University of Oxford. This implies that the use of the case study examples is for illustrative purposes and this paper does not make claims of generalisability based on this early qualitative field data. © 2004 Elsevier Ltd. All rights reserved.

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## 1. A real problem for on-line retail businesses: growth without profit

This paper attempts to deal with two related problems: how to maximise returns from on-line transactions and how to increase the number of profitable on-line transactions. A successful business is made

up not only of individually profitable transactions but a sufficient number of them.

Nordan (2001) estimates that retail revenue online now accounts for half a percent of total retail sales worldwide. However, the underlying problem seems to lie in the fact that many retailers have so far failed to convert these revenues into profits. Consequently, global consumers spent €13 billion online and have tended to be the beneficiaries of the experience rather than retailers themselves. Fig. 1 shows how the economic surplus has been distributed, with retailers trailing other stakeholders. Retailers have experienced a cost saving of €1.2b, hardware and software companies with economic

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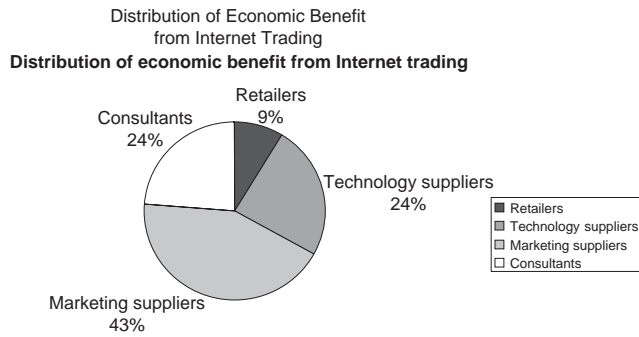


Fig. 1. Distribution of economic benefit from internet trading. Source: Nordan (2001).

surplus of €3.2b, and marketing spending of €5.5b and consulting spending of €3.2b. This shows a total net surplus of €13.1 billion between 1998 and 2000 (Nordan, 2001)

For this reason, the question that the majority of retail managers are currently facing is how to ensure on-line revenues generate higher profit per transaction?

According to Reichheld and Sasser (1990), the probability of an on-line business making above industry average profits per transaction is predicated upon the degree to which the transaction is perceived to be creating sufficient net value for the customer. As a result, poor transaction profitability will lead to poor return on investment which in turn leads to less profit to reinvest in creating value for customers. (Reichheld 1996; Reichheld and Sasser, 1990) suggested that creating value for customers builds loyalty and loyalty in turn builds growth, profit, and more value. Thus profit is a consequence of value creation which along with loyalty makes up the real heart of any successful, long lasting business. So unless browsers can be converted into buyers and be kept by creating value for them, online transactions will not be profitable and the problem of low returns to online retailers will remain.

This article will attempt to address this issue by seeking to understand the causes of the problem at both a strategic level and at an operational level. Models will then be developed in an attempt to provide a solution to the problem facing retail businesses.

## 2. Major causes of the problem of converting revenues into profits

### 2.1. Strategic level analysis

Porter’s (2001) model of the impact of the Internet on industry structure suggests how Internet businesses can lose bargaining power to other industry stakeholders. This model shows the five basic competitive forces that

determine the average rate of return in an industry (Fig. 2).

According to Porter’s model the problem of low transaction profitability has arisen because of a combination of the following: reduced barriers to information coupled to low cost access to a larger number of potential suppliers and increased threat of substitutes. In addition the Internet has reduced differentiation amongst products and services and consequently has switched the focus to price discounting (Porter, 2001).

As a result, the industry faces a much more competitive environment in which companies are operating and the long run return on invested capital will be affected. Given these changes some traditional business models of customer loyalty may not be applicable. In this case companies may need to deconstruct their value chains to adapt to this new Internet environment and develop new ways to create sustainable value for customers by attracting and converting browsers into buyers and by keeping them. Durability is also an issue due to the transparency capability of the Internet.

Porter’s model on “How the Internet Influences Industry Structure” is linked to the other models of this paper as it provides an analysis of the strategic nature of the problem of low transaction profitability. It is looking at the problem from a strategic point of view by considering the industry context before analysing the operational nature of the problem of low transaction profitability as demonstrated in Fig. 9.

This second strategic model unique to this paper seeks to provide an understanding of where various generic Internet businesses models are positioned now and then understanding where they should be in order to maximise their on-line transaction profitability. One way to achieve this is through the on-line profitability matrix shown in Fig. 3.

These are external measures of the firm against which consumers judge it. By examining the parameters of on-line transaction profitability we may be able to see whether factors such as pricing relative to other marketing channels, perceived non-price transaction benefit relative to other marketing channels and the durability of these benefits, work to enhance the firm’s ability to perform well on the order winning criteria. The model below seeks to do this, in attempting to develop insights into the likelihood that transactions generated by the on-line business marketing strategy will be profitable.

The matrix comprises three dimensions:

- The first dimension is that of the on-line pricing level relative to that of other marketing channels. This relative pricing lies on a continuum from high

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