

HKEX GUIDANCE LETTER HKEX-GL36-12 (May 2012) <u>(Updated in February 2020)</u>	
Subject	<u>Guidance on due diligence to be conducted by the sponsor Distributorship business model - risks and disclosure in the listing documents relating to a distributorship business model</u>
Listing Rules and Regulations	Main Board Rules 2.13(2) and 11.07 GEM Rules 14.08(7) and 17.56(2)
Related Publications	N/A
Author	IPO Transactions Department
<p>Important note: <i>This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing <u>Department Division</u> on a confidential basis for an interpretation of the Listing Rules, or this letter.</i></p>	
<p>1. Purpose</p> <p>1.1 This document<u>letter provides guidance on due diligence to be conducted by the sponsors and discusses the Exchange’s observations on the risks involving distributions and gives guidance on how disclosure should be made</u> in the listing document <u>relating to material distributorships.</u></p> <p>1.2 <u>For investors to properly assess the quality of an applicant’s sales revenue, they need confidence that such sales revenue correlates to the market trend and actual end-customer demand. An applicant that sells its products to end-customers through multiple levels of third-party intermediaries may not be able to accurately assess end-customer demand as discussed below.</u></p> <p><u>2. Definition of distributors</u> <u>2. Relevant Listing Rules</u></p> <p>2.1 <u>In this letter, “distributors” refer to an applicant’s direct counterparties who contractually resell, or are reasonably expected to resell the applicant’s products, which include franchisees and consignees. Other intermediaries who purchase an applicant’s product from its distributors to resell are referred to as “sub-distributors”. For the avoidance of doubt, retail buyers who are not expected to further resell the applicant’s products would not normally be considered a distributor even if they occasionally resell the products to other parties. The sponsors should assess the substance of the applicant’s business relationship with its counterparties to identify the applicant’s distributors.</u>Main</p>	

~~Board Rule 2.13(2) (GEM Rule 17.56(2)) provides that the information contained in an issuer's document must be accurate and complete in all material respects and not be misleading or deceptive. In complying with this requirement, the issuer must not, among other things:~~

- ~~(a) omit material facts of an unfavourable nature or fail to accord them with appropriate significance;~~
- ~~(b) 2.1 present favourable possibilities as certain or as more probable than is likely to be the case.~~

~~2.2 Main Board Rule 11.07 (GEM Rule 14.08(7)) states that as an overriding principle, all listing documents must contain such particulars and information which, according to the particular nature of the issuer and the securities for which listing is sought, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer and of its profits and losses and of the rights attaching to such securities.~~

3. Risks

3.1 The type and level of risk depends on the level of control an applicant (or a distributor) has over its distributor (or sub-distributor). Risks arising from a distributorship business model include:

Channel Stuffing

3.2 If an applicant's distributors or sub-distributors are subject to mandatory sales targets and/ or unusually long return policies, there is a risk that the products are not reaching end-customers but remain in the applicant's distribution network.

3.3 Especially where there are minimum sales targets or requirements, the sponsors are expected to conduct due diligence to determine whether sales correspond to actual end-customer demand. The listing document should disclose the applicant's overall inventory control and management policy, including how the applicant monitors the inventory level of its distributors and the amount of unsold inventory held by distributors as at the end of each track record period and the latest practicable date.

3.4 In the absence of required sales targets, sales may still not accurately reflect actual demand if the applicant offers long or extensive return/refund terms. Sales recognized may be subsequently reversed if actual sales return is higher than the expected return rate.

3.5 The sponsors and the reporting accountants must examine the listing applicant's goods return policy and the amount of returned goods during the track record period. The above is not meant to be exhaustive and the sponsors and the reporting accountants should review all other relevant information as the situation may require.

Recoverability of Accounts Receivables

3.6 Long outstanding accounts receivables from distributors or sub-distributors may be another red flag. A substantial increase in aged accounts receivable and debtors' turnover days may also increase risk of receivables' recoverability and affect the liquidity and sustainability of the applicant's business.

3.7 In the event of the above, the applicant's directors and the sponsors are required to provide their views, with basis, on whether the applicant's credit management policy is appropriate. The applicant's directors and the reporting accountants must also substantiate their views as to adequacy of the provisions for accounts receivable. The listing document should include:

(i) a discussion on the recoverability of accounts receivable and the subsequent settlement of the balance as at the latest practicable date; and

(ii) the impact of the increase in accounts receivable and debtors' turnover days on the liquidity and cash flow of the applicant.

3.8 The sponsors should assess the risks discussed in paragraphs 3.2 to 3.7 above with respect to sub-distributors to the extent the applicant or its distributors can control the sub-distributors and conduct appropriate due diligence. The Exchange recognizes that an applicant may not be able to control its distributors or its sub-distributors in the absence of a written agreement. The listing document should include a discussion on the applicant's level of direct and indirect control over its distributors or sub-distributors and include a relevant risk factor.

1.4. General disclosure in listing documents requirement

~~3.14.1 The terms distributorship, franchising, and consignment cover a wide range of different business models. The use of these terms in a listing document is insufficient to convey the true nature of an applicant's business. Given that a seller an applicant may have different arrangements and degrees of control over their distributors, franchisees or consignees (referred to as "distributors" in this guidance), the consequential risks could be very different. An applicant must clearly explain its business model to enable investors to understand how revenue is generated. assess the risks of the distributorship business model:~~

~~3.2 The Exchange expects sponsors to have performed sufficient due diligence work in relation to the fairness and reasonableness of sales to distributors recorded during the track record period and to disclose in the listing document:~~

~~(a) the applicant's different distribution channels and their total revenue contribution during the track record period;~~

~~(b) the degree of control over distributors, in particular, with respect to compliance with the applicant's pricing policy, sales and avoidance of competition between different levels of distributors;~~

(i) the extent to which historical sales are non-recurring, the reasons therefor and the associated risk;

~~(e)(ii)~~ benefits and reasons of using the particular distributorship business model and whether it is an industry norm;

(iii) the applicant's different distribution channels and their respective revenue contribution during the track record period;

(iv) if the applicant is adopting a cannibalisation strategy, a discussion on the rationale for this strategy and its impact on the applicant's historical and expected financial performance;

(v) whether the distributor is an independent third party or has any other relationship with the applicant (e.g. the distributor is controlled by the applicant's former or current employees, uses the applicant's brand/name or has received any material advance or financial assistance from the applicant);

~~(d)(vi)~~ whether the applicant's relationship with the distributors is as a buyer/seller or as a principal/agent;

~~(e) the turnover rate of distributors and movements in the number of distributors during the track record period and reasons for the major changes;~~

~~(f) the amounts of sales to and goods returned from distributors during the track record period;~~

(vii) a discussion of the applicant's revenue recognition and ~~unsold~~ goods return/refund policies;

~~(g)(viii)~~ the principal terms of the distribution/consignment/franchise agreements such as: including whether there are any terms (a) requiring a minimum purchase amount or a minimum sales target, (b) restricting the appointment of sub-distributors; (c) that mandate selling price(s) to sub-distributor or end-customers; and (d) relating to a goods return policy and whether such policy is in line with industry practice. If not, disclose the number of sub-distributors (if any) during the track record period and the applicant's control (if any) over the sub-distributors; and

~~(h)~~ —

~~i. their duration;~~

~~ii. geographic or other exclusivity;~~

~~iii. the rights and obligations of parties involved;~~

~~iv. sales and pricing policies;~~

~~v. obsolete stock arrangements;~~

~~vi. goods return arrangements;~~

~~vii. sales and expansion targets;~~

~~viii. sales and inventory reports and estimates;~~

- ~~ix. any minimum purchase amounts;~~
 - ~~x. payment and credit terms; and~~
 - ~~xi. conditions for terminating and renewing the agreements.~~
- ~~(i) the turnover rates and movement in the number of distributors during the track record period and reasons for any major changes.~~

~~3. Areas of concern~~

~~4.1 Concerns arising from business models that involve sales of goods or services through multi-level distributors are:~~

~~*Inventory risk remains with applicant*~~

~~4.2 While a sharp increase in sales during the track record period may indicate a vibrant business, there is a risk that these are artificially pumped-up sales unsustainable by an actual rise in demand from ultimate end-users. Goods may be shipped to distribution channels and not to end customers (channel stuffing). The excess inventory may be stocked in multiple warehouses and retail outlets throughout the distribution chain over which the applicant has no information and control, thereby making it difficult to determine and manage the amount of excess inventory.~~

~~4.3 A minimum purchase condition in the applicant's distribution agreement with its distributors may be translated into a risk of inventory accumulation.~~

~~4.4 The presence of one or more features may require delay in revenue recognition:~~

- ~~• the applicant retains significant risks of ownership although legal title has been passed to the distributors;~~
- ~~• sales to distributors on a "right of return" basis and payment is delayed or otherwise different from typical sales agreements;~~
- ~~• the applicant is required to repurchase the product at a price with adjustment that covers the distributor's cost of holding the product, including financing cost; and~~
- ~~• the applicant guarantees a minimum resale value.~~

~~(ix) 4.5 The sponsors and the reporting accountants must reasonably believe that the revenue recognition is appropriate in the applicant's case. When making the assessment, the applicant's returned goods policy and the amount of returned goods must be examined.~~

~~*Cannibalisation*~~

~~4.6 An aggressive growth in sales can be achieved by sales made to a rapidly increasing number of distributors. However, these distributors have to share the market and to compete with each other. Profits arising from royalty payments, if any, received from distributors for initial set up may not be sustainable if there are too many distributors in the market.~~

~~4.7 The sponsors must reasonably believe that the applicant's revenue is not the result of cannibalisation among distributors. The turnover of distributors during~~

~~the track record period, including the reasons for their termination or replacement, must be carefully assessed and stated in the listing document to enable investors to appreciate the sustainability of the business.~~

~~**Recoverability of accounts receivables**~~

~~4.8 Where a substantial increase in sales is coupled with a substantial increase in accounts receivable and debtors' turnover days, issues arise about the recoverability of these receivables and the sustainability of the applicant's business.~~

~~4.9 In light of a persistent increase in accounts receivables and debtors' turnover days in the track record period, the applicant's directors and the sponsors are required to provide their views, with basis, on whether the applicant's credit management policy is appropriate and the provisions for trade receivables are adequate. The listing document should include:~~

- ~~• a commentary on the recoverability of accounts receivable and the subsequent settlement of the balance as at the latest practicable date; and~~
- ~~• the impact of the increase in accounts receivable and debtors' turnover days on the liquidity and cash flow of the applicant.~~

~~**Independence of distributors**~~

~~4.10 Goods may be sold to (i) distributors or sales representatives who were previously employees of the applicant or (ii) sales partners who trade under the applicant's name. This gives rise to uncertainty as to the independence of customers and the authenticity of sales.~~

~~4.11 For instance, in one case, the applicant encouraged its employees to become its independent distributors during the track record period. The Exchange raised concerns on the independence of these distributors. The sponsor confirmed, after performing its due diligence, that the sales to these distributors had been on normal commercial terms which were fair and reasonable to the applicant and consistent with the terms offered to other non-employee distributors, that no employees had acted as distributors while still being employees and that it would cease this practice after listing. Full disclosure was made in the listing document.~~

~~4.12 In another case, the applicant distributed its products either directly through its own sales representatives who were part-time employees or indirectly through its sales partners that were corporate entities using the applicant's name in their trading. Some of the applicant's sales representatives or their associates also held equity interests in the sales partners. The Exchange suggested that the applicant should clearly delineate its sales between the sale representatives and the sales partners.~~

~~4.13 In addition to the general disclosure for applicants with distributorship models, the applicant's listing document should contain:~~

- ~~• the terms of the agreement with the sales partners, including conditions of use of the applicant's name;~~
- ~~• measures to address the potential conflict of interests between the sales representatives and the sales partners;—~~
- ~~• internal controls and corporate governance measures to monitor the applicant's sales activities to detect potential abuses; and~~
- ~~• management of the sales partners using the applicant's trading name and the associated risks that the applicant's overall business could be adversely affected by improper use of the applicant's name by the sales partners.~~

5. Distribution through social media platforms

5.1 With the rise of social media platforms and key opinion leaders (KOLs) as a means to promote and sell goods, an applicant may have hundreds or even thousands of buyers who may be distributors or end customers. Depending the level of control an applicant may have on these social media platforms and KOLs, the sponsors should perform sufficient due diligence as they deem appropriate to address the risks discussed above and comply with the Code of Conduct and Practice Note 21.