

HKE_x GUIDANCE LETTER
HKE_x-GL36-12 (May 2012)

Subject	Distributorship business model - risks and disclosure in listing documents
Listing Rules	Main Board Rules 2.13(2) and 11.07 GEM Rules 14.08(7) and 17.56(2)
Related Publications	N/A
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Important note: *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.*

1. Purpose

1.1 This document discusses the Exchange’s observations on the risks involving distributorships and gives guidance on how disclosure should be made in the listing document.

2. Relevant Listing Rules

2.1 Main 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) 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. General disclosure in listing documents

3.1 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 sellers 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 in the listing document its business model to enable investors to understand how revenue is generated.

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;
- (c) the benefits of using the particular distributorship model and whether it is an industry norm;
- (d) whether the applicant's relationship with the distributors is seller/buyer or 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;
- (g) a discussion of the applicant's revenue recognition and unsold goods return policies;
- (h) the principal terms of the distribution/consignment/franchise agreements such as:
 - 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.

4. 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.
- 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.
