

HKEX GUIDANCE LETTER HKEX-GL36-12 (May 2012) (Updated in February 2020) <u>[Streamlined and incorporated into the Guide for New Listing Applicants in January 2024]</u>	
Subject	Guidance on due diligence to be conducted by the sponsor and disclosure in the listing document relating to a distributorship business model
Listing Rules and Regulations	Main Board Rules 2.13(2) and 11.07 GEM Rules 14.08(7) and 17.56(2)
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<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 Division on a confidential basis for an interpretation of the Listing Rules, or this letter.</i></p>	
<p>1. Purpose</p> <p>1.1 This letter provides guidance on due diligence to be conducted by the sponsors and disclosure in the listing document relating to material distributorships.</p> <p>1.2 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.</p> <p>2. Definition of distributors</p> <p>2.1 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.</p> <p>3. Risks</p> <p>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:</p> <p>Channel Stuffing</p> <p>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.</p>	

- 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.

4. General disclosure requirement

- 4.1 Given that an applicant may have different arrangements and degrees of control over its distributors, the consequential risks could be very different. The following disclosure should be included in the listing document to enable investors to assess the risks of the distributorship business model:

- (i) the extent to which historical sales are non-recurring, the reasons therefor and the associated risk;
- (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);
- (vi) whether the applicant's relationship with the distributors is as a buyer/ seller or principal/ agent;
- (vii) a discussion of the applicant's revenue recognition and goods return/ refund policies;
- (viii) the principal terms of the distribution/ consignment/franchise agreements, 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
- (ix) the turnover rates and movement in the number of distributors during the track record period and reasons for any major changes.

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.