Softening the 'Red Edge'

Last month, Coca-Cola formally applied to buy China Huiyuan Juice for $2.4 billion. The deal's fate is still in question -- it challenges Beijing's new anti-monopoly law that prohibits foreign companies buying majority stakes in large, successful Chinese companies. But Coke is also offering an attractive 300% premium that could tip the scales in its favor. No matter how this is resolved, however, the nature of the deal is exposing a fundamental difference that still exists in the capabilities of Chinese companies relative to their foreign peers.

A Coke acquisition of Huiyuan would fit an established pattern in China of foreign multinationals building market share in "high touch" businesses -- generally defined as industries where advertising expenditure as a percentage of revenues is high and where new consumer products, and new variations of existing products, are frequently brought to market. Large foreign companies are able to tap long, worldwide experience managing their brand images and gauging consumer tastes during product development.

That helps explain the logic of the Huiyuan bid from Coke's perspective. Coke would immediately augment its product line with Huiyuan's pure juices and nectars, which fetch higher prices than Coke's diluted juice products and offer better growth prospects than the maturing carbonated-beverages market segment. Meanwhile, it could piggyback marketing and distribution on its more than 200,000 retail outlets in China -- the kind of distribution and marketing it already does well.

Although it's not as much of an issue in the Coke case, foreign companies also still hold a significant edge in another broad industry type: businesses where research and development spending is high as a percentage of revenues. Despite the Chinese government's recent push in technology products, Chinese companies still struggle in this kind of industry, which includes pharmaceuticals, software and mobile phones. The experience of multinational Cummins in high-performance diesel engines illustrates how. It draws on its global network of research and production facilities to develop a range of engines Chinese makers cannot match. So as China tries to enforce new low-emissions regulations, few Chinese engine makers can meet them.

These examples challenge claims, much hyped during the Olympics especially, that Chinese companies will enjoy a "red edge" moving forward -- a home-team advantage in the growing Chinese market. Under this theory, Chinese consumers would increasingly favor local companies' brands over foreign competitors as these Chinese companies caught up to foreign companies' branding savvy and technology levels.
The reality is still very different. For one thing, foreign brands are not always so "foreign" in the eyes of today's Chinese consumer. Coca-Cola entered China's market in 1979, the first Western brand to do so after opening started. Cummins has long partnered with a local company, Dongfeng Motors -- a large truck maker and highly respected Chinese company that's now one of Cummins's largest customers globally.

Chinese companies, meanwhile, are certainly growing but they haven't yet acquired the skills that make their Western peers so successful in "high tech and high touch" industries. Chinese companies tend to lead industries where both the advertising and technology intensity are low. These are products like steel, home appliances, port handling cranes and shipping containers that are essentially mature products with limited scope to "build a better mousetrap." Local companies' competitive advantage is still their ability to produce and distribute large quantities of such products relatively cheaply.

Which isn't to demean these companies -- they're very good at what they do. Pearl River Piano, for example, is China's piano leader and its 100,000-pianos-per-year production capacity is the world's largest. Based in southern Guangzhou province where the first new rich of China emerged, Pearl River out-invested domestic rivals over 30 years, then in 2000 absorbed Ritmuller, an upscale German brand that has broadened Pearl River's reputation and price points. Pearl River is now the leader in the low end of the U.S. upright piano market and looks fairly unassailable.

Local heroes in China succeed in slower moving, less differentiated businesses by adapting mature products and production and distribution practices to the less-than-perfect conditions in their home market and by exploiting the large cost differences between China and advanced economies.

This way of thinking about sources of advantage in cross-border competition helps to visualize the interactions between foreign and local companies as a race toward the middle. In this race, foreign companies try to become more adapted to and reach deeper into China. Meanwhile, local challengers start expanding internationally to build brands and know-how while still trading on their cheap-production advantage at home.

China after nearly 30 years of opening has yet to produce star global consumer brands like Japan did at the same stage of its development with the likes of Sony, Toyota and Nikon. Industry is not, of course, always destiny. Some companies break this pattern, like, on the one hand, Otis, which leads China in elevators and elevator service, and, on the other, Huawei, which is breathing down the necks of global telecom equipment manufacturers. But in general, both Chinese and Western companies can carve out successful niches given the fundamental differences in expertise that remain between them.

So much for a "red edge" that would see Chinese companies pushing Western brands out of the market. The reality turns out to be that there's still room for both.

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