2013 Annual Report

China Nepstar Chain Drugstore Ltd.

Quality assurance Professional service Customer satisfaction

海王星辰 NEPSTAR DRUGSTORE

Quality assurance
Professional service
Customer satisfaction

TABLE OF CONTENTS

PAGE

LETTER FROM CHAIRMAN

Dear Shareholders,

Our strategy continued to deliver results in 2013. We have steadily improved sales momentum and strengthened customer relationships in a challenging retail environment. I am pleased to report our achievement of over 10% growth in same store sales and a nearly 6% increase in revenue for fiscal 2013. Our constant focus on product mix, store transaction efficiency and increasing foot traffic are working. We successfully strengthened our marketing and promotional efforts, introduced loyal member reward shopping programs and improved our range of product offerings.

We have taken a balanced approach to growth in order to remain competitive. The overall Chinese consumer market remains attractive, however the drugstore market continues to stagnate largely due to the control of hospitals over the lion's share of drug disbursement. Productivity of our existing store network is a priority. In 2013, we further streamlined Nepstar's operations by closing 188 underperforming stores and only gradually increasing new store openings, as new stores generally incur high initial costs, but generate lower revenues during their first two years of operations. We also undertook a more targeted approach to new store openings, locating our 122 newly built stores in well-established residential communities of well-developed cities in China.

Our efforts to expand and enhance Nepstar's product portfolio have also yielded success. We increased sales in the category of prescription and OTC drugs from 59.5% of total revenue in 2012 to 61.5% of total revenue in 2013. Private label product offerings rose from 2,019 at the end of 2012 to 2,104 at the end of 2013. We continue to optimize our product lines in non-pharmaceutical categories and significantly expanded offerings in the convenience and other product categories, where we have successfully procured top quality products with the best value for our customers.

2013 was also a year of more proactive marketing strategies, which have propelled growth in revenues and improved store traffic. Our average daily store traffic increased to 77 visits, up from 67 in 2012. This approach has impacted our near-term gross margin and profitability, however we believe it will balance out in the longer-term as store productivity continues to improve and our loyalty programs create more repeat customers.

Our stringent cost control measures have enabled us to manage operating expenses during current inflationary concerns. We managed to further shrink total operating expenses down to 42.5% in 2013 from 44.2% in 2012. We continue to be challenged by pricing in the pharmaceutical sector due to regulation by the Chinese government of retail pharmaceutical product prices in an effort to maintain social stability. As a result, our gross margin reduced to 43.7% from 46.3% in 2012.

Our commitment to enhancing shareholder value remains constant. In November 2013, we announced a special cash dividend of US$0.32 per ADS, which represents a total value to shareholders of approximately US$32 million.

As we move further into 2014, we will continue to balance revenue growth with store network improvement. Our objective is to capitalize on our existing extensive store network, customer loyalty and constantly improving product mix to achieve improved economies of scale and leverage operational efficiencies to improve margins.

On behalf of 14,017 Nepstar employees and millions of customers in 77 cities throughout China, we thank our shareholders for their ongoing support.

Sincerely,

Simin Zhang
Chairman
China Nepstar Chain Drugstore

You should read the following discussion and analysis of our corporate background, competition landscape, financial condition and results of operations in conjunction with our consolidated financial statements included elsewhere in the annual report on Form 20-F filed with Securities and Exchange Commission. This discussion may contain forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under "Risk Factors" or in other parts of the Form 20-F.

Introduction

This annual report on Form 20-F includes our audited consolidated financial statements for the years ended December 31, 2013, as well as December 31, 2009, 2010, 2011, 2012 and 2013.

We completed the initial public offering of 23,718,750 ADSs, each representing two ordinary shares, in November 2007. On November 9, 2007, we listed our ADSs on the New York Stock Exchange under the symbol "NPD."

Selected Financial Data

The following selected consolidated statement of comprehensive income data for the years ended December 31, 2011, 2012 and 2013 and selected consolidated balance sheet data as of December 31, 2012 and 2013 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The following selected consolidated statement of comprehensive income data for the years ended December 31, 2009 and 2010 and selected consolidated balance sheet data as of December 31, 2009, 2010 and 2011 have been derived from our audited consolidated financial statements not included in this annual report. You should read the selected consolidated financial data in conjunction with our consolidated financial statements included in this annual report and Operating and Financial Review and Prospects. Our consolidated financial statements are prepared and presented in accordance with United States generally accepted accounting principles, or U.S. GAAP. Our historical results are not necessarily indicative of our results expected for any future periods.

	Year Ended December 31,					
	2009	2010	2011	2012	2013	
	RMB	RMB	RMB	RMB	RMB	US$
	(in thousands, except share and per share data)					
Consolidated Statement of Comprehensive Income Data						
Revenue	2,217,613	2,356,604	2,491,290	2,549,856	2,699,103	445,860
Gross profit	1,074,215	1,163,939	1,188,637	1,180,544	1,178,307	194,642
Sales, marketing and other operating expenses (1)	(858,072)	(985,510)	(1,015,165)	(1,011,695)	(1,026,798)	(169,615)
General and administrative expenses (2)	(105,652)	(128,196)	(120,671)	(115,734)	(121,542)	(20,077)
Income from operations	110,491	21,270	38,637	46,946	22,983	3,796
Gain on disposal of an equity method investee (3)	—	—	—	68,440	—	—
Net income attributable to China Nepstar Chain Drugstore Ltd.	139,976	16,508	35,933	90,092	11,828	1,954
Earnings per share						
Basic	0.67	0.08	0.17	0.45	0.06	0.01
Diluted	0.66	0.08	0.17	0.45	0.06	0.01
Shares used in computation						
Basic	208,215,802	209,550,935	206,127,305	199,198,962	197,446,940	197,446,940
Diluted	210,655,820	210,406,560	206,377,682	199,263,363	197,446,940	197,446,940

(1) Sales, marketing and other operating expenses included share-based compensation expenses of RMB73,000 in 2009, RMB18,000 in 2010, nil in 2011, 2012 and 2013.

(2) General and administrative expenses included share-based compensation expenses of RMB2.9 million in 2009, RMB5.8 million in 2010, nil in 2012 and nil in 2013. In 2011, 600,000 unvested share options granted to a former executive officer were forfeited. As a result, the corresponding share-based compensation costs recognized in previous year for the unvested share options were reversed and an amount of RMB1.2 million was credited to general and administrative expenses for 2011.

(3) On December 28, 2012, we disposed of our 40.0% ownership in JZJ which had been accounted for under the equity method.

	As of December 31,					
	2009	2010	2011	2012	2013	
	RMB	RMB	RMB	RMB	RMB	US$
			(in thousands)			
Consolidated Balance Sheet Data						
Cash, cash equivalents and other bank deposits	666,012	1,139,796	810,885	608,356	545,586	90,124
Restricted cash	765,000	5,000	—	36,000	37,000	6,112
Held-to-maturity investment securities	400,000	—	—	—	—	—
Inventories	369,775	433,265	437,058	478,483	551,783	91,148
Accounts receivable, net of allowance for doubtful accounts	72,561	83,722	102,937	114,601	131,984	21,802
Prepayments for purchase of merchandise paid to related parties	38,102	—	—	—	—	—
Total current assets	2,469,817	1,805,442	1,480,369	1,394,650	1,442,272	238,246
Property and equipment, net	204,710	192,019	141,817	120,237	123,183	20,348
Long-term bank time deposits	—	—	169,000	20,000	40,256	6,650
Total assets	2,820,576	2,153,109	1,942,197	1,644,011	1,727,115	285,299
Accounts payable	313,794	313,773	352,386	356,095	403,558	66,663
Amounts due to related parties	12,533	24,461	18,169	18,381	29,247	4,831
Total current liabilities	995,202	548,186	527,818	555,807	808,494	133,554
Total non-current liabilities	47,642	35,716	60,125	62,101	73,095	12,074
Total shareholders' equity	1,777,732	1,569,207	1,354,254	1,026,103	845,526	139,671

Exchange Rate Information

This annual report on Form 20-F contains translations of certain Renminbi amounts into U.S. dollar amounts at specified rates. Unless otherwise noted, all translations from Renminbi to U.S. dollars and from U.S. dollars to Renminbi in this annual report were made at the rate of RMB6.0537 to US$1.00, the exchange rate as set forth in the weekly H.10 statistical release of the Federal Reserve Board of the United States as of December 31, 2013. We make no representation that the RMB or U.S. dollar amounts referred to in this annual report could have been or could be converted into U.S. dollars or RMB, as the case may be, at any particular rate or at all. Fluctuations in the exchange rates of the Renminbi may have a material adverse effect on your investment" and "—Governmental control of currency conversion may affect the value of your investment" for discussions of the effects of fluctuating exchange rates and currency control on the value of our ADSs. On April 18, 2014, the exchange rate as published by the Federal Reserve Board of the United States was RMB6.2240 to US$1.00.

The following table sets forth information concerning exchange rates between the RMB and the U.S. dollar for the periods indicated.

Period	RMB per U.S. Dollar Exchange Rate (1) Period End	Average (2)	Low	High
	(RMB per US$1.00)			
2009	6.8259	6.8307	6.8470	6.8176
2010	6.6000	6.7696	6.8330	6.6000
2011	6.2939	6.4630	6.6364	6.2939
2012	6.2301	6.2990	6.3879	6.2221
2013	6.0537	6.1412	6.2438	6.0537
October	6.0943	6.1032	6.1209	6.0815
November	6.0922	6.0929	6.0993	6.0903
December	6.0537	6.0738	6.0927	6.0537
2014				
January	6.0590	6.0509	6.0600	6.0402
February	6.1448	6.0816	6.1448	6.0591
March	6.2117	6.1707	6.2273	6.1183
April (through April 18)	6.2240	6.2121	6.2240	6.1966

(1) For all periods the exchange rate refers to the rate as set forth in the weekly H.10 statistical release of the Federal Reserve Board of the United States.

(2) Annual averages are calculated from month-end rates. Monthly averages are calculated using the average of the daily rates during the relevant period.

History and Development of the Company

China Nepstar is incorporated in the Cayman Islands. Our principal executive offices are located at 6th Floor, Tower B, Xinnengyuan Building, Nanhai Road, Nanshan District, Shenzhen, Guangdong Province 518054, People's Republic of China. Our telephone number is (86) 755-2643-3366 and our website is www.nepstar.cn. The information contained on our website is not a part of this annual report. Our agent for service of process in the United States is CT Corporation System, located at 111 Eighth Avenue, New York, New York 10011.

Our predecessor, Nepstar Pharmaceutical, was founded in June 1995 by the Neptunus Group, a PRC company established and controlled by Simin Zhang, the chairman of our board of directors. In January 1998, the Neptunus Group established Shenzhen Nepstar Health Chain Stores Ltd., or Nepstar Health, as a holding company for Neptunus Group's equity interests in Nepstar Pharmaceutical with the aim of building a nationwide drugstore chain in China. Prior to the restructuring in 2004, Nepstar Health was 93.0% owned by the Neptunus Group and 7.0% owned by the management team of Nepstar Health, and Nepstar Pharmaceutical was 85.0% owned by Nepstar Health and 15.0% owned by the management team of Nepstar Health.

In connection with a restructuring of the Nepstar group companies in 2004 as part of an effort to raise capital from investors outside of China, Nepstar Health and the management team of Nepstar Health established Nepstar Commerce and Nepstar Electronic in August 2004, and transferred their entire equity interests in Nepstar Pharmaceutical to Nepstar Commerce and Nepstar Electronic, respectively. After this transfer, Nepstar Pharmaceutical became 65.0% owned by Nepstar Commerce and 35.0% owned by Nepstar Electronic. Concurrently, Nepstar Health also transferred the equity interests it held in the regional Nepstar companies to Nepstar Commerce and Nepstar Electronic.

On August 13, 2004, Mr. Simin Zhang incorporated China Neptunus Drugstore Holding Ltd. in the British Virgin Islands, or Neptunus BVI, and on August 20, 2004, Neptunus BVI incorporated China Nepstar in the Cayman Islands. Upon incorporation, China Nepstar issued 115 million ordinary shares, of which 107.8 million shares, or 93.7%, were issued to Neptunus BVI. The remaining shares were issued to China Star Chain Ltd., or China Star Chain, a British Virgin Islands company beneficially owned by management team of Nepstar Health. China Nepstar became the holding company of the Nepstar group companies after it acquired all outstanding equity interests in Nepstar Commerce and Nepstar Electronic from their respective shareholders in September 2004.

On October 6, 2004, China Nepstar entered into an agreement with five institutional investors affiliated with The Goldman Sachs Group, Inc., or the GS Funds, pursuant to which China Nepstar issued an aggregate of 30,000,000 and 20,000,000 of Series A redeemable convertible preferred shares to the GS Funds on October 6, 2004 and December 1, 2005 for cash consideration of US$15.0 million and US$10.0 million, respectively. Immediately upon the completion of the Series A private placement, the GS Funds, Neptunus BVI and China Star Chain owned 30.3%, 66.06% and 3.64% equity interest in China Nepstar, respectively, on an as-converted basis.

Since our inception, we have conducted our operations in China primarily through Nepstar Pharmaceutical, which became a wholly foreign-owned enterprise in China in August 2004 as the result of our restructuring in 2004. As applicable PRC laws, rules and regulations effectively limit any foreign investor's ownership of drugstores to 49.0% if the investor owns interests in more than 30 drugstores in China that sell a variety of branded pharmaceutical products sourced from different suppliers, we undertook another restructuring in May 2007. In connection with the May 2007 restructuring, Nepstar Commerce, Nepstar Electronic and Nepstar Pharmaceutical transferred all or part of their equity interests in regional Nepstar companies to two newly established PRC companies, Shenzhen Nepstar Information & Technology Service Co., Ltd., or Nepstar IT Service, and Shenzhen Nepstar Management Consulting Co., Ltd., or Nepstar Management Consulting, which are wholly owned by Liping Zhou and Feng Tu, respectively. Liping Zhou and Feng Tu are both employees of our company and PRC citizens. After we completed our restructuring in May 2007, neither Nepstar Commerce nor Nepstar Electronic retained any direct ownership interest in any of the regional Nepstar companies.

On November 9, 2007, our ADSs were listed on the New York Stock Exchange.

On May 19, 2008, Nepstar Pharmaceutical entered into a Transfer Agreement with Pacific Gateway Capital Company Ltd. to sell the 51.0% of equity interest it owns in Medicine Shoppe for RMB2.5 million in cash. The carrying value of our share of Medicine Shoppe's net assets was RMB2.3 million as of March 31, 2008.

In January 2009, our board of directors approved the termination of a voting rights agreement which had assigned 30% of the total voting rights of JZJ to us. JZJ's other shareholders have expressed an intention to pursue the listing of the portion of the equity interest they hold in JZJ on the Shenzhen Stock Exchange in three years through a holding company. As of December 31, 2008, JZJ had 355 drugstore outlets, all of which were located in Yunnan province in southwestern China. We disposed of our 40% ownership in JZJ on December 28, 2012. As a result, during the period from the first quarter of 2009 to the time of disposal of our ownership in JZJ, JZJ had not been our consolidated subsidiary and had been accounted for under the equity method.

In August 2009, we established Fuzhou Nepstar Chain Co., Ltd., or Fuzhou Nepstar, with Nepstar Pharmaceutical holding 49.0% and Nepstar IT Service and Nepstar Management Consulting holding the remaining 51.0% of the equity interest.

In December 2009, we formed Nepstar E-Commerce as a subsidiary of Nepstar Pharmaceutical to operate our e-commerce business. On May 20, 2010, Nepstar Pharmaceutical entered into transfer agreements with Nepstar IT Service and Nepstar Management Consulting, respectively, to transfer to each a 50.0% equity interest in Nepstar E-Commerce. In August 2011, we changed the operator of our e-commerce business from Nepstar E-Commerce to Shenzhen Nepstar. As of January 28, 2013, Shenzhen Nepstar obtained all the licenses which are required for the operation of our e-commerce business. We launched a pilot version of our e-commerce website in November 2010. In January 2011, we launched our official e-commerce website, www.star365.com. On October 1, 2011, we began selling over-the-counter drugs through the website.

In August 2011, we transferred our 100% equity interest in Shenzhen Nepstar Industrial Co., Ltd., or Nepstar Industrial, to the Neptunus Group, for cash consideration of RMB20.0 million (US$3.2 million). Such divestment simplified our corporate structure with no impact on our financial position or business, as we had not conducted any operations under Nepstar Industrial since its establishment in 2009.

In July 2013, we established Shenzhen Nepstar Group Siping Northeast Co., Ltd. in Siping City, solely owned by Shenzhen Nepstar.

We currently operate our drugstore business in China through a series of contractual arrangements Nepstar Pharmaceutical entered into with Nepstar IT Service, Nepstar Management Consulting and their shareholders to retain control over the regional Nepstar companies, including Fuzhou Nepstar, and Nepstar E-Commerce, as well as to retain the economic risks and rewards of these entities.

Although we have been advised by our PRC counsel, Beijing Kang Da Law Firm, that based on their understanding of the current PRC laws, rules and regulations, the structure for operating our business in China (including our corporate structure and contractual arrangements with the regional Nepstar companies, Nepstar E-Commerce, Nepstar IT Service and Nepstar Management Consulting and their respective shareholders) complies with all applicable PRC laws, rules and regulations, and does not violate, breach, contravene or otherwise conflict with any applicable PRC laws, rules or regulations, we cannot assure you that the PRC regulatory authorities will not determine that our corporate structure and contractual arrangements violate PRC laws, rules or regulations. If the PRC regulatory authorities determine that our contractual arrangements are in violation of applicable PRC laws, rules and regulations, our contractual arrangements will become invalid or unenforceable. If the PRC regulatory bodies determine that the agreements that establish the structure for operating our business in China do not comply with applicable PRC regulatory restrictions on foreign investment, we could be subject to severe penalties."

In 2011, 2012 and 2013, our capital expenditures totaled RMB32.8 million, RMB35.0 million and RMB47.2 million (US$7.8 million), respectively. In the past, our capital expenditures were used primarily to open drugstores, acquire drugstores through business combinations, set up distribution centers and install and upgrade our integrated information management system. We estimate that our capital expenditures in 2014 will range from approximately RMB50.0 million to RMB80.0 million, which we plan to use for setting up new stores and distribution centers as well as upgrading our information management system.

Business Overview

We are a leading retail drugstore chain in China, with a network of 2,066 directly operated drugstores spanning 77 cities across 14 provinces and direct-controlled municipalities in China as of December 31, 2013. We believe we have succeeded in building a national retail drugstore chain with an extensive footprint in China and we have the leading market position in a number of the most developed cities in China, including Shenzhen, Dalian, Hangzhou, Ningbo, and Guangzhou, in terms of store count.

We provide our customers with high-quality, professional and convenient pharmacy services and a wide variety of other merchandise, including over-the-counter drugs, nutritional supplements, herbal products, personal care products, family care products, as well as convenience products including consumable, seasonal and promotional items. Unlike most other drugstores and retail drugstore chains in China, we also offer private label products, which we believe distinguishes our company from our key competitors. We launched our first private label products in September 2005 and offered 2,104 private label products as of December 31, 2013. Sales of our private label products accounted for 23.5% of our revenue and 31.8% of our gross profit in 2013.

We also operate an Internet website, www.star365.com, where online shoppers can purchase over-the-counter drugs, nutritional supplements, herbal products, personal care products, reproductive health products and household convenience products, among other products. Online sales accounted for 2.4% of our revenue and 1.1% of gross profit in 2013.

Our Store Network

We are a leading retail drugstore chain in China based on the number of directly operated stores, with a store network comprising 2,066 directly operated stores as of December 31, 2013. We operate all of our stores directly, which we believe is critical in building a strong brand name and offering a more consistent customer experience across our store network. Moreover, we believe direct operation of our drugstores is very important to our success in the retail drugstore chain business in China, given the highly fragmented market, the relatively small size of other retail drugstore chains and their short operating histories. Through a decade of direct operating experience, we have developed standards among various aspects of drugstore operations in order to provide a high quality of services in all of our stores. Direct operation also enables us to better select store locations that meet the consumer traffic requirements, target new neighborhoods and allows us to leverage our existing distribution centers. In addition, our direct operation business model allows us to operate a relatively centralized and streamlined organizational structure, which enables us to expedite decision making and thus deploy our financial, operational and management resources more effectively. Furthermore, our business model also allows us to address local demand for specific products and services more accurately, to control our corporate overhead expenses and to provide uniform and high-quality training for our employees.

We carefully select our store sites to maximize consumer traffic, store visibility and convenience for our customers. Substantially all of our stores are located in well-established urban residential communities in 77 cities in China, where living standards and consumer purchasing power are generally higher than in rural areas. The following table sets forth the number of stores we owned and operated as of the dates indicated in the following top ten cities that we operated in as of December 31, 2013:

	As of December 31,		
City	2011	2012	2013
Shenzhen	387	344	329
Dalian	196	197	203
Hangzhou	173	158	145
Ningbo	170	141	126
Guangzhou	145	132	120
Qingdao	119	104	93
Weifang	89	82	84
Suzhou	91	78	82
Chengdu	85	77	79
Tianjin	108	78	74
Others	832	741	731
Total	2,395	2,132	2,066

The following table provides a history of our store openings and acquisitions as of the dates indicated:

	As of December 31,		
	2011	2012	2013
Number of stores at the beginning of the period	2,547	2,395	2,132
Acquired stores during the period	1	—	—
Stores closed/disposed of during the period	228	319	188
New stores opened during the period	75	56	122
Number of stores at the end of the period	2,395	2,132	2,066

Our stores are typically between 80 and 120 square meters in floor area, and conduct business from 8:30 a.m. to 10:30 p.m., seven days a week. Our stores are generally staffed with three employees per shift, including an in-store pharmacist, who in many cases also functions as the store manager, and two healthcare consultants. Our in-store pharmacists assist with the sales of prescription drugs, and each member of our store staff has received training regarding our products as well as how best to interact with customers. In addition, we regularly carry out training programs on medicinal information, nutritional information, selling skills for our store staff and pharmacists, as well as management training for our regional managers and senior management officers at our headquarters.

We are the first retail drugstore chain in China to sell over-the-counter drugs on open shelves. Consumers have easy access to all products we sell except prescription drugs, and we aim to provide them with a relaxing, clean and bright shopping environment to improve their shopping experience. We have also developed a uniform and distinctive layout, color scheme and design specification for our drugstores. We believe that the use of a uniform layout, color scheme and design promotes our corporate image and enhances the public perception of our brand.

Our Products and Services

We provide our customers with high-quality, professional and convenient pharmacy services and a wide variety of other merchandise, including over-the-counter drugs, nutritional supplements, herbal products, personal care products, family care products, as well as convenience products including consumable, seasonal and promotional items. We have rigorously analyzed a large number of drugs available for sale in China, and have concluded that a much smaller quantity of active ingredients are present in a significant majority of drugs purchased by our consumers. Accordingly, we have selected a diverse range of medicines based upon these ingredients which we believe drive consumer demand. Our typical store carries approximately 1,900 to 2,500 different products. We constantly review and refine our product selection in order to respond to changing demographics, lifestyles, habits and product preferences of our customers. Our product selection is designed to offer choices and convenience to our customers and to achieve high gross margins for us.

Product Offerings

Our merchandise can be broadly classified into the following categories:

Prescription Drugs. We offer approximately 2,883 prescription drugs. We accept prescriptions only from licensed health care providers and do not prescribe medications or otherwise practice medicine. Our in-store pharmacists verify the validity, accuracy and completeness of all prescription drug orders. We request that all prescription drug customers provide us with information regarding drug allergies, current medical conditions and current medications. Our in-store pharmacists also perform a drug utilization review in which they cross-check every prescription against the customer's submitted information for drug, disease and allergy interactions. Sales of prescription drugs accounted for 22.3% of our revenue in 2013.

Over-the-Counter Drugs. We offer approximately 2,996 over-the-counter drugs, including western medicines and traditional Chinese medicines, for the treatment of common diseases. Sales of over-the-counter drugs accounted for 39.2% of our revenue in 2013.

Nutritional Supplements. We offer approximately 523 nutritional supplements, including a variety of healthcare supplements, vitamins, minerals and dietary products. Nutritional supplements normally generate higher gross margins than prescription and over-the-counter drugs. Sales of nutritional supplements accounted for 14.5% of our revenue in 2013.

Herbal Products. We offer various types of drinkable herbal remedies and packages of assorted herbs for making soup, which are used by consumers as health supplements. Herbal products typically have higher gross margins than prescription and over-the-counter drugs. Sales of herbal products accounted for 4.1% of our revenue in 2013.

Other Products. Our other products include personal care products such as skin care, hair care and beauty products, family care products such as portable medical devices for family use, birth control and early pregnancy test products, and convenience products, including soft drinks, packaged snacks, cleaning agents and stationery. Our other products also include seasonal and promotional items tailored to local consumer demand for convenience and quality. In May 2010, we began to further expand our product offerings by introducing general merchandise and consumables, primarily in the following categories: convenience foods, produce, household cleaning and laundry products, and mother and baby products. We believe that offering these products and consumables increases the amount that customers spend per visit by meeting growing demand for one-stop shopping convenience, and helps mitigate the negative impact of ongoing healthcare reform and government policies, which have caused price reductions to pharmaceutical products on the national Essential Drug and Reimbursement Lists. Sales of other products accounted for 19.9% of our revenue in 2013.

Private Label Products

We launched our first private label product in September 2005, and since then our private label portfolio has increased to 2,104 products marketed under 160 private labels, covering all categories of products we offer. In 2013, private label products accounted for approximately 23.5% of our revenue and 31.8% of our gross profit. We believe private label branding gives us more freedom and flexibility in pricing and more control over product attributes and quality.

As the sourcing of private label products eliminates much of manufacturers' promotional costs and distributors' profit margin in the traditional merchandise supply chain, we are able to price our private label products at competitive prices while maintaining favorable margins. In addition, we believe our private label products are particularly attractive to customers because our brand name and reputation command customer confidence. We believe that the quality of our private label products has won trust from our customers, and we operate rigorous quality control to retain that trust. We intend to continue to focus significant marketing efforts to enhance the reputation of the private label products available in our stores to drive their sales because they generally generate higher gross margins than branded products.

Marketing and Promotion

Our marketing and promotion strategy is to build brand recognition, increase customer traffic to our stores, attract new customers, build strong customer loyalty, maximize repeat customer visits and develop incremental revenue opportunities.

Our marketing department designs our nationwide marketing efforts while our regional Nepstar companies design regional promotions based on local demographics and market conditions. We also launch single store promotional campaigns and community activities in connection with the opening of new stores. Our store managers and staff are also encouraged to propose their own advertising and promotion plans, including holiday promotions, posters and billboards. In addition, we offer special discounts and gift promotions for selected merchandise periodically in conjunction with our suppliers' marketing programs. We also provide ancillary services such as providing free blood pressure measurements in our stores. For our member customers, we offer free samples of selected merchandise periodically to promote sales and introduce new products.

Many of our promotion programs are designed to encourage manufacturers to invest resources to market their brands within our stores. We typically receive from the manufacturers certain fees that offset part of our promotional costs to promote such manufacturers' products. We believe that manufacturer promotions improve our customers' shopping experience because manufacturers provide purchasing incentives and information to help customers to make informed purchase decisions. We work to maintain strong inventory positions for merchandise featured in our promotions, as we believe this increases the effectiveness of our spending on promotion activities.

As part of our marketing efforts and in order to build customer loyalty, we launched our "Loyal Customer" program in 1999. As of December 31, 2013, this program had more than 12.3 million members, approximately 4.9 million of whom were active members, which are defined as customers who make purchases from our stores at least once a year and whose contact information is available in our database. We also award VIP memberships to those member customers who make purchases of at least RMB2,000 from our stores annually. As of December 31, 2013, the number of our VIP members accounted for approximately 1.4% of our total members. Under the loyalty points collection program we implemented in 2011, our member customers are entitled to receive free healthcare circulars published by our stores and gain one loyalty point for every RMB10.0 spent on our products and our VIP members are entitled to receive additional two loyalty points for every RMB10.0 spent on our products. Loyalty points may be used as discounts for future purchase and also to exchange for gifts. At the end of calendar year, except for the loyalty points earned by our VIP members, unutilized loyalty points are forfeited or carried forward for a very short period. For our VIP members, the unutilized loyalty points (excluding Dalian Nepstar Chain Co., Ltd.) can be carried forward through the end of the next year.

We maintain a database of our loyalty scheme membership, including customer profiles and purchasing records, which help us to tailor our promotional programs to meet our customers' specific needs. On average, members of our loyalty scheme spend approximately 2.3 times more per sales transaction than non-member customers, and our member customers purchase more frequently from our stores than non-member customers. Sales to our member customers accounted for 74.6% of our revenue in 2013.

The following table sets forth the approximate number of our loyalty scheme members as of the dates indicated:

	As of December 31,		
	2011 [(1)]	2012	2013
		(In thousands)	
Members	9,197	10,261	12,285
Active members	4,748	4,376[(2)]	4,891

(1) In 2011, we terminated the memberships of approximately 7.5 million inactive members in our loyalty scheme membership database.

(2) The decrease in active members was primarily due to the closure of 319 stores in 2012.

Since 2010, we have started to selectively introduce the Nepstar Shopper's Card program, which we implemented in all of our stores by September 2010. The Nepstar Shopper's Card is a prepaid card, bearing a face value of RMB100, RMB300, RMB500 or RMB1,000. During the launch stage, customers were encouraged to use their Nepstar Shopper's Cards to purchase certain beverage, convenience food, household and personal care products at certain Nepstar stores and accumulate bonus credits, which could then be used to purchase pharmaceutical and nutritional products in those stores. Currently, customers may use their Nepstar Shopper's Cards to purchase any products at any of our stores.

Customers

During 2013, our stores served an average of approximately 77 customers per day per store. Our typical customers are urban residents in major Chinese cities. We periodically conduct qualitative customer surveys in cities in which we operate more than 100 drugstores, helping us to build a stronger understanding of our market position and our customers' purchasing habits. In addition, we sell prescription and over-the-counter drugs to non-retail customers who choose to purchase from us rather than from manufacturers and distributors of pharmaceutical products directly, as these non-retail customers believe they can leverage the economies of scale realized by our greater purchasing power and obtain better pricing terms from us than directly purchasing the same products from the manufacturers and distributors. Sales to these non-retail customers accounted for less than 1.0% of our revenue in each of 2011, 2012 and 2013.

Our sales to retail customers are paid in cash or by debit or credit cards, or by medical insurance cards under the national medical insurance program. We obtain payments from the relevant government social security bureaus, for sales made to eligible participants in the national medical insurance program every one to three months. As of December 31, 2013, 1,050, or 50.8% of our stores are designated stores under the PRC national medical insurance program.

Procurement

We currently source our merchandise from 1,467 suppliers, including 599 manufacturers and 868 wholesalers. In 2013, 67.1% of our total purchases were from wholesalers, with the remainder purchased directly from manufacturers. The transaction value of purchases from our largest supplier accounted for 6.8% of our total purchases in 2013. The transaction value of purchases from our largest five suppliers accounted for 21.1% of our total purchases in 2013. We believe that competitive sources are readily available for substantially all of the merchandise we carry in our stores, and our strategy is to consolidate our procurement through centralized purchasing from fewer suppliers.

While our selection of suppliers is currently centralized, supplier negotiations and placing of purchase orders are to a large degree handled by the regional Nepstar companies, partly reflecting the dominance of regional wholesalers in China's drug supply chain. We are in the process of centralizing our merchandise procurement and replenishment operations. We believe a more centralized and controlled procurement strategy not only benefits us by reducing our cost of purchase, but also benefits the manufacturers from whom we source our products. This is because drug manufacturers have historically relied on wholesalers to sell their products due to the relative small size of drug retailers, and manufacturers incur significant marketing expense to promote their brands and products. As we grow our revenue and as we continue to centralize our merchandise procurement, our greater sourcing capability makes us a more attractive distribution channel for many drug manufacturers. In addition, as our customers choose to purchase drugs from our stores due to their trust in our brand name and reputation, manufacturers can reduce their marketing expenses while increasing their sales volume by selling directly to us.

We conduct in-depth research of the characteristics of the merchandise under each of the categories, make on-site visits to the places of origin of the merchandise to conduct a thorough analysis of the cost structure of the merchandise in order to increase cost-effectiveness, and for those merchandise labeled as our private label products, we procure supplies from famous brands and major manufacturers to meet quality control standards.

Distribution

Our stores are supported by our national distribution center located near our headquarters in Shenzhen and 16 regional distribution centers serving our drugstores located in 77 cities across China.

Our suppliers normally deliver merchandise to our regional distribution centers, but we arrange for the transportation of merchandise to our national distribution center if a particular supplier cannot deliver regionally, and in these cases we levy a fee on the supplier for reimbursement of the transportation costs we incur. Merchandise is delivered from our national distribution center to the regional distribution centers which in turn serve our stores in the region, partly using our own vehicles and partly using third party logistics services. At each distribution center, we maintain a small fleet of trucks to deliver products to our stores and we replenish merchandise for each of our stores twice every week.

The operations of all of our distribution centers, including inventory management and deliveries, are integrated and coordinated by our ERP system, which is our integrated information management system. This system provides us with up-to-date product availability information so as to optimize our inventory management.

Information Management and Inventory Control

Each of our drugstores is equipped with computer terminals that are connected with our ERP system via real time broadband Internet links. Each merchandise item offered by our stores is coded with a unique bar-coded item number for its identification in the store point-of-sale system which, in turn, is linked to our ERP system in real time. Cashiers scan the merchandise being sold and the data are recorded instantly. This integrated information management system generates a daily sales report, which enables us to quickly collect sales information, track and analyze inventory levels and sales trends, and enable us to optimize merchandise levels and product mix. Sales reports can also be produced at more frequent intervals, for example to monitor sales generated by a new product or by a promotional event. We also use this system to facilitate our category management decisions, fine-tune product selection, pricing, shelf space allocation, store replenishment triggers and distribution center replenishment triggers.

We manage our inventory carefully in order to minimize inventory holding cost, ensure timely delivery of merchandise and maintain the variety of merchandise available in our stores. We perform quarterly and ad hoc inventory counts in our stores and distribution centers, and perform daily inventory counts in stores for expensive merchandise and products that are vulnerable to pilferage. We require our store managers to follow up on any inventory discrepancies discovered during each inventory count and report the results to the relevant regional Nepstar company management.

Cash Control

A substantial portion of our sales are made in cash, and we have adopted strict cash control procedures in all of our stores. In particular, the details of each sales event are recorded in our integrated information management system, and the cash generated at our stores is collected and deposited daily in designated bank accounts, which are controlled by our headquarters. On a daily basis, staff working in our stores reconcile the sales record with the cash received, and staff in our finance department reconcile the sales record with the amounts deposited. Our finance department then reviews the monthly reconciliation of sales data collected on our information management system with cash receipts as confirmed by the banks. The cash needs of each regional Nepstar company are dispatched centrally on a weekly basis based on budgeted amounts.

Quality Control

We have selected 427 manufacturers as suppliers of our private label products after reviewing product selection, quality and manufacturing, packaging, transportation and storage capabilities as well as cost competitiveness. We had selected these vendors out of a large number of manufacturers after reviewing these manufacturers' GMP compliance status and their product quality, manufacturing facilities and technology, packaging, transportation and storage capabilities as well as the cost competitiveness of their products.

We conduct random quality inspections of each batch of products we procure. We replace our suppliers if they fail to pass our quality inspections. Since there is a significant manufacturing capability surplus within the Chinese pharmaceutical industry, it is possible for us to change suppliers without a material interruption to our business. We have established a quality control department at our headquarters and we maintain quality inspectors at each of our regional Nepstar companies. We regularly dispatch quality inspectors to our stores to monitor the service quality of our staff. We take into account the feedback received during these inspections when determining the bonus portion of our store employee's salaries.

Competition

The drugstore industry in China is intensely competitive, rapidly evolving and highly fragmented. We primarily compete with other retail drugstore chains or independent drugstores. We compete for customers primarily on the basis of our brand name, store location, merchandise selection, prices, and services that we offer. We believe that continued consolidation of the drugstore industry and continued new store openings by chain store operators will further increase competitive pressures in the industry. In addition, in certain of our targeted cities, such as Beijing and Shanghai, where local regulations prohibit the opening of new drugstores within certain distances of an existing store, and where other retail drugstore chains and independent drugstores have occupied many prime locations, we expect to face additional competition in terms of finding suitable new store locations if we expand into these cities.

Our primary competitors vary from region to region as most other retail drugstore chains in China operate on a regional basis. We do not consider independent drugstores as our major competitors, although we compete with them on an aggregate basis. There are significant differences between regions in the PRC due to distinctive demographics, local regulations and shopping habits, among other factors. Over the past decade, we have gained valuable and extensive expertise in operating a cross-region retail drugstore chain, which we believe will continue to give us advantages in competing with other drugstore chains.

Insurance

We maintain property insurance policies covering our distribution centers, stores and vehicles for losses due to fire, flood and a wide range of other disasters. In 2013, our total insurance coverage totaled approximately RMB677.5 million (US$110.3 million) and we paid approximately RMB0.4 million (US$0.1 million) in insurance premiums for the coverage. In addition, like other similar companies in China, we do not carry product liability insurance, and we do not have any business interruption insurance due to the limited coverage of any business interruption insurance in China. We consider our current insurance coverage to be adequate. However, successful product liability and personal injury claims and uninsured damages to any of our distribution centers and our stores could have a material adverse effect on our financial condition and results of operations.

Regulation

As a distributor and retailer of pharmaceutical products, we are subject to regulation and oversight by different levels of the food and drug administration in China, in particular, the State Food and Drug Administration, or the SFDA. In November 2009, the PRC Ministry of Commerce and the SFDA jointly issued a notice to strengthen the PRC Ministry of Commerce's regulation of drugstores.

The Law of the PRC on the Administration of Pharmaceutical Products, as amended, provides the basic legal framework for the administration of the production and sale of pharmaceutical products in China and governs the manufacturing, distributing, packaging, pricing and advertising of pharmaceutical products in China. The corresponding implementation regulations set out detailed rules with respect to the administration of pharmaceuticals in China. We are also subject to other PRC laws, rules and regulations that are applicable to business operators, retailers and foreign-invested companies.

Distribution of Pharmaceutical Products

A distributor of pharmaceutical products must obtain a distribution permit from the relevant provincial — or designated municipal — or county-level food and drug administration. The grant of such permit is subject to an inspection of the distributor's facilities, warehouses, hygienic environment, quality control systems, personnel and equipment. The distribution permit is valid for five years, and the holder must apply for renewal of the permit within six months prior to its expiration. In addition, a pharmaceutical product distributor needs to obtain a business license from the relevant administration for industry and commerce prior to commencing its business. All of our consolidated entities that engage in the retail pharmaceutical business have obtained necessary pharmaceutical distribution permits, and we do not expect any difficulties for us to renew these permits and/or certifications.

In addition, under the Supervision and Administration Rules on Pharmaceutical Product Distribution promulgated by the SFDA on January 31, 2007, and effective May 1, 2007, a pharmaceutical product distributor is responsible for its procurement and sales activities and is liable for the actions of its employees or agents in connection with their conduct of distribution on behalf of the distributor. A retail distributor of pharmaceutical products is not allowed to sell prescription pharmaceutical products, or Tier A over-the-counter pharmaceutical products, listed in the Essential Drug and Reimbursement Lists without the presence of a certified in-store pharmacist. See "— Reimbursement under the National Medical Insurance Program."

Essential Drugs and Reimbursement Lists

On April 18, 2009, the Ministry of Health (now NHFPC) and other eight PRC ministries and commissions issued the Provisional Administrative Measures of the National List of Essential Drugs, stipulating the criteria and procedures to determine the items included in the Essential Drugs and Reimbursement Lists. In principle, the Essential Drugs and Reimbursement Lists are subject to review every three years. The latest list (2012 Version) was published on March 13, 2013 and came into effect on May 1, 2013.

Regulations on Value-Added Telecommunications Services

On September 25, 2000, the State Council promulgated the Telecommunications Regulations, or the Telecom Regulations. The Telecom Regulations draw a distinction between "basic telecommunications services" and "value-added telecommunications services." Internet information service, or ICP service, is a subcategory of value-added telecommunications services. Under the Telecom Regulations, commercial operators of value-added telecommunications services must first obtain an operating license from the Ministry of Industry and Information Technology, or the MIIT, or its provincial level counterparts.

On September 25, 2000, the State Council issued the Administrative Measures on Internet Information Services, or the Internet Measures, which in particular regulate ICP services. According to the Internet Measures, commercial ICP service operators must obtain an ICP license from the relevant government authorities before engaging in any commercial ICP operations within the PRC.

The Internet Measures further specify that the Internet information services regarding, among others, news, publication, education, medical and health care, pharmacy and medical appliances are required to be examined, approved and regulated by the relevant authorities. ICP service providers are prohibited from providing services beyond that included in the scope of their ICP license or the registration information. Furthermore, the Internet Measures clearly specify a list of prohibited content. ICP service providers must monitor and control the information posted on their websites. If any prohibited content is found, they must cease dissemination of the offending content immediately, keep a record and report to the relevant authorities.

On December 26, 2001, the MIIT promulgated the Administrative Measures on Telecommunications Business Operating Licenses, or the Telecom License Measures. On March 1, 2009, the MIIT issued revised Telecom License Measures, which took effect on April 10, 2009. The Telecom License Measures set forth the types of licenses required to operate value-added telecommunications services and the qualifications and procedures for obtaining such licenses. For example, an information services operator providing value-added services in multiple provinces is required to obtain an inter-provincial license, whereas an information services operator providing the same services in a single province is required to obtain a local license.

On December 12, 2001, Beijing Telecommunications Administration issued the Preliminary Administrative Measures on Mobile Network Value-added Telecommunications Business in Beijing, which specifically set forth certain rules and requirements on mobile information provision services through service platforms connected via a mobile network. Among other things, the mobile information services operators in Beijing must obtain mobile network value-added telecommunication licenses.

Regulations on Internet Information Services

National security considerations are an important factor in the regulation of Internet information in China.

ICP service operators are required to monitor their websites in accordance with relevant PRC laws and regulations, including but not limited to the Internet Measures. They may not produce duplicate, post or disseminate any content that falls within the prohibited categories and must remove any such content from their websites, including any content that:

- opposes the fundamental principles stated in the PRC constitution;
- compromises national security, divulges state secrets, subverts state power or damages national unity;
- harms the dignity or interests of the state;
- incites ethnic hatred or racial discrimination or damages inter-ethnic unity;
- undermines the PRC’s religious policy or propagates heretical teachings or feudal superstitions;
- disseminates rumors, disturbs social order or disrupts social stability;
- disseminates obscenity or pornography, gambling, violence, murder or terror or incites the commission of a crime;
- insults or slanders a third party or infringes upon the lawful rights and interests of a third party; or is otherwise prohibited by law or administrative regulations.

To the extent that PRC regulatory authorities find any content displayed on or through our website objectionable, they may require us to limit or eliminate the dissemination or availability of such content on our website or impose penalties, including the revocation of our operating licenses or the suspension or shutdown of our online operations. In addition, the costs of compliance with these regulations may increase as the volume of content and users on our website increases.

Regulation on Information Security and Censorship

Regulations governing information security and censorship include:

- Law of the People’s Republic of China on the Preservation of State Secrets promulgated by the Standing Committee of the National People’s Congress on September 5, 1988 and amended on April 29, 2010, which became effective from October 1, 2010, together with its Implementing Rules (1990);
- Rules of the People’s Republic of China for Protecting the Security of Computer Information Systems promulgated by the State Council on February 18, 1994, as amended in January 2011;
- Provisional Regulations of the People’s Republic of China on the Administration of International Networking of Computer Information Networks promulgated by the State Council on February 1, 1996 and amended on May 20, 1997, together with its Implementing Rules (1998);
- Administrative Measure for the Security Protection of International Connections to Computer Information Network promulgated by the Ministry of Public Security on December 16, 1997 and amended on January 8, 2011;
- Provisional Regulations for the Secrecy Protection of Computer Information Systems promulgated by the State Secrecy Bureau on February 26, 1998;
- Notice Regarding Issues Relating to the Implementation of the Administrative Measures for the Security Protection of International Connections to Computer Information Networks promulgated by the Ministry of Public Security on February 13, 2000;
- Decision Regarding the Safeguarding of Internet Security promulgated by the Standing Committee of the National People’s Congress on December 28, 2000 and amended on August 27, 2009;

- Measures for the Administration of IP Address Archiving promulgated by the MIIT on February 8, 2005;
- Provision on Technical Measures for Internet Security Protection promulgated by the Ministry of Public Security on December 13, 2005; and
- Administrative Measures for the Graded Protection of Information Security promulgated by the Ministry of Public Security, the State Secrecy Bureau, the State Cipher Code Administration and the Information Office of the State Council on June 22, 2007.

These legislations specifically prohibit the use of Internet infrastructure where it may breach public security, provide content harmful to the stability of society or disclose state secrets. According to these legislations, it is mandatory for Internet information service providers, or the ICP service providers, in the PRC to complete security-filing procedures and regularly update information security and censorship systems for their websites with the local public security bureau. In addition, the newly amended Law on Preservation of State Secrets, which became effective on October 1, 2010, provides that whenever an Internet information service provider detects any leakage of state secrets in the distribution of online information, it should stop the distribution of such information and report to the authorities of state security, public security and secrecy protection. As per a request from the state security, public security or state secrecy authorities, the Internet information service provider should delete any content on its website that may lead to disclosure of state secrets. Failure to do so on a timely and adequate basis may subject the Internet information service provider to liability and certain penalties applied by the State Secrecy Bureau, the Ministry of Public Security, the authority of state security and/or the MIIT or their respective local counterparts.

Restrictions on Foreign Ownership of Wholesale or Retail Pharmaceutical Businesses in China

PRC regulations on foreign investment currently permit foreign companies to establish or invest in wholly foreign-owned enterprises or joint ventures that engage in wholesale or retail sales of pharmaceuticals in China. For retail sales, these regulations restrict the number and size of retail pharmacy stores that a foreign investor may establish. If a foreign investor owns more than 30 stores that sell a variety of branded pharmaceutical products sourced from different suppliers, the foreign investor’s ownership interests in the stores are limited to 49.0%.

Our wholly owned subsidiary Nepstar Pharmaceutical currently owns 49.0% of the equity interest in each regional Nepstar company and has entered into contractual arrangements with each of these entities, including Nepstar IT Service, Nepstar Management Consulting and their shareholders.

Restrictions on Foreign Ownership of Online Businesses in China

Foreign ownership of Internet-based businesses is subject to significant restrictions under current PRC laws and regulations. The PRC government regulates Internet access, the distribution of online information and the conduct of online commerce through strict business licensing requirements and other government regulations. Specifically, investors are not allowed to own more than 50.0% of the equity interests in any “value-added telecommunications services” provider, or an entity conducting an Internet content distribution business such as Shenzhen Nepstar in its operation of www.star365.com.

Our wholly owned subsidiary Nepstar Pharmaceutical has entered into contractual arrangements with Nepstar IT Service, Nepstar Management Consulting and their shareholders to retain control over Shenzhen Nepstar.

Good Supply Practice Standards

GSP standards regulate wholesale and retail pharmaceutical product distributors to ensure the quality of distribution of pharmaceutical products in China. On January 22, 2013, the Ministry of Health (now NHFPC) promulgated the New GSP, which became effective on June 1, 2013. The New GSP strengthens the previous GSP’s requirements for pharmaceutical product distributors to implement strict controls on the distribution of medicine products, including standards regarding staff qualifications, distribution premises, warehouses, inspection equipment and facilities, management and quality control. The GSP certificate is usually valid for five years.

Pursuant to the Circular on Implementation of the New GSP Rules issued by SFDA on June 24, 2013, where a GSP certificate expired on and before December 31, 2013 but the wholesaler or retailer holding such certificate didn’t meet the New GSP’s requirements, the term of the certificate can be extended to June 30, 2014 provided that the wholesaler or retailer made an application for extension. We have proceeded to renew our GSP certification in our subsidiaries due to the expiry of certifications.

Prescription Administration

Under the Rules on Administration of Prescriptions promulgated by the SFDA, effective May 1, 2007, doctors are required to include the chemical ingredients of the medicine they prescribe in their prescription and are not allowed to include brand names in their prescription. This regulation is designed to provide consumers with choices among different pharmaceutical products that contain the same chemical ingredients.

Advertisement of Pharmaceutical Products

In order to prevent misleading advertising of pharmaceutical products, the Ministry of Health (now NHFPC), the SAIC and the SFDA jointly promulgated the Standards for Examination and Publication of Advertisements of Pharmaceutical Products and Rules for Examination of Advertisement of Pharmaceutical Products in March 2007. Under these regulations, the advertising of certain pharmaceutical products is prohibited, and the advertising of prescription pharmaceutical products may only be made in authorized medical magazines. In addition, an approval must be obtained from the provincial level of the food and drug administration before a pharmaceutical product may be advertised. Such approval, once obtained, is valid for one year.

Product Liability and Consumers Protection

Product liability claims may arise if the products sold have any harmful effect on the consumers. The injured party may claim for damages or compensation. The General Principles of the Civil Law of the PRC, which became effective in January 1987, state that manufacturers and sellers of defective products causing property damage or injury shall incur civil liabilities for such damage or injuries.

The Product Quality Law of the PRC was enacted in 1993 and amended in 2000 to strengthen the quality control of products and protect consumers' rights and interests. Under this law, manufacturers and distributors who produce or sell defective products may be subject to confiscation of earnings from such sales, revocation of business licenses and imposition of fines, and in severe circumstances, may be subject to criminal liability.

The Law of the PRC on the Protection of the Rights and Interests of Consumers was promulgated on October 31, 1993 and became effective on January 1, 1994 to protect consumers when they purchase or use goods or services. All business operators must comply with this law when they manufacture or sell goods and/or provide services to customers. In extreme situations, pharmaceutical product manufacturers and distributors may be subject to criminal liability if their goods or services lead to the death or injuries of customers or other third parties.

The Tort Law of the PRC was promulgated in December 2009, which stipulates that if damages to consumers are caused by defective products as a result of the fault of a third party such as a transportation carrier or a warehouse, the producers and the sellers of the products have the right to recover their respective losses from such third party. If defective products are identified after they have been put into distribution, the producers or the sellers are required to take remedial measures in a timely manner, such as issuance of warming, recall of products, etc., or otherwise will be subject to liabilities. If the products are produced and sold with known defects, causing deaths or severe damage to the health of others, the consumers suffering from damages have the right to claim punitive damages in addition to compensatory damages.

Price Controls

The retail prices of some pharmaceutical products sold in China, primarily those included in the Essential Drug and Reimbursement Lists and those pharmaceutical products whose production or distribution are deemed to constitute monopolies, are subject to price controls in the form of fixed prices or price ceilings. In particular, manufacturers or distributors cannot freely set or change the retail price for any price-controlled product above the applicable price ceiling or deviate from the applicable fixed price imposed by the PRC government. The prices of medicines that are not subject to price controls are determined freely at the discretion of the respective pharmaceutical companies, subject to notification to the provincial pricing authorities. The National Development and Reform Commission, or the NDRC, may grant premium pricing status to certain pharmaceutical products that are subject to price controls, and may set the price-ceiling of pharmaceutical products that have obtained such status at a level that is significantly higher than comparable products.

The retail prices of medicines that are subject to price controls are administered by the Price Control Office of the PRC National Development and Reform Commission, or the NDRC, and provincial and regional price control authorities. The retail price, once set, also effectively determines the wholesale price of that medicine. From time to time, the NDRC publishes and updates a list of medicines that are subject to price controls. Fixed prices and price ceilings on medicines are determined based on profit margins that the relevant government authorities deem reasonable, the type and quality of the medicine, its production costs, the prices of substitute medicine and the extent of the manufacturer's compliance with the applicable GMP standards. The NDRC directly regulates the pricing of a portion of the medicine on the list, and delegates to provincial and regional price control authorities the authority to regulate the pricing of the rest of the medicine on the list. Provincial and regional price control authorities have discretion to authorize price adjustments based on the local conditions and the level of local economic development.

Only the manufacturer of a medicine may apply for an increase in the retail price of the medicine, and it must either apply to the provincial price control authorities in the province where it is incorporated, if the medicine is provincially regulated, or to the NDRC, if the medicine is regulated by the NDRC. For a provincially regulated medicine, in cases where provincial price control authorities approve an application, manufacturers must file the newly approved price with the NDRC for record and thereafter the newly approved price will become binding and enforceable across China.

Since May 1998, the relevant PRC government authorities have ordered price reductions of thousands of pharmaceutical products. In 2011, 2012 and 2013, approximately 30.0%, 30.4% and 31.0% of our revenue was derived from sales of pharmaceutical products that were subject to price controls, respectively. Any future price controls or government mandated price reductions may have a material adverse effect on our financial condition and results of operations, including significantly reducing our revenue and profitability. The retail prices of some of our products are subject to control, including period downward adjustment, by PRC government authorities.

Reimbursement under the National Medical Insurance Program

Eligible participants in the national medical insurance program, mainly consisting of urban residents, are entitled to purchase medicine when presenting their medical insurance cards in an authorized pharmacy, provided that the medicine they purchase have been included in the Essential Drug and Reimbursement Lists. Depending on relevant local regulations, authorized pharmacies either sell medicine on credit and obtain reimbursement from relevant government social security bureaus on a monthly basis, or receive payments from the participants at the time of their purchases, and the participants in turn obtain reimbursement from relevant government social security bureaus.

Medicine included in the Essential Drug and Reimbursement Lists is divided into two tiers. Purchases of Tier A pharmaceutical products are generally fully reimbursable, except that certain Tier A pharmaceutical products are only reimbursable to the extent the medicine is used for purposes specifically stated in the Essential Drug and Reimbursement Lists. Purchasers of Tier B pharmaceutical products, which are generally more expensive than Tier A pharmaceutical products, are required to make a certain percentage of co-payments, with the remaining amount being reimbursable. The percentage of reimbursement for Tier B over-the-counter pharmaceutical products varies in different regions in the PRC. Factors that affect the inclusion of medicine in the Essential Drug and Reimbursement Lists include whether the medicine is consumed in large volumes and commonly prescribed for clinical use in China and whether it is considered to be important in meeting the basic healthcare needs of the general public.

The PRC Ministry of Labor and Social Security, together with other government authorities, has the power to determine every two years which medicines are included in the national medical insurance catalog, under which of the two tiers the included medicine falls, and whether an included medicine should be removed from the catalog. Provincial governments are required to include all Tier A medicines listed on the national medical insurance catalog in their respective provincial Essential Drug and Reimbursement Lists. For Tier B medicines listed in the national medical insurance catalog, provincial governments have the discretion to adjust upwards or downwards by no more than 15% from the number of Tier B medicine listed in the national medical insurance catalog that is to be included in their respective provincial Essential Drug and Reimbursement Lists. The amount in a participant's individual account under the program varies, depending on the amount of contributions from the participant and his or her employer. Generally, participants under the national medical insurance program who are from relatively wealthier parts of China and metropolitan centers have greater amounts in their individual accounts than those from other parts of the country. Different regions in China have different requirements regarding the limitations on reimbursements in excess of the amounts in the individual accounts.

Sales of Nutritional Supplements and Other Food Products

According to the PRC Food Safety Law that took effect on June 1, 2009 and the Rules on Food Safety Certificate that took effect on July 30, 2009, a distributor of nutritional supplements and other food products must obtain the relevant license for food distribution from relevant local regulatory authorities. The license holder is responsible for establishing and improving its internal rules and management for the food to be distributed, such as establishing internal safety management rules and health examination system, establishing and maintaining employees' health records and keeping records of food inspection and distribution. The license for food distribution is valid for three years, and the holder must apply for renewal of the license within 30 days prior to its expiration.

On October 20, 2010, the Ministry of Health (now NHFPC) published Administrative Measures for National Food Safety Standards to promote and supervise the formulation of national standards for food safety in China. Since then, various national food safety standards have been proposed, including General Rules for Prepackaged Food Labels, which took effect on April 20, 2012. These rules apply to all prepackaged food products sold in China and set forth standards and specifications for the labeling of prepackaged food, which would help consumers better understand relevant nutritional and safety information.

Trademarks

The PRC Trademark Law and the PRC Trademark Implementing Regulations provide the basic legal framework for the regulation of trademarks in China, and the SAIC is responsible for the registration and administration of trademarks throughout the country. The PRC has adopted a "first-to-file" principle with respect to trademarks.

PRC law provides that each of the following acts constitutes infringement of the exclusive right to use a registered trademark:

- use of a trademark that is identical with or similar to a registered trademark in respect of the same or similar commodities without the authorization of the trademark registrant;
- sale of commodities infringing upon the exclusive right to use the trademark;
- counterfeiting or making, without authorization, representations of a registered trademark of another person, or sale of such representations of a registered trademark;
- changing a registered trademark and selling products on which the altered registered trademark is used without the consent of the trademark registrant; and
- otherwise infringing upon the exclusive right of another person to use a registered trademark.

In the PRC, a trademark owner who believes the trademark is being infringed can provide his trademark registration certificate and other relevant evidence to the state or local Administration for Industry and Commerce, or AIC, which can, in its discretion, launch an investigation. The AIC may take actions such as ordering the infringer to immediately cease the infringing behavior, seizing and destroying any infringing products and representations of the trademark in question, closing the facilities used to manufacture the infringing products or imposing a fine. If the trademark owner is dissatisfied with the AIC's decision, he may institute civil proceedings against the infringer in court.

The trademark owner may also institute civil proceedings directly in court. Civil remedies for trademark infringement include:

- injunctions;
- requiring the infringer to take steps to mitigate the damage, such as publishing notices in newspapers; and
- damages, such as compensation for the economic loss and injury to reputation as a result of trademark infringement suffered by the trademark owner.

The amount of compensation is calculated according to either the gains acquired by the infringer from the infringement, or the losses suffered by the trademark owner, including expenses incurred by the trademark owner to claim and litigate such infringement. If it is difficult to determine the gains acquired by the infringer from the infringement, or the losses suffered by the trademark owner, the court may elect to award compensation of not exceeding RMB500,000 according to the currently effective PRC Trademark Law, and compensation of not exceeding RMB3 million according to the newly promulgated Third Amendment to PRC Trademark Law to be effective on May 1, 2014.

If the trademark infringement is so serious as to constitute a crime, the trademark owner may file a complaint with the police and the infringer would be subject to investigation for criminal liability in accordance with PRC law.

Dividend Distribution

The principal laws, rules and regulations governing dividends paid by our PRC operating subsidiaries include the Company Law of the PRC (1993), as amended in October 2005 and December 2013, Wholly Foreign Owned Enterprise Law (1986), as amended in 2000, and Wholly Foreign Owned Enterprise Law Implementation Rules (1990), as amended in 2001. Under these laws and regulations, each of our consolidated PRC entities, including wholly foreign-owned enterprises, or WFOEs, and domestic companies in China may pay dividends only out of their accumulated profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, each of our consolidated PRC entities, including WFOEs and domestic companies, is required to set aside at least 10% of its after-tax profit based on PRC accounting standards each year to its statutory surplus reserve fund until the accumulated amount of such reserve reaches 50% of its respective registered capital. These reserves are not distributable as cash dividends. As of December 31, 2013, the accumulated balance of our statutory reserve funds totaled RMB99.4 million (US$16.4 million).

Property and Equipment

Our corporate headquarters are located in Shenzhen, where we lease an aggregate of 1,413 square meters of office space. As of the date of this annual report, we operated one national distribution center located near our headquarter and 16 regional distribution centers with a combined total of approximately 63,836 square meters of space.

Substantially all of our store space is leased from third parties. Our leases in respect of those properties generally have a five-year term. As of December 31, 2013, 904 leases (covering an aggregate gross floor area of approximately 98,036 square meters, equivalent to approximately 30.3% of the total gross floor area of properties we occupied) will terminate within two years. We must negotiate with the landlords for an extension of the old leases or enter into new leases upon their termination, and our landlords may request a rent increase. Under applicable PRC law, we have priority over other potential lessees with respect to the leased store space on the same terms. Our community stores are normally relatively small in size and the facilities inside the store are easily movable. As a result, we do not expect our drugstore operations to be materially and adversely affected by any failure to renew or enter into new leases.

As of December 31, 2013, we had 2,100 leased properties with an aggregate gross floor area of 323,576 square meters, of which 243,409 square meters were used as drugstores. 225 or approximately 10.7% of these leased properties had defects in their legal titles. Of all of the properties with defects in legal titles, 24,826 square meters were used as drugstores, equivalent to approximately 10.2 % of the total gross floor area of our drugstores. The defects in title with respect to these properties generally fall into two categories: (i) the proper property title deeds cannot be obtained from the relevant landlord; and (ii) the identity of the landlord as it appears on the relevant leasing contract does not match the identity of the registered owner as it appears on the property title deeds and a formal approval by the registered owner as noted on the property title deeds for the lease of the property to us cannot be obtained by the relevant parties. The total floor area of properties with the former type of defects in title was 23,432 square meters, or approximately 9.6 % of the total gross floor area of our drugstores, and with the latter type of defects in title was 1,394 square meters, or approximately 0.6 % of the total gross floor area of our drugstores. In addition, 99,524 square meters, or approximately 30.8 % of our leased properties, including properties with defects in title, have not been registered as required by applicable PRC regulations. We do not possess clear leasehold titles or written agreements providing for usage rights in respect of some of our occupied properties.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Operating Results

Overview

Since our inception in 1995, we have expanded our operations through organic growth and selective acquisitions of drugstores in China. In 2009, we acquired a total of seven stores, consisting of five stores in Beijing from Beijing Zeruntang Medical Ltd. and two stores in Shanghai from Shanghai Riye Chain Co., Ltd. In 2010, we acquired three other stores from Shanghai Riye Chain Co., Ltd., six stores from Beijing Xiang Yun Kang Drugstore and eight stores from Wenzhou Ren Ren Hao Chain Drugstore Co., Ltd. In 2011, we completed the acquisition of another store from Shanghai Riye Chain Co., Ltd. We accounted for these acquisitions using the acquisition method of accounting under FASB ASC Topic 805, Business Combinations. See note 8 to our audited consolidated financial statements included in this annual report. In 2012, we disposed the eight stores we acquired from Wenzhou Ren Ren Hao Chain Drugstore Co., Ltd. We also close stores that do not perform well. We closed 188 stores and opened 122 new stores in 2013. As of December 31, 2013, we had a total of 2,066 directly operated drugstores.

We believe that we have the leading market position in a number of the most developed cities in China, including Shenzhen, Dalian, Hangzhou, Ningbo and Suzhou, in terms of store count. Our total revenue was RMB2,491.3 million, RMB2,549.9 million and RMB2,699.1 million (US$445.9 million) and our net income was RMB35.9 million, RMB90.1 million and RMB11.8 million (US$2.0 million) in 2011, 2012 and 2013, respectively. Apart from the effect of the disposal of our 40% equity interest in JZJ and the subsequent recognition of a one-off gain of RMB68.4 million in 2012, the decrease in the net income in 2013 from 2012 was additionally due to lower gross profit margin by more sales promotion initiatives conducted to increase our market share, higher effective tax rate in 2013 and the penalty charge of RMB5.7 million imposed by the Price Bureau of Yuexiu District in Guangzhou City of Guangdong Province for noncompliance with the pricing guidelines.

The major financial performance indicators that our management uses to manage and assess our business include our revenue, average daily revenue per store, sales per customer visit, gross profit and gross margin, operating income, private label product revenue as a percentage of total revenue, inventory turnover days and cash flow from operating activities. The major non-financial performance indicators that our management uses to manage and assess our business include number of stores, number of customer visits per store per day and the average time required for us to open a new store.

Factors Affecting Our Results of Operations

We believe that the most significant factors that affect our results of operations are:

- the size of the retail market of pharmaceutical products in China and changes in government regulations affecting the drugstore industry;
- our ability to manage our drugstore network;
- our ability to optimize product offerings and increase sales, including the sales of private label products;
- our ability to control procurement cost and optimize product pricing; and
- our ability to control operating expenses and achieve a high level of operating efficiency.

The Size of the Retail Market of Pharmaceutical Products in China and Changes in Government Regulations Affecting the Drugstore Industry

Our business and revenue growth depend on the size of the retail market of pharmaceutical products in China. Retail sales of pharmaceutical products in China have grown significantly in recent years. In the medium-to long-term, we believe that future growth in the Chinese drugstore industry will be driven by compelling industry fundamentals and favorable demographics. In particular, the increasing wealth and disposable income of Chinese people, an aging and more health conscious population and continued urbanization will contribute to the continued growth of the drugstore industry in China in the foreseeable future.

In particular, regulatory changes in China are expected to affect the growth of drug sales at retail drugstores. On one hand, beginning in 1998, reimbursements under the national medical insurance program have become available for purchases of medicines from designated retail pharmacies. In addition, the PRC government authorities have imposed additional restrictions on the advertisement of drugs in recent years, which we expect to increase drug manufacturers' reliance on retail drugstores to build brand familiarity among the general public. Furthermore, regulations were passed in 2005 to encourage the separation of pharmacy functions from the medical services offered by hospitals. On the other hand, in 2008, the enforcement of a PRC regulation restricting drugstores from selling products with certain steroid ingredients had a negative impact on our revenue growth.

In March 2009, the State Council announced plans to establish community health clinics in urban areas, which would provide essential drugs to patients at or near cost. While we believe that these community health clinics will primarily serve lower income, more price sensitive customers, compared to those primarily served by our stores, these community health clinics may attract customers who would otherwise purchase drugs from our stores, alter foot traffic into our stores or otherwise directly or indirectly compete with us, which could have a material adverse effect on our financial condition, results of operations and prospects.

In August 2009, the Ministry of Health (now NHFPC) established the Essential Drug List, which contains 205 types of chemical drugs and 102 types of traditional Chinese medicines. In October 2009, the NDRC implemented price ceilings on 2,349 pharmaceutical products, including drugs or medicines on the Essential Drug and Reimbursement Lists, which included 1,728 pharmaceutical products carried by our stores. Due in part to the implementation of these price ceilings, our gross margins experienced downward pressure in 2010 as compared to 2009 and continued to experience downward pressure in 2011. In March 2013, NHFPC updated the Essential Drug List, which contains 317 types of chemical drugs and 203 types of traditional Chinese herbal medicines. As of December 31, 2013, 2,113 pharmaceutical products carried by our stores were on the List. If more pharmaceutical products carried by our stores become subject to price ceilings or if any reductions in existing price ceilings are implemented, our gross margins could be further reduced and our net income and profitability could be materially reduced. In addition, NDRC published an Interim Measures on the Price Control of Drugs (Opinion Solicitation Draft) in February 2012, which proposed that the selling price premium at not-for-profit hospitals and other not-for-profit healthcare institutions of any pharmaceutical product that is subject to price control cannot exceed the higher of 25% of the sourcing price or RMB69. Since a substantial number of drugs carried in our stores are also available for distribution through hospitals, such price control may have a material adverse effect on our revenue and profitability if such price control goes into effective.

We believe that our extensive store network and operational expertise, strong brand name and expansion plan provide us with a strong platform and we are well-positioned to capture growth opportunities in China's drugstore industry.

Our Ability to Manage Our Drugstore Network

We earn our revenue primarily from the sale of products carried by our drugstores, and our ability to increase revenue is directly affected by the number of drugstores in our network and our revenue per drugstore. Historically, we have expanded our retail network through both organic growth and acquisitions of stores. The following table sets forth certain information with respect to our stores for the periods indicated:

	Year Ended December 31,		
	2011	2012	2013
Number of stores at the beginning of the year	2,547	2,395	2,132
Number of stores at the end of the year	2,395	2,132	2,066

During 2013, our stores served an average of approximately 77 customers per day per store. Our customer visits in 2013 increased as compared with 67 customers per day per store in 2012, primarily because of the expansion of our products offerings into non-pharmaceutical categories, the closure of underperforming stores and more intensive sales promotion initiatives in 2013.

We believe that store location is an important factor driving our store sales. Our goal is to establish stores in clusters in well-developed cities in China. Within each major city, we aim to locate our stores in well-established residential communities. In 2013, in order to manage our stores more effectively and to improve the overall quality of store sales performance, we closed 188 stores, most of which were performing below our expectations. The number of closed stores in 2013 decreased from 319 in 2012 and 228 in 2011, due to an improvement in the sales performance of our stores. We also sped up the pace of new store openings, adding 122 new stores in 2013 as compared to 56 new stores in 2012 and 75 new stores in 2011, as a result of the improvement in the sales performance of our stores generally, despite that new stores may incur high initial costs.

For our drugstores that had been opened prior to December 31, 2011, the average daily revenue per store increased from RMB3,167 in 2012 to RMB3,492 in 2013. The increase was mainly due to our effort in closing poorly performing stores, expanding product offerings into non-pharmaceutical categories, as well as streamlining our store operations.

	2012		2013	
	Number of drugstores as of year end	Daily Average Revenue per Store	Number of drugstores as of year end	Daily Average Revenue per Store
Opened prior to December 31, 2010	2,009	3,085	1,829	3,533
Opened in 2011	68	1,760	64	2,240
Opened prior to December 31, 2011	2,077	3,167	1,893	3,492

Our Ability to Optimize Product Offerings and Increase Sales, including Sales of Private Label Products

The following table sets out a breakdown of our revenue by product categories for the periods indicated:

	Year Ended December 31,						
	2011		2012		2013		
	RMB'000	% of Revenue	RMB'000	% of Revenue	RMB'000	US$'000	% of Revenue
Prescription drugs	495,352	19.9	519,557	20.4	601,934	99,432	22.3
Over-the-counter drugs	911,412	36.6	997,997	39.1	1,059,154	174,960	39.2
Nutritional supplements	450,714	18.1	399,397	15.7	392,009	64,755	14.5
Herbal products	99,627	4.0	100,419	3.9	109,284	18,053	4.1
Other products [(1)]	534,185	21.4	532,486	20.9	536,722	88,660	19.9
Total	2,491,290	100.0	2,549,856	100.0	2,699,103	445,860	100.0

(1) Includes personal care, family care and convenience products.

Our ability to optimize product offerings is an important factor affecting customer visits, store traffic, sales volume, and margins thus affecting our results of operations. It is essential for us to balance the brand name products, which are popular among customers, and private label products, which generate higher margin. In addition, we also need to balance our offering of pharmaceutical products and non-pharmaceutical products to achieve the right balance of store traffic, sales volume and margins. As a result, we continuously review and refine our product offerings to respond to changing demographics, lifestyles, habits and preferences of customers. We aim to improve our product range to increase sales volume and revenue in a competitive market.

We generate a substantial portion of our revenue from sales of prescription drugs, over-the-counter drugs and nutritional supplements. In particular, sales of prescription drugs accounted for 22.3% of our revenue in 2013, sales of over-the-counter drugs accounted for 39.2% of our revenue in 2013 while sales of nutritional supplements accounted for 14.5% of our revenue in 2013.

In 2013, we expanded our product offerings and introduced 203 new non-pharmaceutical products, of which 51 are private label products. Sales of food, household, personal care and other products accounted for 19.9% of our revenue in 2013. We plan to continue to expand our offering of personal care, family care and convenience products, which we believe will increase expenditure per customer visit by providing greater one-stop shopping convenience for our customers. We believe that our extensive store network and operational expertise, strong brand name and expansion plan provide us with a strong platform to capture growth opportunities in China's retail market for convenience products.

Our private label products generally have higher margins than our other products, because we are able to eliminate much of the manufacturers' promotional costs in the sourcing of our private label products and the distributors' profit margin in the traditional merchandise supply chain. We launched our first private label product in September 2005, and since then our private label portfolio has increased to 2,104 products marketed under 160 private labels as of December 31, 2013, covering all categories of products we offer. The increase in private label product sales was a significant factor contributing to the increases in our gross margin since late 2005.

To develop our private label products, we have also obtained rights to use an aggregate of 522 additional trademarks, including 251 registered trademarks that we have obtained exclusive rights to use, 248 registered trademarks that we have obtained non-exclusive rights to use, and 23 trademarks that are in the process of being registered by subsidiaries of the Neptunus Group. We use these licensed trademarks to develop our private label products. As of December 31, 2013, we have developed 2,104 private label products with these licensed trademarks. Private label products accounted for approximately 26.8% and 23.5% of our revenue, and 38.0% and 31.8% of our gross profit in 2012 and 2013, respectively. Private label branding also gives us more freedom and flexibility in pricing and more control over product attributes and quality.

The following tables set forth certain information with respect to our private label products for the year ended December 31, 2013:

	Private Label Revenue as a Percentage of Revenue of the Category
Prescription drugs	11.8%
Over-the-counter drugs	16.0%
Nutritional supplements	50.8%
Herbal products	31.8%
Others [1]	29.9%
Total [2]	23.5%

(1) Includes personal care, family care and convenience products.
(2) Certain private labels are used in multiple categories of products.

Our Ability to Control Procurement Cost and Optimize Product Pricing

Our cost of goods sold represents primarily our purchase cost of merchandise. No depreciation or amortization is included in our cost of goods sold because our business does not involve manufacturing, and the amount of property and equipment we use in acquiring, warehousing and transporting merchandise to our stores is limited and hence the related depreciation and amortization is immaterial. We have been consolidating our procurement through centralized purchases from fewer suppliers, which we believe will enable us to procure goods on more favorable terms due to our enhanced bargaining position with our suppliers. We do not expect, however, to be dependent on any particular supplier, and expect to continue purchasing merchandise from a large number of suppliers in the foreseeable future. We currently source our merchandise from 1,467 suppliers, including 599 manufacturers and 868 wholesalers. In 2013, 67.1% of our total purchases were from wholesalers, with the remainder purchased directly from manufacturers. The transaction value of purchases from our largest supplier accounted for 6.8% of our total purchases in 2013. The transaction value of purchases from our largest five suppliers accounted for 21.1% of our total purchases in 2013. We believe that competitive sources are readily available for substantially all of the merchandise we carry in our stores, and our strategy is to consolidate our procurement through centralized purchases from fewer suppliers.

We source the majority of our merchandise from regional manufacturers and wholesalers of drug and non-drug products, and we make pricing decisions for these products, including all of our private label products. We set the retail prices of these products based on various factors, including our procurement costs, our agreements with suppliers, government policy and regulation, competition, customer preference and regional market considerations. In determining prices, we seek to maximize our gross margin as well as remain competitive in the market. For example, we set prices for some of our private label products lower than those of equivalent products. We are able to do so while commanding higher gross margins for our private label products as we are able to eliminate much of the manufacturers' promotional costs in the sourcing of our private label products and distributors' profit margin in the traditional merchandise supply chain. In addition, we source a portion of our drugs from large manufacturers, and the pricing decisions for these products are usually made by the manufacturers based on factors such as the prices of competitive drugs and the expected marketing expenditures.

We purchase and sell certain merchandise from and to the Neptunus Group and its affiliates. In 2011, 2012 and 2013, we purchased merchandise from the Neptunus Group and its affiliates totaling RMB105.2 million, RMB92.9 million and RMB138.8 million (US$22.9 million), respectively, and sold merchandise to the Neptunus Group and its affiliates totaling RMB2.2 million, RMB5.5 million and RMB2.2 million (US$0.4 million), respectively.

A portion of the medicines sold in our stores, primarily those included in the Essential Drug and Reimbursement Lists are subject to price controls in the form of fixed prices or price ceilings. From time to time, the PRC government publishes a list of medicines that are subject to price controls either at the national level or the provincial or regional level. Fixed prices and price ceilings on medicines are determined based on profit margins that the relevant government authorities deem reasonable, the type and quality of the medicine, its production costs and the prices of substitute medicines. Any future price controls or government mandated price reductions may have a material adverse effect on our financial condition and results of operations, including significantly reducing our revenue and profitability.

While carrying medicines subject to price controls generally increases customer traffic and sales of other products, these medicines also generally have lower margins compared to our other products. Since May 1998, the relevant PRC government authorities have ordered price reductions of thousands of pharmaceutical products. In 2011, 2012 and 2013, approximately 30.0%, 30.4% and 31.0%, respectively, of our revenue was derived from sales of pharmaceutical products that were subject to price controls. The increase in the number of pharmaceutical products we offered that were subject to price controls from the level of 2009 reflected the inclusion of more pharmaceutical products, especially popular pharmaceutical products, in China's national medical insurance catalog. We expect that sales of pharmaceutical products that are subject to price controls as a percentage of our total revenue to further increase in the future, which we expect to have a negative effect on our gross margin.

Our Ability to Control Operating Expenses and Achieve a High Level of Operating Efficiency

Our ability to control operating expenses and achieve a high level of operating efficiency is a key factor driving our results of operations. The following table sets forth our operating expenses as a percentage of our revenue for the periods indicated:

	Year Ended December 31,		
	2011	**2012**	**2013**
Sales, marketing and other operating expenses	40.7%	39.7%	38.0%
General and administrative expenses	4.8%	4.5%	4.5%
Impairment losses of property and equipment	0.6%	0.3%	0.3%
Total operating expenses	46.1%	44.5%	42.8%

Our sales, marketing and other operating expenses primarily consist of salaries and benefits of our in-store pharmacists and other store and distribution center staff as well as rental and utility expenses of our stores and distribution centers. Sales, marketing and other operating expenses also include depreciation of leasehold improvements of our stores, distribution centers and store equipment as well as costs associated with organizing promotional and marketing activities. Sales, marketing and other operating expenses as a percentage of our revenue decreased from 40.7% in 2011 to 39.7% in 2012 and 38.0% in 2013 due to the closure of underperforming stores. We expect our total sales, marketing and other operating expenses to increase as a result of inflation as well as future growth of our business.

Our general and administrative expenses primarily consist of salaries and benefits for our management and administrative personnel, rental and utility expenses of premises used for administrative purposes, depreciation of our administrative equipment, fees and expenses of legal, accounting and other professional services, office consumables and other expenses associated with our administrative offices. We expect general and administrative expenses to increase as we recruit additional professionals and incur additional costs as a result of inflation as well as future growth of our business.

Other key factors affecting our operating expenses include the following:

- ***Inventory levels***. We must maintain sufficient inventory levels to meet our customers' needs while balancing the risk of accumulating excess inventory. Carrying excess inventory would increase our inventory holding costs, and failure to have sufficient inventory could cause us to lose customers, either of which could reduce our revenue and profitability. In 2011, 2012 and 2013, our inventory turnover days, calculated as the average of inventory at the beginning of the year and inventory at each quarter end of the year, divided by cost of goods sold for the year and then multiplied by 365, was 120 days, 120 days and 119 days, respectively.
- ***Costs associated with closing underperforming stores.*** We closed 228, 319 and 188 underperforming stores during 2011, 2012 and 2013, respectively. The cost associated with closing underperforming stores are RMB8.6 million, RMB8.9 million and RMB5.7 million (US$0.9 million) for 2011, 2012 and 2013, respectively.
- ***The amount of time required to open new stores***. The amount of time required for us to open new stores, measured from date of initial occupation to commencement date of operations, increased from an average of 36 days in 2011 and 2012 to 45 days in 2013. The amount of time required for us to open new stores is primarily

determined by the amount of time the relevant local government authority takes to grant license for us to open our new stores. As part of our efforts to continue to reduce the amount of time for new stores to become profitable, we have developed uniform standards and streamlined our store operations through centralized management.

Seasonality

Our business is subject to seasonal variations in demand. In particular, traditional retail seasonality affects the sales of nutritional supplements, herbal products, personal and family care products, convenience products and certain drugs. Sales of our pharmaceutical products typically benefit in the fourth quarter from the winter cold season, and are lower in the first quarter of each year because the Chinese New Year holidays are in the first quarter of each year, which result in our customers generally pay fewer visits to drugstores during this period. Sales of some health and beauty products are also driven, to some extent, by seasonal purchasing patterns and seasonal product changes.

Taxation

The CIT Law provides that enterprises established outside of China whose "de facto management bodies" are located in China are considered "resident enterprises" and are generally subject to the uniform 25% enterprise income tax rate as to their worldwide income. Under the implementation regulations for the CIT Law, "de facto management body" is defined as a body that has material and overall management and control over the manufacturing and business operations, personnel and human resources, finances and treasury, and acquisition and disposition of properties and other assets of an enterprise. Although substantially all of our operational management is currently based in the PRC, our listed entity itself does not have a place of business in the PRC. We cannot assure you that PRC tax authorities would agree to treat us as a non-resident enterprise for PRC tax purposes.

Under the CIT Law and implementation regulations, PRC income tax at the rate of 10%, or the lower applicable tax rate if specified in a tax treaty, is applicable to dividends payable to investors that are "non-resident enterprises," which do not have an establishment or place of business in the PRC, or which have such establishment or place of business but the relevant income is not effectively connected with the establishment or place of business, to the extent such dividends are derived from sources within the PRC. As we derive substantially all of our revenue and income from our operations in China, if we are considered to be a "non-resident enterprise" for PRC tax purposes, dividends to be paid by our PRC subsidiaries to us will be subject to PRC income tax.

All of our operating subsidiaries, including the regional Nepstar companies, were incorporated in the PRC. Prior to January 1, 2008, certain subsidiaries and tax paying retail store entities located and conducting operations in the Shenzhen Special Economic Zones, Zhuhai Special Economic Zones and the Yunnan Province in the PRC were subject to a preferential tax rate of 15%. Under the implementation rules of the CIT Law, companies that enjoyed preferential income tax rates prior to January 1, 2008 had a five-year period to transition to the 25% statutory income tax rate. In particular, companies that were subject to a tax rate of 15% were subject to tax rates of 20%, 22%, 24%, 25% and 25% in 2009, 2010, 2011, 2012 and 2013 onwards, respectively. Accordingly, our operating subsidiaries and retail store entities in Shenzhen and Zhuhai were subject to 24%, 25% and 25% income tax rates in 2011, 2012 and 2013 onwards, respectively. Our subsidiaries outside of Shenzhen and Zhuhai have been subject to the 25% statutory income tax rate since January 1, 2008.

Critical Accounting Policies

We prepare our consolidated financial statements in accordance with U.S. GAAP, which requires us to make judgments, estimates and assumptions that affect: (i) the reported amounts of our assets and liabilities; (ii) the disclosure of our contingent assets and liabilities at the end of each reporting period; and (iii) the reported amounts of revenue and expenses during each reporting period. We continually evaluate these estimates based on our own historical experience, knowledge and assessment of current business and other conditions, our expectations regarding the future based on available information and reasonable assumptions, which together form our basis for making judgments about matters that are not readily apparent from other sources. Since the use of estimates is an integral component of the financial reporting process, our actual results could differ from those estimates.

We believe that any reasonable deviation from those judgments and estimates would not have a material impact on our financial condition or results of operations. To the extent that the estimates used differ from actual results, however, adjustments to the consolidated statements of comprehensive income and corresponding balance sheet accounts would be necessary. These adjustments would be made in future financial statements.

When reading our financial statements, you should consider: (i) our critical accounting policies; (ii) the judgment and other uncertainties affecting the application of such policies; and (iii) the sensitivity of reported results to changes in conditions and assumptions. We believe the following accounting policies involve the most significant judgment and estimates used in the preparation of our financial statements.

Realization of Deferred Tax Assets

We account for deferred income taxes using the asset and liability method required by FASB ASC Topic 740, Income Taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

At each balance sheet date, we assess the need to establish a valuation allowance that reduces deferred tax assets when it is more likely than not that all, or some portion, of the deferred tax assets will not be realized. A valuation allowance would be based on all available information including but not limited to our projections of future taxable income, which take into account the market environment for each of the tax-paying entities within the period during which temporary differences reverse or before our tax loss carry-forwards expire, and any available tax planning strategies. Sufficient negative evidence may require that a valuation allowance be established with respect to the deferred tax assets. The deferred tax assets balance is analyzed regularly by management. Based on our historical operating results and projections for our future taxable income over the periods during which the tax loss can be utilized, we believe it is more likely than not we will not realize some portion of our deferred tax assets and, as a result, a valuation allowance of RMB31.9 million (US$5.3 million) was provided for as of December 31, 2013. Projections of future taxable income incorporate several assumptions of future business and operations that may differ from actual experience. If, in the future, our assumptions and estimates that resulted in our projections for future taxable income for each tax-paying component prove to be incorrect, the valuation allowance against our deferred tax assets may be adjusted.

Depreciation and Amortization

Our long-lived assets include property and equipment and intangible assets. We amortize our long-lived assets using the straight-line method over the estimated useful lives of the assets. We make estimates of the useful lives of property and equipment (including the salvage values), and intangibles, in order to determine the amount of depreciation and amortization expenses to be recorded during any reporting period. We amortize leasehold improvements of our retail drugstores and other business premises over the shorter of five years or the lease term. A majority of our leases have a five-year term. We estimate the useful lives of our other property and equipment at the time we acquire the assets based on our historical experience with similar assets as well as anticipated technological and other changes. If technological changes were to occur more rapidly than anticipated or in a different form than anticipated, we may shorten the useful lives assigned to these assets as appropriate, which will result in the recognition of increased depreciation and amortization expense in future periods. There was no change to the estimated useful lives and salvage values in 2011, 2012 and 2013.

Impairment of Long-Lived Assets

We evaluate long-lived assets, including property and equipment and intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We assess recoverability by comparing the carrying amount of an asset to the estimated undiscounted future cash flow expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, we recognize an impairment charge based on the amount by which the carrying amount of the asset exceeds the fair value of the asset. We estimate the fair value of the asset based on the best information available, including prices for similar assets and in the absence of an observable market price, the results of using a present value technique to estimate the fair value of the asset. We recognized impairment losses of RMB14.2 million, RMB7.6 million and RMB7.0 million (US$1.2 million) in 2011, 2012 and 2013, respectively, with respect to leasehold improvements and store fixtures of certain underperforming stores.

Impairment of Goodwill

Our goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in business combinations. We evaluate goodwill at least annually for impairment, and more frequently if events and circumstances indicate that it might be impaired.

We evaluate the recoverability of goodwill using a two-step impairment test approach at the reporting unit level at the end of each year. The first step of the impairment test involves comparing the fair value of our reporting unit with the reporting unit's carrying amount, including goodwill. Next, if the carrying amount of the reporting unit exceeds its fair value, we then recognize an impairment loss for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. We determine the implied fair value by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB ASC Topic 805, Business Combinations. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. We did not recognize any goodwill impairment loss in 2011, 2012 or 2013.

Inventories

Our inventories are stated at the lower of cost, determined under the weighted average cost method, or market value. Our inventories are not subject to significant risk of obsolescence. We manage our inventory level based on historical sales trends, forecasted customer demand and lead time in supplier delivery. We identify inventories of medicine products which have remaining shelf life of six months or less, which under the terms of our purchase agreements, may be returned to the suppliers in exchange for new batches of products. Our inventory write-downs due to shrinkage losses and damaged merchandise in 2011, 2012 and 2013 were RMB9.4 million, RMB9.1 million and RMB11.9 million (US$2.0 million), respectively.

Results of Operations

The following table sets forth a summary of our consolidated statements of comprehensive income for the periods indicated. Our historical results presented below are not necessarily indicative of the results that may be expected for any other future period.

	Year Ended December 31,						
	2011		2012		2013		
	RMB	% of Revenue	RMB	% of Revenue	RMB	US$	% of Revenue
	(In thousands, except percentage and per share data)						
Revenue	2,491,290	100.0	2,549,856	100.0	2,699,103	445,860	100.0
Cost of goods sold	(1,302,653)	(52.3)	(1,369,312)	(53.7)	(1,520,796)	(251,218)	(56.3)
Gross profit	1,188,637	47.7	1,180,544	46.3	1,178,307	194,642	(43.7)
Operating expenses:							
Sales, marketing and other operating expenses	(1,015,165)	(40.7)	(1,011,695)	(39.7)	(1,026,798)	(169,615)	(38.0)
General and administrative expenses (1)	(120,671)	(4.9)	(115,734)	(4.5)	(121,542)	(20,077)	(4.5)
Impairment losses of property and equipment	(14,164)	(0.6)	(7,649)	(0.3)	(6,984)	(1,154)	(0.3)
Other income	—	—	1,480	0.1	—	—	—
Income from operations	38,637	1.5	46,946	1.8	22,983	3,796	0.9
Net interest income (2)	23,154	0.9	16,435	0.6	15,713	2,596	0.6
Dividend income from cost method investments	3,616	0.1	4,528	0.2	5,232	865	0.2
Equity in income of an equity method investee	1,552	0.1	1,337	0.1	—	—	—
Gain on disposal of an equity method investee (3)	—	—	68,440	2.7	—	—	—
Income tax expense	(31,026)	(1.2)	(47,594)	(1.9)	(32,100)	(5,303)	(1.2)
Net income attributable to China Nepstar Chain Drugstore Ltd.	35,933	1.4	90,092	3.5	11,828	1,954	0.4
Earnings per ordinary share							
Basic	0.17		0.45		0.06	0.01	
Diluted	0.17		0.45		0.06	0.01	

(1) General and administrative expenses in 2011 included reversal of share-based compensation expenses of RMB1.2 million.

(2) Net interest income includes "interest income" and "interest expense" set forth in our consolidated financial statements included elsewhere in this annual report.

(3) Gain on disposal of an equity method investee in 2012 represents the gain from the disposal of our 40% equity interest in JZJ. On December 28, 2012 the Company completed the sales of its 40% equity interests in JZJ to Yunnan Jianzhijia Holding Co., Ltd. ("JZJ Holding") for a total cash consideration of RMB81.5 million. A gain of RMB68.4 million was recognized in income upon completion of the sales.

Comparison of Years Ended December 31, 2012 and December 31, 2013

Revenue. Our revenue was RMB2,699.1 million (US$445.9 million) in 2013 compared to RMB2,549.9 million in 2012. The same store sales (for 1,893 operating stores opened prior to December 31, 2011) increased by 10.3% from RMB3,167 in 2012 to RMB3,492 (US$576.8) in 2013. The increase in revenue as well as same store sales was driven by continued optimization of our merchandise portfolio through diversification into non-pharmaceutical categories, the closure of underperforming stores and more intensive sales promotion initiatives. Sales of over-the-counter drugs accounted for 39.1% and 39.2% of our revenue in 2012 and 2013, respectively; sales of prescription drugs accounted for 20.4% and 22.3% of our revenue in 2012 and 2013, respectively; and sales of nutritional supplements accounted for 15.7% and 14.5% of our revenue in 2012 and 2013, respectively.

Gross Profit. Our gross profit was RMB1,178.3 million (US$194.6 million) in 2013 compared to RMB1,180.5 million in 2012. Our gross margin was 43.7% in 2013 compared to 46.3% in 2012. This decrease in gross margin was primarily due to downward pressure on sales price as a result of the implementation of more sales promotion initiatives to increase our market share.

Operating Expenses. Our operating expenses were RMB1,155.3 million (US$190.8 million) in 2013 compared to RMB1,135.1 million in 2012. Operating expenses as a percentage of our revenue was 42.8% in 2013, compared to 44.5% in 2012.

- ***Sales, Marketing and Other Operating Expenses.*** Our sales, marketing and other operating expenses increased by 1.5% from RMB1,011.7 million in 2012 to RMB1,026.8 million (US$169.6 million) in 2013, primarily due to the implementation of more sales promotion initiatives.
- ***General and Administrative Expenses.*** Our general and administrative expenses increased by 5.0% from RMB115.7 million in 2012 to RMB121.5 million (US$20.1 million) in 2013.
- ***Impairment Losses***. We recognized impairment losses of RMB7.6 million and RMB7.0million (US$1.2 million) in 2012 and 2013, respectively, representing the reduction of the carrying amount of the property and equipment of certain underperforming stores.

Income from Operations. As a result of the foregoing, our income from operations was RMB23.0 million (US$3.8 million) in 2013 compared to RMB46.9 million in 2012. Our operating margin was 0.9% in 2013 compared to 1.8% in 2012.

Net Interest Income. Our net interest income was RMB15.7 million (US$2.6 million) in 2013, compared to RMB16.4 million in 2012.

Dividend Income from Cost Method Investments. Dividends received from our investments in companies accounted for under the cost method were RMB5.2 million (US$0.9 million) in 2013 compared to RMB4.5 million in 2012.

Equity income of an equity method investee. Equity income of an equity method investee was nil in 2013, compared to that of RMB1.3 million in 2012. The decrease was due to the disposal of our 40% interest in JZJ in 2012.

Gain on Disposal of an Equity Method Investee. Gain on disposal of an equity method investee decreased from RMB68.4 million in 2012 to nil in 2013, due to the disposal of our 40% interest in JZJ in 2012.

Income Tax Expense. Our income tax expense decreased from RMB47.6 million in 2012 to RMB32.1 million (US$5.3 million) in 2013. Our effective tax rate increased to 73.1% in 2013 as compared to 34.6% in 2012, primarily due to non-deductible expenses and the relatively high operating losses from loss-making subsidiaries, for which full valuation allowances were made on their deferred tax assets as compared to the overall results of the Company. In the PRC, losses in companies which are part of a group are not allowed to be off-set against profits of other companies in the same group. In addition, in February 2014, the Company was denied its Hong Kong tax residency that applied to the year ended December 31, 2013 by the Hong Kong Inland Revenue Department. The Company is therefore now subject to a standard withholding tax rate of 10%, rather than a reduced tax rate of 5% under the tax treaty previously applied by the Company, for dividends to be paid or appropriated from the Company's PRC subsidiaries.

Net Income. As a result of the foregoing, our net income was RMB11.8 million (US$2.0 million) in 2013 compared to RMB90.1 million in 2012.

Comparison of Years Ended December 31, 2011 and December 31, 2012

Revenue. Our revenue was RMB2,549.9 million (US$409.3 million) in 2012 compared to RMB2,491.3 million in 2011. The same store sales for stores opened prior to December 31, 2010 increased from RMB2,838 in 2011 to RMB3,085 (US$495) in 2012. The increase in revenue as well as same store sales was principally driven by the optimization of our merchandise portfolio through diversification into non-pharmaceutical product categories, the closure of underperforming stores as well as the strengthening of our marketing and promotion efforts. Sales of over-the-counter drugs accounted for 36.6% and 39.1% of our revenue in 2011 and 2012, respectively; sales of prescription drugs accounted for 19.9% and 20.4% of our revenue in 2011 and 2012, respectively; and sales of nutritional supplements accounted for 18.1% and 15.7% of our revenue in 2011 and 2012, respectively.

Gross Profit. Our gross profit was RMB1,180.5 million (US$189.5 million) in 2012 compared to RMB1,188.6 million in 2011. Our gross margin was 46.3% in 2012 compared to 47.7% in 2011. The decrease in gross margin was primarily due to changes in product mix and the negative impact from the mandatory price cuts on pharmaceuticals by the PRC government authorities. We expect our gross margin to decline gradually in the near to mid-term as we anticipate further price reductions on pharmaceutical products mandated by the PRC government authorities. In addition, we will continue to increase our offerings of non-pharmaceutical products, which are expected to generate lower gross margins compared to pharmaceutical products.

Operating Expenses. Our operating expenses were RMB1,135.1 million (US$182.2 million) in 2012 compared to RMB1,150.0 million in 2011. Operating expenses as a percentage of our revenue was 44.5% in 2012 compared to 46.1% in 2011.

- ***Sales, Marketing and Other Operating Expenses.*** Our sales, marketing and other operating expenses was RMB1,011.7 million (US$162.4 million) in 2012, which is approximately the same as the expenses of RMB1,015.2 million we incurred in 2011.
- ***General and Administrative Expenses.*** Our general and administrative expenses decreased by 4.1% to RMB115.7 million (US$18.6 million) in 2012 from RMB120.7 million in 2011. The decrease was primarily due to the facts that the Company continued to implement cost management across the entire organization and the Company has written off certain long-aged payables due to discontinued suppliers.
- ***Impairment Losses.*** We recognized impairment losses of RMB14.2 million and RMB7.6 million (US$1.2 million) in 2011 and 2012, respectively, in respect of leasehold improvements and store fixture of certain underperforming stores.

Income from Operations. As a result of the foregoing, our income from operations was RMB46.9 million (US$7.5 million) in 2012 compared to RMB38.6 million in 2011. Our operating margin was 1.8% in 2012 compared to 1.6% in 2011.

Net Interest Income. Our net interest income decreased to RMB16.4 million (US$2.6 million) in 2012 compared to RMB23.2 million in 2011. This decrease was principally a result of reduced cash balance after the distribution of special dividend in the second quarter of 2012. We paid a special cash dividend of US$0.60 per ADS on or around May 24, 2012 totaling RMB378.5 million (US$60.2 million) to shareholders of record as of the close of business on May 7, 2012.

Dividend Income from Cost Method Investments. Dividends received from our investments in companies accounted for under the cost method were RMB4.5 million (US$0.7 million) in 2012 compared to RMB3.6 million in 2011.

Equity income of an equity method investee. Equity income of an equity method investee was RMB1.3 million (US$0.2 million), compared to that of RMB1.6 million in 2011. The decrease in equity income of an equity method investee was mainly due to the weak performance of JZJ in 2012.

Income Tax Expense. Our income tax expense increased to RMB47.6 million (US$7.6 million) in 2012 from RMB31.0 million in 2011. Our effective tax rate decreased from 46.3% in 2011 to 34.6% in 2012. The decrease in our effective tax rate was primarily due to the reversal of deferred tax liabilities arising from equity method investment of RMB6.3 million as a result of dividends distributed from JZJ and reversal of valuation allowance at RMB7.0 million due to utilization of tax losses as a result of the gain from disposal of our 40% equity interest in JZJ.

Net Income. As a result of the foregoing, our net income was RMB90.1 million (US$14.5 million) in 2012 compared with RMB35.9 million in 2011.

<u>Liquidity and Capital Resources</u>

The following table sets forth a summary of our net cash flow information for the periods indicated:

	Year Ended December 31,			
	2011	2012	2013	
	RMB	RMB	RMB	US$
		(In thousands)		
Net cash provided by operating activities	108,152	41,376	6,883	1,137
Net cash provided by/(used in) investing activities	287,647	(19,589)	(15,257)	(2,520)
Net cash used in financing activities	(250,140)	(417,688)	—	—
Net increase/(decrease) in cash	141,089	(396,629)	(10,110)	(1,670)
Cash and cash equivalents at end of the year	767,885	371,256	361,146	59,657

In 2011, 2012 and 2013, we were able to finance a significant portion of our operations and capital investments from our cash flows from operations. As of December 31, 2013, we had RMB361.1 million (US$59.7 million) in cash and cash equivalents. Before 2010, we deposited significant amount of proceeds from our initial public offering with various domestic banks, enrolling in their various wealth management programs, which guarantee principal amounts and provide higher returns compared to ordinary bank deposits. Such deposits were carried as held-to-maturity investment securities in our financial statements and matured in 2010. As of December 31, 2013, no held-to-maturity securities were on our balance sheet. As of December 31, 2013, our total cash, cash equivalents, bank deposits and restricted cash amounted to RMB622.8 million (US$102.9 million). As of December 31, 2013, we had no short-term bank loan balances.

We expect to continue to generate positive operating cash flow in 2014. We believe that our current levels of cash and cash flows from operations will be sufficient to meet our anticipated cash needs for at least the next 12 months.

We are a Cayman Islands holding company and substantially all of our income is derived from the operations of our operating subsidiaries located in the PRC. Therefore, dividends paid to us by our subsidiaries in China are subject to income tax if we are considered a “non-resident enterprise” under the PRC Corporate Income Tax Law. Dividends we receive from our operating subsidiaries located in the PRC may be subject to PRC withholding tax.

We plan to further refine our product selection to include more convenience products with lower gross profit margin. We may need additional cash resources in the future if we experience changed business conditions or other developments. We may also need additional cash resources in the future if we find and wish to pursue opportunities for investment, acquisition, strategic cooperation or other similar actions.

If we determine that our cash requirements exceed the amounts of cash on hand, we may seek to issue debt or equity securities or obtain short-term or long-term bank financing, or we may postpone or downsize our investment plan. Any issuance of equity securities could cause dilution for our shareholders. Any incurrence of indebtedness could increase our debt service obligations and cause us to be subject to restrictive operating and financial covenants. It is possible that, when we need additional cash resources, financing will only be available to us in amounts or on terms that would not be acceptable to us or financing will not be available at all.

Operating Activities

Net cash provided by operating activities was RMB6.9 million (US$1.1 million) in 2013 compared to RMB41.4 million in 2012, primarily due to increased purchases of merchandise on increased sales achieved in 2013.

Net cash provided by operating activities was RMB41.4 million in 2012 compared to RMB108.2 million in 2011. Net cash provided by operating activities in 2012 was lower by comparison to 2011, primarily as a result of the increases in inventory of the non-pharmaceutical categories due to the optimization of the Company’s product portfolio. It was also partially caused by stocking of certain best—selling pharmaceutical products, for which the Company has relatively shorter credit terms than the other merchandise items, for the peak sales season of the coming quarter.

Investing Activities

Net cash used in investing activities was RMB15.3 million (US$2.5 million) in 2013 compared to net cash used in investing activities of RMB19.6 million in 2012, primarily due to the increase of cash proceeds from withdrawal of time deposits with original maturity over three months.

Net cash used in investing activities was RMB19.6 million in 2012 compared to net cash provided by investing activities of RMB287.6 million in 2011, primarily as the result of decrease of cash proceed from withdrawal of time deposits with original maturity over three months and the increase on restricted cash.

Financing Activities

Net cash provided by or used in financing activities was nil in 2013. The dividend declared on November 26, 2013 was paid on or around January 24, 2014 to shareholders of record as of the close of business on December 20, 2013.

Net cash used in financing activities was RMB417.7 million in 2012, which primarily consisted of dividends payments in 2012 totaling RMB378.5 million.

Net cash used in financing activities was RMB250.1 million in 2011, which primarily consisted of dividends payments in 2011 totaling RMB205.2 million.

Restrictions on Cash Dividends

For a discussion on the ability of our subsidiaries to transfer funds to our company, and the impact this has on our ability to meet our cash obligations. We rely on dividends paid by our consolidated operating subsidiaries to fund any cash and financing requirements we may have, and any limitation on the ability of our consolidated PRC entities to pay dividends to us could have a material adverse effect on our ability to conduct our business. PRC rules and regulations may subject our PRC resident shareholders and our PRC share option holders to personal liability, limit our ability to inject capital into our consolidated PRC entities, limit the ability of our consolidated PRC entities to distribute profits to us, or otherwise adversely affect us. Dividends we receive from our operating subsidiaries located in the PRC may be subject to PRC withholding tax.

Capital Expenditures

In 2011, 2012 and 2013, our capital expenditures totaled RMB32.8 million, RMB35.0 million and RMB47.2 million (US$7.8 million), respectively. In the past, our capital expenditures were used primarily to open drugstores, acquire drugstores through business combinations, set up distribution centers and install and upgrade our integrated information management system. We estimate that our capital expenditures in 2014 will range from approximately RMB50.0 million to RMB80.0 million, which we plan to use to open new stores, remodel existing stores and upgrade our integrated information management system.

Borrowings

During November 2009, certain financial institutions in the PRC provided us with short-term bank loans in the aggregate amount of RMB410.0 million and credit facilities in the aggregate amount of RMB250.0 million. Time deposits that we had placed with such financial institutions in the amount of RMB500.0 million and RMB250.0 million were pledged as security interests for the short-term bank loan and credit facilities, respectively. The security interests for the short-term bank loans are released upon repayment and the security interests for the credit facilities are released upon the expiration of such facilities, which was three months from the date such credit facilities became available to us. The short-term borrowings were primarily obtained for general working capital purposes, including dividend payments. All outstanding short-term borrowings were repaid in January 2010 and the security deposits were released accordingly. As of December 31, 2013, we had no outstanding short-term borrowings.

Inflation

According to the National Bureau of Statistics of China, China's overall national inflation rate, as represented by the general consumer price index, was approximately 5.4% in 2011, 2.6% in 2012 and 2.6% in 2013.

Intellectual Property

Our rights to our trade names and trademarks are the most important factor in marketing our stores and private label products. Our company's name, Nepstar, means "Neptunus & Star" in Chinese. The trademark "Neptunus," or "Haiwang," is owned by the Neptunus Group, and we have obtained the non-exclusive right to use "Neptunus" for free so long as the trademark is valid through a licensing agreement with the Neptunus Group. The "Haiwang" trademark was designated as a "China Well-Known Trademark" by the SAIC in 2004, and the Neptunus Group may apply to the relevant administrative authority for an injunction prohibiting a third party's use of the "Haiwang" name as well as to compel the third party to cancel any other registration of the "Haiwang" name under certain circumstances. In addition, we have registered four trademarks in China, and are in the process of applying for five additional trademarks. Our trademarks include the Chinese characters for "Star" and related logos.

In addition to "Neptunus," we have also obtained rights to use an aggregate of 522 additional trademarks, including 251 registered trademarks that we have obtained exclusive rights to use, 248 registered trademarks that we have obtained non-exclusive rights to use, and 23 trademarks that are in the process of being registered by subsidiaries of the Neptunus Group. We use these licensed trademarks to develop our private label products. As of December 31, 2013, we have developed 2,104 private label products with these licensed trademarks.

Under PRC law, we have the exclusive right to use a trademark for products and services for which the trademark has been registered with the SAIC. Trademark registration is valid for 10 years, starting from the day the registration is approved. If we believe that a third party has infringed upon our exclusive rights with respect to any of our registered or licensed trademarks, we may, through appropriate administrative and civil procedures, institute proceedings to request the relevant authority for an injunction. The relevant authority also has power to impose fines, confiscate or destroy the infringing products or equipment used to manufacture the infringing products. As our brand names and trademarks become more recognized in the drug market in China, we are devoting additional resources to increasing and enforcing our trademark rights, which is critical to our overall branding strategy and reputation.

We also rely on trade secrets to protect our know-how and other proprietary information. Similar to other retailers, we generate proprietary information in connection with our operations, such as pricing, purchasing, promotional strategies, customer lists and supplier lists. We believe this proprietary information is essential to the operations of our business and the success of our competition strategies, and we strive to protect such information. For example, the key members of our management team have signed a confidentiality agreement with us pursuant to which they have committed not to disclose the confidential information acquired during their employment with us and not to compete with us for three years after their employment terminates.

If our trademarks are challenged, our brand name is damaged and/or our trade secrets become known by our competitors, there could be an adverse effect on our business. Our brand name, trade names, trademarks, trade secrets and other intellectual property are valuable assets. If we are unable to protect them from infringement, our business and prospects may be harmed.

Trend Information

Other than as disclosed elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events for the period from January 1, 2013 to the date of this annual report that are reasonably likely to have a material effect on our revenue, net income, profitability, liquidity or capital resources, or that would cause the disclosed financial information to be not necessarily indicative of future operating results or financial conditions.

Off-Balance Sheet Arrangements

We have not entered into, nor do we expect to enter into, any off-balance sheet arrangements. We also have not entered into any financial guarantees or other commitments to guarantee the payment obligations of third parties. In addition, we have not entered into any derivative contracts that are indexed to our equity interests and classified as shareholders' equity. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or that engages in leasing, hedging or research and development services with us.

Tabular Disclosure of Contractual Obligations

The following table sets forth our contractual obligations as of December 31, 2013:

	Payment due by period				
Contractual Obligations	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**	**Total**
	(In thousands of RMB)				
Operating lease commitments	218,622	374,495	152,511	35,410	781,038
Total	218,622	374,495	152,511	35,410	781,038

Safe Harbor

This annual report contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended that relate to our current expectations and views of future events. The forward-looking statements are contained principally in the sections entitled “Risk Factors,” “Item 4. Information on the Company” and “Item 5. Operating and Financial Review and Prospects.” These statements relate to events that involve known and unknown risks, uncertainties and other factors, including those listed under “Risk Factors,” which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. In some cases, these forward-looking statements can be identified by words or phrases such as “aim,” “anticipate,” “believe,” “continue,” “estimate,” “expect,” “intend,” “is/are likely to,” “may,” “plan,” “potential,” “will” or other similar expressions. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements include, among other things, statements relating to:

- our growth strategies;
- our future business development, financial condition and results of operations;
- market acceptance of the merchandise we carry in our stores, especially our private label products;
- our ability to identify and respond to changing customer preferences;
- our ability to enhance and maintain our brand names;
- our ability to achieve anticipated volume purchasing benefits;
- our ability to establish effective advertising, marketing and promotional programs;
- our ability to manage our supply chain and our distribution centers;
- our ability to attract and retain a sufficient number of pharmacists for our stores;
- our ability to manage our operations;
- competition from other drugstore chains and independently operated drugstores;
- the expected growth of the drugstore industry in China;
- our ability to obtain permits and licenses to carry on our business; and
- fluctuations in general economic and business conditions in China.

The forward-looking statements made in this annual report relate only to events or information as of the date on which the statements are made in this annual report. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, after the date on which the statements are made or to reflect the occurrence of unanticipated events. You should read this annual report and the documents that we reference in this annual report and have filed as exhibits to this annual report with the understanding that our actual future results may be materially different from what we expect.

This annual report also contains data related to the pharmaceutical market in China, and we have derived such data from *China Drugstore* magazine. These market data include projections that are based on a number of assumptions. Unlike in the United States, there are limited authoritative data in China on the pharmaceutical market, particularly on a nationwide basis. In addition, any data that is available may not be current. Moreover, the pharmaceutical retail market in China may not grow at the rates projected by the market data, or at all. The failure of the market to grow at the projected rates may have a material adverse effect on our business, financial condition, results of operations and the market price of our ADSs. In addition, the rapidly changing nature of the pharmaceutical market subjects any projections or estimates relating to the growth prospects or future condition of our market to significant uncertainties. Further, if any one or more of the assumptions underlying the market data turns out to be incorrect, actual results may differ from the projections based on these assumptions. You should not place undue reliance on these forward-looking statements.

DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

The following table sets forth information regarding our directors and executive officers as of the date of this annual report on Form 20-F.

Name	Age	Position/Title*
Simin Zhang	52	Chairman of the Board of Directors
Barry J. Buttifant	69	Independent Director (1)(2)(3)
Stephanie Hui	41	Director
Alistair Eric MacCallum Laband	62	Independent Director (1)(2)(3)
Alan Au	42	Independent Director (1)(2)
Fuxiang Zhang	41	Chief Executive Officer
Zixin Shao	45	Chief Financial Officer

(1) Members of the audit committee
(2) Members of the compensation committee
(3) Members of the corporate governance and nominating committee

Simin Zhang is our founder and has served as chairman of our board of directors since June 1995. Mr. Zhang is also the chairman of the board of directors of the Neptunus Group. Prior to founding the Neptunus Group in July 1989, he was an employee in CITIC Group from 1986 to 1989. From 1983 to 1986, he was an employee in the PRC Space Administration. He is currently a guest professor at the Harbin Institute of Technology and Jilin University, an executive director of China Enterprise Confederation and China Enterprise Directors Association and the president of Shenzhen General Chamber of Commerce. Mr. Zhang received a bachelor's degree in precision instruments from Harbin Institute of Technology in 1983, an honorary doctorate from University of Newcastle in Australia in 1997 and a Ph.D. degree in economics from Nan Kai University in 2001.

Barry J. Buttifant has been a director of our company since November 2007. He is a member of our audit committee, compensation committee, corporate governance and nominating committee. He is an independent non-executive director of Daiwa Associate Holdings Limited and Giordano International Limited, all of which are publicly listed companies in Hong Kong. Dr. Buttifant also serves as a non-executive director of Global-Tech Advanced Innovations Inc., a NASDAQ listed company.

Dr. Buttifant is currently an independent adviser to MCL Financial Group Ltd. From 2011 to 2014, he was an executive director of Hsin Chong Construction Group Ltd ("HCCG") and a non-executive director of Synergis Holdings Limited ("Synergis"), both of which are listed on the Stock Exchange of Hong Kong. Prior to that, he was group chief executive officer of IDT International Limited. In October 2009, Dr. Buttifant became a director for corporate finance of Mission Hills Group ("MHG"). Prior to this appointment, he was a consultant to the MHG since December 2008. Prior to joining MHG, he served as a principal to KLC Kennic Lui & Company ("KLC"), a professional accounting firm, and managing director of KLC Transactions Limited. Prior joining KLC, Dr. Buttifant was the executive director for finance, of MHG. In December 2004, he was the managing director of Hsin Chong International Holdings Limited, a controlling shareholder of HCCG (which was acquired by MHG in November 2007) and Synergis (which was acquired by HCCG in September 2008). Dr. Buttifant was also an alternate director to both HCCG and Synergis. Dr. Buttifant was an operating partner of Barings Private Equity Asia Limited. He was also the managing director of Wo Kee Hong (Holdings) Limited ("WKH") from 2001 to 2002 and was the advisor to the Board of Directors of WKH from 2002 to 2004. Prior to joining WKH, he was the managing director of IDT International Limited for over eight years, as well as working for Polly Peck Group and Sime Darby Hong Kong Limited for more than 11 years in the capacity of finance director and managing director. Dr. Buttifant is a fellow member of the Association of Chartered Certified Accountants (UK); the Hong Kong Institute of Certified Public Accountants; the Chartered Management Institute (UK); the Hong Kong Management Association and the Hong Kong Institute of Directors. He was awarded an honorary doctorate of Business Administration (honoris causa) by Edinburgh Napier University, United Kingdom in 2013.

Stephanie Hui has served as a director of our company since October 2004. She is a managing director of Goldman Sachs (Asia) L.L.C. Ms. Hui was with Goldman Sachs & Co. in New York from 1995 to 1997 and Goldman Sachs (Asia) L.L.C. in 1998. Ms. Hui rejoined Goldman Sachs (Asia) L.L.C. in 2000 after obtaining an MBA degree from Harvard Business School in 2000. Ms. Hui received a bachelor's degree in biology from Harvard University in 1995. Ms. Hui currently serves on the board of directors of Shenzhen Hepalink Pharmaceutical Co., Ltd.

Alistair Eric MacCallum Laband has been a director of our company since November 2007. Mr. Laband is a member of our audit committee, our compensation committee and corporate governance and nominating committee. Since August 2013, Mr. Laband has been an Independent Non-Executive Director of The Tom Lee Music Company Ltd. From November 2008 until the end of March 2011 Mr. Laband was a financial consultant to CITIC Pacific Ltd., a company listed on the Hong Kong Stock Exchange. From 2003 to June 2007, he was a partner of PricewaterhouseCoopers, or PwC, Hong Kong/China and until March 2007, secretary of the PwC Asia Region Board. From 2001 to 2002, he was a partner in charge of the Company Secretarial Services Group of PwC's Hong Kong office. From 1997 to 2001, he was finance/operations partner and a management board member of the Hong Kong office of Price Waterhouse, or PW, and subsequently, the Hong Kong office of PwC. From 1997 to 1998, he was also in charge of the company secretarial and legal services group of PW's Hong Kong office. Mr. Laband obtained a bachelor's degree in law from the University of Cambridge in 1973 and a diploma in accountancy from the University of Strathclyde in 1976. Mr. Laband is a Chartered Accountant of the Institute of Chartered Accountants of Scotland and a Fellow of the Institute of Certified Public Accountants of Hong Kong.

Alan Au has been a director of our company since May 2013. He is a member of our audit committee and compensation committee. Mr. Au is a senior adviser of Simcere Pharmaceutical Group, a China-based pharmaceutical company that used to be listed on the New York Stock Exchange, and a venture partner of Ally Bridge Group, a biotech-focused investment fund headquartered in Hong Kong. He also serves on the assessment panel of the Small Entrepreneur Research Assistance Program (SERAP) for the Innovation and Technology Commission of the Hong Kong SAR Government.

Mr. Au was the head of Asia healthcare investment banking group for Deutsche Bank AG from 2011 to 2012, in charge of healthcare IPO and M&A transactions in the region. Prior to that, he was a director at JAFCO Asia Investment Group, responsible for healthcare investments in China from 2008 to 2011, and a director at Morningside Group responsible for healthcare investments in Asia from 2000 to 2005. From 1995 to 1999, Mr. Au worked at KPMG and KPMG Corporate Finance Ltd., responsible for regional M&A transactions and financial advisory services.

Mr. Au is a Certified Public Accountant in the U.S. and holds the Chartered Financial Analyst (CFA) designation. He is an associate member of the Hong Kong Institute of Financial Analysts and member of the American Institute of Certified Public Accountants. Mr. Au received his Bachelor's degree in Psychology from the Chinese University of Hong Kong in 1995, and a Master's degree in Management from Columbia Business School in New York in 2007.

Fuxiang Zhang was appointed by our board of directors as our chief executive officer in August 2011. Mr. Zhang joined our company in 1997 and served as our vice president from 2006 to 2011 and then as our chief operating officer from March 2011 until his promotion in August 2011. From 2003 to 2006, Mr. Zhang served as the general manager of Shenzhen Nepstar Group Co., Ltd., one of our regional Nepstar companies. From 1999 to 2003, he was the vice general manager and then promoted to general manager of Nepstar Dalian. Mr. Zhang received a bachelor's degree in international economics in 1997 and a master's degree in industrial engineering in 2010 from the Harbin Institute of Technology.

Zixin Shao was appointed by our board of directors as our chief financial officer in November 2010. Mr. Shao joined our company in 2003 and has served as financial controller for our company since then. Prior to joining our company, he worked as a director, vice general manager and chief financial officer in China Resources Supermarket (Suzhou) Co., Ltd. from 1999 to 2001. From 1992 to 2002, he also held financial management position at China Resources Supermarket (HK) Co., Ltd. Mr. Shao received a bachelor's degree in accounting from the University of International Business and Economics in China in 1992. Mr. Shao is a PRC certified accountant.

The address of our directors and executive officers is c/o China Nepstar Chain Drugstore Ltd., 6th Floor, Tower B, Xinnengyuan Building, Nanhai Road, Nanshan District, Shenzhen, Guangdong Province 518054, People's Republic of China. No family relationship exists between any of our directors and executive officers.

Compensation of Directors and Executive Officers

Cash Compensation

In 2013, the aggregate cash compensation to our executive officers, including all the directors, was RMB3.2 million (US$0.5 million).

Pre-IPO Share Option Scheme

Our Pre-IPO Share Option Scheme was adopted by our shareholders on August 30, 2005 and amended and restated on March 20, 2006. The purpose of the scheme was to aid us in recruiting and retaining key employees, directors or consultants of outstanding ability and to motivate such employees, directors or consultants to exert their best efforts on behalf of our company by providing incentives through the granting of options. Our board of directors believed that our company's long-term success is dependent upon our ability to attract and retain superior individuals who, by virtue of their ability, experience and qualifications, make important contributions to our business.

Termination of Options. Options granted under the scheme must have specified terms set forth in an option agreement. The board of directors determines, in its absolute discretion, the period during which an option may be exercised, provided that such period shall not commence before the listing date on which dealings in our shares first commence on an approved stock exchange, including the New York Stock Exchange, nor be it longer than five years from the date on which our ADSs are first listed on the New York Stock Exchange, or the listing date. If the options are not exercised or purchased on the last day of the period of exercise, they will terminate.

Duration and Administration. Subject to earlier termination, our Pre-IPO Share Option Scheme was valid and effective until the day immediately prior to the listing date. Thereafter, no further options may be granted under the scheme, but the scheme will remain in full force with respect to the options granted before the listing date. Our Pre-IPO Share Option Scheme is administered by our board of directors. Subject to the terms of the scheme, our board of directors has the right to interpret the scheme, determine the persons who will be awarded options under the scheme and the number of shares to be issued under the scheme, to make such appropriate and equitable adjustments to the terms of options granted under the scheme, and to make any other decisions, determinations or regulations that it deems appropriate for the administration of the scheme. Our board of directors will determine the provisions, terms and conditions of each option in accordance with the scheme, including, but not limited to, the exercise price for an option, vesting schedule of options, forfeiture provisions, form of payment of exercise price and other applicable terms.

Option Exercise. The term during which options granted under our Pre-IPO Share Option Scheme may be exercised shall not commence before our listing date nor be longer than five years from our listing date. The consideration to be paid for our ordinary shares upon exercise of an option or purchase of shares underlying the option may include cash, electronic funds transfer, or certified or cashier's check subject to such specific procedures or discretions of our board of directors.

Amendment and Termination. The provisions of the scheme may be amended or altered in any respect by resolution of our board of directors, provided that such resolution includes the affirmative votes of at least one of the two directors appointed by the GS Funds, or by resolution in writing by all members of our board of directors, except that the certain provisions of the scheme may not be altered to the advantage of the potential participants in the scheme except with the prior approval of our shareholders in general meeting, provided that such approval includes the affirmative votes of members holding more than 50.0% in voting power of the issued and outstanding Series A redeemable convertible preferred shares, or by resolution in writing by all of our shareholders.

Lock-up. Under the option agreements, holders of our options (and permitted transferees) have agreed that they will not, directly or indirectly, offer, sell or transfer or dispose of any of the shares subscribed upon exercise of their options during the period commencing as of 14 days prior to and ending one year after the effective date of the registration statement or prospectus covering any public offering of our securities, or such lesser period of time the underwriters may permit. Holders of our options are permitted to participate in a registered offering with respect to any shares they hold, subject to the discretion of our board of directors.

Our board of directors and shareholders authorized the issuance of up to 8,680,000 ordinary shares upon exercise of options granted under our Pre-IPO Share Option Scheme. On August 30, 2005, we granted options to purchase 1,000,000 ordinary shares to 296 of our staff, including senior management, key employees and other employees, with an exercise price of US$0.075 per share. On March 20, 2006, we granted options to purchase 6,680,000 ordinary shares to 456 of our staff, including senior management, key employees and other employees, with an exercise price of US$0.75 per share. On September 1, 2006, we granted options to purchase 1,000,000 ordinary shares to an executive officer with an exercise price of US$0.75 per share. The Pre-IPO Share Option Scheme terminated after the completion of our initial public offering in November 2007. As of December 31, 2011, all of the ordinary share options granted under the Pre-IPO Share Option Scheme have been vested. The remaining options under the Pre-IPO Share Option Scheme expired on November 10, 2012.

2007 Share Incentive Plan

The 2007 share incentive plan was adopted by our shareholders on June 30, 2007. The 2007 share incentive plan provides for the grant of options, limited share appreciation rights, and other share-based awards such as restricted shares, referred to hereafter as "awards." The purpose of the plan is to aid us in recruiting and retaining key employees, directors or consultants of outstanding ability and to motivate such employees, directors or consultants to exert their best efforts on behalf of our company through the granting of awards. Our board of directors believes that our company's long-term success is dependent upon our ability to attract and retain talented individuals who, by virtue of their ability, experience and qualifications, make important contributions to our business.

Termination of Awards. Options and restricted shares will have specified terms set forth in an award agreement. The compensation committee will determine in the relevant award agreement whether options granted under the award agreement will be exercisable following the recipient's termination of services with us. If the options are not exercised or purchased on the last day of the period of exercise, they will terminate.

Administration. The 2007 share incentive plan is administered by the compensation committee of our board of directors. The committee is authorized to interpret the plan, to establish, amend and rescind any rules and regulations relating to the plan, and to make any other determinations that it deems necessary or desirable for the administration of the plan. The committee will determine the provisions, terms and conditions of each award, including, but not limited to, the exercise price for an option, vesting schedule of options and restricted shares, forfeiture provisions, form of payment of exercise price and other applicable terms.

Option Exercise. The term of options granted under the 2007 share incentive plan may not exceed five years from the date of grant. The consideration to be paid for our ordinary shares upon exercise of an option or purchase of shares underlying the option may include cash, check or other cash-equivalent, ordinary shares, consideration received by us in a cashless exercise, or any combination of the foregoing methods of payment.

Third Party Acquisition. If a third party acquires us through the purchase of all or substantially all of our assets, a merger or other business combination, the compensation committee may decide that all outstanding awards that are unexercisable or otherwise unvested or subject to lapse restrictions will automatically be deemed exercisable or otherwise vested or no longer subject to lapse restrictions, as the case may be, as of immediately prior to such acquisition. The compensation committee may also, in its sole discretion, decide to cancel such awards for fair value, provide for the issuance of substitute awards that will substantially preserve the otherwise applicable terms of any affected awards previously granted, or provide that affected options will be exercisable for a period of at least 15 days prior to the acquisition but not thereafter.

Amendment and Termination of Plan. Our board of directors may at any time amend, alter or discontinue our 2007 share incentive plan. Amendments or alterations to our 2007 share incentive plan are subject to shareholder approval if they increase the total number of shares reserved for the purposes of the plan or change the maximum number of shares for which awards may be granted to any participant, or if shareholder approval is required by law or by stock exchange rules or regulations. Any amendment, alteration or termination of our 2007 share incentive plan must not adversely affect awards already granted without written consent of the recipient of such awards. Unless terminated earlier, our 2007 share incentive plan shall continue in effect for a term of ten years from the date of adoption.

On November 9, 2007, we granted 200,000 shares options with a grant date fair value of approximately US$2.86 per option or US$0.6 million (RMB4.3 million) in the aggregate, to four newly appointed independent directors. The exercise price of such options is US$8.10 per share, which was equal to the initial public offering price of our ordinary shares. The share options vest and become exercisable in three equal annual installments on the first, second and third of the anniversaries of the date of grant, and expire on the tenth anniversary of the date of grant.

On January 5, 2009, we granted 600,000 options with a grant date fair value of approximately US$0.78 per option or RMB3.2 million in aggregate, to our chief financial officer at the time, William Weili Dai. The exercise price of such options is US$2.40 per share. The share options vest and become exercisable in three equal annual installments on the first, second and third of the anniversaries of the date of grant, and expire on the tenth anniversary of the date of grant. On January 5, 2010, we granted another 200,000 options with a grant day fair value of approximately US$0.92 per option to Mr. Dai. The exercise price of such options is US$3.725 per share. The options vest and became exercisable on January 5, 2013, and expire on the tenth anniversary of the date of grant. Upon Mr. Dai’s resignation in November, 2010, 600,000 of the share options granted to him were forfeited.

On January 5, 2010, we granted an aggregate of 800,000 options with a grant day fair value of approximately US$0.91 per option to Jason Xinghua Wu, our former chief executive officer. The exercise price of such options is US$3.725 per share. Upon Mr. Wu’s resignation in August 2011, 600,000 unvested options of the 800,000 options granted to him were forfeited immediately and the remaining 200,000 vested options were forfeited in February 2012.

On March 2, 2010, we granted an aggregate of 150,000 fully vested ordinary shares to our three current independent directors, and 50,000 non-vested ordinary shares to Jason Xinghua Wu, our former chief executive officer. The grant of the fully vested ordinary shares to our independent directors was made in exchange for their forfeiture of 150,000 options granted in November 2007. All of the 50,000 ordinary shares granted to Mr. Wu were fully vested before his resignation in August 2011.

The remaining options under the 2007 share incentive plan expired on November 10, 2012.

Board Practices

Committees of the Board of Directors

Audit Committee

Our audit committee consists of Alistair Eric MacCallum Laband, Barry J. Buttifant and Alan Au. Mr. Laband is the chairman of our audit committee and meets the criteria of an audit committee financial expert as set forth under the applicable rules of the SEC. Our board of directors has determined that all members of our audit committee are “independent directors” within the meaning of NYSE Manual Section 303A(2) and will meet the criteria for independence set forth in Section 10A(m)(3) of the Securities Exchange Act of 1934, as amended, or the Exchange Act. The audit committee oversees our accounting and financial reporting processes and the audits of the financial statements of our company. The audit committee is responsible for, among other things:

- selecting our independent registered public accounting firm and pre-approving all auditing and non-auditing services permitted to be performed by our independent registered public accounting firm;

- reviewing with our independent registered public accounting firm any audit issues or difficulties and management’s response;
- reviewing and approving all proposed related party transactions;
- discussing the annual audited financial statements with management and our independent registered public accounting firm;
- reviewing major issues as to the adequacy of our internal controls and any special audit steps adopted in light of significant control deficiencies;
- annually reviewing and reassessing the adequacy of our audit committee charter;
- such other matters that are specifically delegated to our audit committee by our board of directors from time to time; and
- meeting separately and periodically with management, our internal auditor and independent registered public accounting firm.

Compensation Committee

Our compensation committee consists of Alistair Eric MacCallum Laband, Barry J. Buttifant and Alan Au. Our board of directors has determined that each member of the compensation committee is an “independent director” within the meaning of NYSE Manual Section 303A(2). Our compensation committee assists our board of directors in reviewing and approving the compensation structure of our directors and executive officers, including all forms of compensation to be provided to our directors and executive officers. Members of the compensation committee are not prohibited from direct involvement in determining their own compensation. A chief executive officer may not be present at any committee meeting during which his compensation is deliberated. The compensation committee is responsible for, among other things:

- approving and overseeing the compensation package for our executive officers;
- reviewing and making recommendations to our board of directors with respect to our compensation policies and the compensation of our directors; and
- reviewing periodically and making recommendations to our board of directors regarding any long-term incentive compensation or equity plans, programs or similar arrangements, annual bonuses, employee pension and welfare benefit plans.

Corporate Governance and Nominating Committee

Our corporate governance and nominating committee consists of Barry J. Buttifant and Alistair Eric MacCallum Laband. Our board of directors has determined that each member of the corporate governance and nominating committee is an “independent director” within the meaning of NYSE Manual Section 303A(2). The corporate governance and nominating committee assists our board of directors in identifying individuals qualified to become our directors and in determining the composition of our board of directors and its committees. The corporate governance and nominating committee is responsible for, among other things:

- identifying and recommending to our board of directors nominees for election or re-election to our board of directors, or for appointment to fill any vacancy of our board of directors;
- reviewing annually with our board of directors the current composition of our board of directors in light of the characteristics of independence, age, skills, experience and availability of service to us;
- advising our board of directors periodically with respect to significant developments in the law and practice of corporate governance as well as our compliance with applicable laws and regulations, and making recommendations to our board of directors on all matters of corporate governance and on any corrective action to be taken; and
- monitoring compliance with our code of business conduct and ethics, including reviewing the adequacy and effectiveness of our procedures to ensure proper compliance.

Our board of directors has adopted a code of business conduct and ethics, which is applicable to our senior executive and financial officers. Our code of business conduct and ethics has been filed as exhibits to our registration statement on Form F-1 (File No. 333-146767), as amended, initially filed with the SEC on October 17, 2007.

In addition, our board of directors has adopted a set of corporate governance guidelines. The guidelines will reflect certain guiding principles with respect to the structure of our board of directors, procedures and committees. These guidelines are not intended to change or interpret any law, or our second amended and restated memorandum and articles of association.

Duties of Directors

Under Cayman Islands law, our directors have a fiduciary duty to act honestly, in good faith and with a view to our best interests. Our directors also have a duty to exercise the skills they actually possess and such care and diligence that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our memorandum and articles of association, as amended and restated from time to time. A shareholder has the right to seek damages if a duty owed by our directors is breached.

The functions and powers of our board of directors include, among others:

- convening shareholders’ annual general meetings and reporting its work to shareholders at such meetings;
- issuing authorized but unissued shares and redeeming or purchasing outstanding shares of our company;
- declaring dividends and other distributions;
- appointing officers and determining the term of office of officers;
- exercising the borrowing powers of our company and mortgaging the property of our company; and
- approving the transfer of shares of our company, including the registering of such shares in our share register.

Terms of Directors and Executive Officers

Our executive officers are elected by and serve at the discretion of our board of directors. Our directors are not subject to a term of office and hold office until such time as they resign or are removed from office without cause by special resolution or the unanimous written resolution of all shareholders or with cause by ordinary resolution or the unanimous written resolution of all shareholders. A director will be removed from office automatically if, among other things, the director: (i) becomes bankrupt or makes any arrangement or composition with his creditors; or (ii) dies or is found by our company to be or becomes of unsound mind.

Employment Agreements

We have entered into employment agreements with all of our executive officers. Under these agreements, each of our executive officers is employed for a specified time period. We may terminate his or her employment for cause at any time, with prior written notice, for certain acts of the employee, including but not limited to a felony conviction, or willful gross misconduct by the employee in connection with his employment, and in each case if such acts have resulted in material and demonstrable financial harm to us. An executive officer may, with prior written notice, terminate his or her employment at any time for any material breach of the employment agreement by us that is not remedied promptly after receiving the remedy request from the employee. Furthermore, either party may terminate the employment agreement at any time without cause upon advance written notice to the other party. Upon termination, the employee is generally entitled to a severance pay of at least one month's salary.

Each executive officer has agreed to hold, both during and subsequent to the terms of his or her agreement, in confidence and not to use, except in pursuance of his or her duties in connection with employment by us, any of our confidential information, technological secrets, commercial secrets and know-how. Each of our executive officers has also agreed to disclose to us all inventions, designs and techniques resulted from work performed by him or her, and to assign us all right, title and interest of such inventions, designs and techniques. Moreover, each of our executive officers has agreed that during the term of his or her employment with us and three years thereafter: (i) not to serve, invest or assist in any business that competes with our business; and (ii) not to solicit any of our officers, directors, employees or agents.

Employees

We had 15,189, 14,500 and 14,017 employees as of December 31, 2011, 2012 and 2013, respectively. The following table sets forth the number of our employees for each of our areas of operations and as a percentage of our total workforce as of December 31, 2013:

	As of December 31, 2013	
	Number of Employees	Percentage of Total
Non-pharmacist store staff	8,435	60.2%
Pharmacists	3,598	25.7%
Management	1,305	9.3%
Logistics	679	4.8%
Total	14,017	100%

We place strong emphasis on the quality of our employees at all levels, including in-store pharmacists and store staff who directly interact with our customers. We provide extensive training for newly recruited employees in the first three months of their employment. The training is designed to encompass a number of areas, such as knowledge about our products and how best to interact with our customers. In addition, we regularly carry out training programs on medicine information, nutritional information, selling skills for our store staff and in-store pharmacists, as well as management training for our regional managers and senior management officers at the headquarters. We have also established the Nepstar School of Drugstore Management, with the cooperation and faculty support from Shenzhen Vocational College of Technology, and through this facility we offer training to our senior management and regional managers on store management, procurement and distribution. We believe these programs have played an important role in strengthening the capabilities of our management team.

We are required under PRC law to make contributions to our employee benefit plans including pension, medical insurance, work-related injury insurance, unemployment insurance and maternity insurance. Our contributions are made based on salaries, bonuses and certain allowances of our employees, in amounts within a range specified by the respective local government authorities where we operate our businesses. The total amount of contributions we incurred for these employee benefit plans in 2011, 2012 and 2013 was RMB34.4 million, RMB37.8 million and RMB39.2million(US$6.5 million), respectively.

Our employees are not covered by any collective bargaining agreement. We believe that we have a good relationship with our employees.

Share Ownership

The following table sets forth information with respect to the beneficial ownership of our ordinary shares as of March 31, 2014 by:

- each of our directors and executive officers; and
- each person known to us to own beneficially more than 5.0% of our ordinary shares.

	Shares Beneficially Owned (1)	
	Number	%
Directors and Executive Officers:		
Simin Zhang (2)	107,000,000	54.2
Barry J. Buttifant	—	—
Alistair Eric MacCallum Laband	*	*
Stephanie Hui (3)	50,000,000	25.3
Alan Au	—	—
Fuxiang Zhang	*	*
Zixin Shao	—	—
Principal Shareholders		
China Neptunus Drugstore Holding Ltd.	107,000,000	54.2
GS Funds (4)	50,000,000	25.3

* Beneficially own less than 1.0% of our outstanding ordinary shares.

(1) Beneficial ownership is determined in accordance with Rule 13d-3 under the Exchange Act, and includes voting or investment power with respect to the securities. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, we have included shares that the person has the right to acquire within 60 days. Percentage of beneficial ownership of each listed person is based on 197,446,940 ordinary shares outstanding as of March 31, 2014.

(2) Represents the beneficial ownership of 107,000,000 ordinary shares held by China Neptunus Drugstore Holding Ltd. Simin Zhang is the chairman of the board of directors and owns 100.0% of the equity interest in China Neptunus Drugstore Holding Ltd. China Neptunus Drugstore Holding Ltd. is a BVI company and its address is P.O. Box 3140, Road Town, Tortola, British Virgin Islands.

(3) Represents 50,000,000 ordinary shares held by the GS Funds. Ms. Stephanie Hui, a managing director of Goldman Sachs (Asia) L.L.C., disclaims beneficial ownership of shares held by the GS Funds except to the extent of her pecuniary interest in these shares.

(4) Includes a total of 50,000,000 shares owned by (i) GS Capital Partners 2000, L.P., GS Capital Partners 2000 Employee Fund, L.P. and Goldman Sachs Direct Investment Fund 2000, L.P., each of which is a limited partnership organized under the laws of the State of Delaware, (ii) GS Capital Partners 2000 Offshore, L.P., a Cayman Islands exempted limited partnership, and (iii) GS Capital Partners 2000 GmbH & Co. Beteiligungs KG, a German KG. Each of the GS Funds has a mailing address of c/o Goldman, Sachs & Co., 85 Broad Street, 10th Floor, New York, NY 10004. Affiliates of The Goldman Sachs Group, Inc. are the general partner, managing general partner or investment manager of each of the GS Funds, and each of the GS Funds shares voting and investment power with certain of its respective affiliates. Each of the GS Funds is affiliated with or managed by Goldman, Sachs & Co., a wholly owned subsidiary of The Goldman Sachs Group, Inc. Each of The Goldman Sachs Group, Inc., Goldman, Sachs & Co. and Goldman Sachs (Asia) L.L.C. disclaims beneficial ownership of the shares owned by each of the GS Funds, except to the extent of their pecuniary interest therein.

For details of the options granted to our directors and executive officers, including the title and amount of securities covered by the options, the exercise price, the purchase price and the expiration date of the options, see "—B. Compensation of Directors and Executive Officers—2007 Share Incentive Plan."

None of our shareholders has different voting rights from other shareholders. We are not aware of any arrangement that may, at a subsequent date, result in a change of control of our company. As of March 31, 2014, of the 197,446,940 issued and outstanding ordinary shares, 40,446,940 ordinary shares were registered in the name of a nominee of JPMorgan Chase Bank, N.A., the depositary of our ADSs. Approximately 20.5% of our ordinary shares, representing our ordinary shares held by the depositary, were held in the United States.

Related Party Transactions

After the completion of our initial public offering on November 9, 2007, we adopted an audit committee charter, which requires that the audit committee review all related party transactions on an ongoing basis and all such transactions be approved by the committee. Set forth below is a description of all of our material related party transactions since the beginning of 2007 up to the date of this annual report.

Transactions with Companies in Which a Major Shareholder Had Equity Interests

Simin Zhang, our founder, the chairman of our board of directors and the sole beneficial owner of our controlling shareholder, Neptunus BVI, is the chairman of the board of directors and the controlling person of the Neptunus Group. In 2011, 2012 and 2013, we purchased merchandise from the Neptunus Group and its affiliates totaling RMB105.2 million, RMB92.9 million and RMB138.8 million (US$22.9 million), respectively, and sold merchandise to the Neptunus Group and its affiliates totaling RMB2.2 million , RMB5.5 million and RMB2.5 million (US$0.4 million), respectively. As of December 31, 2010, we fully utilized prepayments of RMB132.9 million made in April 2008 to the Neptunus Group. These prepayments were made in exchange for an 8% to 10% discount of procurement value on more than 100 types of national branded products procured from several companies under the Neptunus Group, namely Shandong Neptunus Galaxy Medicine Co. Ltd. and Shenzhen Neptunus Changjian Pharmaceutical Co. Ltd. and its affiliates. In 2010, we purchased merchandise totaling RMB38.1 million, from these companies under the Neptunus Group. The payment terms offered by the Neptunus Group for the purchase of merchandise ranged from 60 to 90 days. As of December 31, 2012 and 2013, the amounts due to the Neptunus Group and its affiliates in connection with our purchase of merchandise totaled RMB18.4 million and RMB29.2 million (US$4.8 million), respectively.

As of December 31, 2012 and 2013, the amounts due from the Neptunus Group and its affiliates totaled RMB8.3 million and RMB0.4 million (US$0.1 million), respectively, related to the sale of merchandise. As of December 31, 2012 and 2013, amounts related to expenses we paid on behalf of the Neptunus Group and its affiliates were RMB1.0 million and RMB44,000 (US$7,300), respectively.

Transaction related to the Disposal of Our 100% Equity Interest in Nepstar Industrial

In August 2011, we disposed of our 100% equity interest in Nepstar Industrial to Neptunus Group at a total cash consideration of RMB20.0 million. The difference between consideration received and the carrying amount of the net assets of the subsidiary amounting to RMB19.0 million was recognized in additional paid-in capital. We have not conducted any operations under Nepstar Industrial since its establishment in 2009. The purpose of the transaction is to simplify corporate structure and the divestment has not adversely affected our financial position or business operation.

Transactions Related to Our Regional PRC Companies

We, through our PRC operating subsidiary, Nepstar Pharmaceutical, have entered into a series of contractual arrangements with Nepstar IT Service, Nepstar Management Consulting, their respective shareholders, the regional Nepstar companies, including Fuzhou Nepstar, and Nepstar E-Commerce, including contracts relating to the provision of services and certain shareholder rights and corporate governance matters. Nepstar Pharmaceutical owns a 49.0% equity interest in each of the regional Nepstar companies, including Fuzhou Nepstar, and Nepstar IT Service and Nepstar Management Consulting collectively own the remaining 51.0% equity interest in each of the regional Nepstar companies, including Fuzhou Nepstar. In addition, Nepstar IT Service and Nepstar Management Consulting each own a 50.0% equity interest in Nepstar E-Commerce. Each of these contractual arrangements may only be amended with the approval of our audit committee or another independent body of our board of directors. See “Item 4. Information on the Company — C. Organizational Structure.”

The following is a summary of the material provisions of these arrangements. For more complete information, you should read these agreements in their entirety, which are filed with the SEC.

Loan Agreements

Under applicable PRC law, a company that is not a licensed financial institution is not permitted to extend loans directly to another company in China. As a result, a financial institution, such as a commercial bank, is typically involved in loan arrangements between companies that are not financial institutions by acting as an intermediary, whereby the financial institution receives the funds from the lending company and disburses the funds to the borrowing company. These types of loan arrangements are commonly referred to in China as “entrustment loans.” Through an intermediary bank, Nepstar Pharmaceutical provided interest-free entrustment loans to Nepstar IT Service and Nepstar Management Consulting in accordance with loan agreements dated June 13, 2007 in the aggregate principal amounts of RMB10.0 million and RMB26.0 million, respectively. In 2010, Nepstar Pharmaceutical renewed the interest-free entrustment loans to Nepstar IT Service and Nepstar Management Consulting in accordance with loan agreements dated June 25, 2010 in the aggregate principal amounts of RMB8.0 million and RMB22.8 million, respectively, and loan agreements dated December 1, 2010 in the aggregate principal amounts of RMB5.9 million and RMB6.3 million, respectively. In 2012, Nepstar Pharmaceutical renewed the interest-free entrustment loans to Nepstar IT Service and Nepstar Management Consulting in accordance with the loan agreements dated June 28, 2012 in the aggregate principal amounts of RMB14.1 million and RMB29.3 million, respectively. In 2013, Nepstar Pharmaceutical renewed the interest-free entrustment loans to Nepstar IT Service and Nepstar Management Consulting in accordance with the loan agreements dated August 28, 2013 in the aggregate principal amounts of RMB14.1 million and RMB29.3 million, respectively. As consideration for the loans, Nepstar IT Service, Nepstar Management Consulting and their respective shareholders entered into a series of contractual arrangements that allow us to retain, through Nepstar

Pharmaceutical, substantially all the economic risks and rewards of the regional Nepstar companies, including Fuzhou Nepstar, and Nepstar E-Commerce, as well as provide us with effective unilateral control over Nepstar IT Service, Nepstar Management Consulting, the regional Nepstar companies, including Fuzhou Nepstar, and Nepstar E-Commerce.

Logistics Service and Information Technology Support Agreements

Under the logistics service and information technology support agreements dated May 28, 2007 between Nepstar Pharmaceutical and each of the regional Nepstar companies, the logistics service and information technology support agreement dated August 18, 2009 between Nepstar Pharmaceutical and Fuzhou Nepstar, and the logistics service and information technology support agreement dated May 28, 2010 between Nepstar Pharmaceutical and Nepstar E-Commerce, Nepstar Pharmaceutical will provide logistics services, information technology support and consulting services in exchange for an annual service fee calculated based on the respective Nepstar company's gross profit for the corresponding year. The term of each logistics service and information technology support agreement is ten years from the effective date thereof, renewable by agreement between the parties. The logistics service and information technology support agreements will be automatically renewed for additional one-year terms on an annual basis unless Nepstar Pharmaceutical gives prior written notice regarding its decision not to renew the agreements.

Trade Name License Agreements

Under the trade name license agreements dated May 28, 2007 between Nepstar Pharmaceutical and each of the regional Nepstar companies, the trade name license agreement dated August 18, 2009 between Nepstar Pharmaceutical and Fuzhou Nepstar, and the trade name license agreement dated May 28, 2010 between Nepstar Pharmaceutical and Nepstar E-Commerce, Nepstar Pharmaceutical has granted a non-exclusive license to use its trade names and brand names in exchange for an annual license fee calculated based on the respective Nepstar company's gross profit for the corresponding year. The term of each trade name license agreement is ten years from the date thereof, renewable by agreement between the parties. The trade name license agreements will be automatically renewed for additional one-year terms on an annual basis unless Nepstar Pharmaceutical gives prior written notice regarding its decision not to renew the agreements.

Supply Agreements

Under the supply agreements dated May 28, 2007 between Nepstar Pharmaceutical and each of the regional Nepstar companies, the supply agreement dated August 18, 2009 between Nepstar Pharmaceutical and Fuzhou Nepstar, and the supply agreement dated May 28, 2010 between Nepstar Pharmaceutical and Nepstar E-Commerce, Nepstar Pharmaceutical is the exclusive supplier of all products sold by each of the respective Nepstar companies and the businesses they operate. The purchase price to be paid by the respective Nepstar company will be determined by Nepstar Pharmaceutical monthly based on the prevailing market conditions. In each month, Nepstar Pharmaceutical will notify the respective Nepstar company of the applicable purchase price for the following month. Nepstar Pharmaceutical also has the right to adjust the purchase price for any current month in its sole discretion. As a result, Nepstar Pharmaceutical has effective control over the price the respective Nepstar company pays for its merchandise. The term of each supply agreement is ten years from the effective date thereof, renewable by agreement between the parties. The supply agreements will be automatically renewed for additional one-year terms on an annual basis unless Nepstar Pharmaceutical gives prior written notice regarding its decision not to renew the agreements.

Shareholders Agreements

Under the shareholders agreements dated April 28, 2007 among Nepstar Pharmaceutical, Nepstar IT Service and Nepstar Management Consulting with respect to each of the regional Nepstar companies:

- Neither Nepstar IT Service nor Nepstar Management Consulting is allowed to transfer its equity interests in the regional Nepstar companies to a third party, nor is it allowed to pledge, dispose of or create any encumbrance on such equity interest, without the prior written consent of Nepstar Pharmaceutical;
- Each of Nepstar IT Service and Nepstar Management Consulting agrees to delegate all the rights to exercise their voting power as shareholders of the regional Nepstar companies to persons designated by Nepstar Pharmaceutical. In addition, each of Nepstar IT Service and Nepstar Management Consulting agrees to delegate the voting rights of the directors representing it on the board of directors of the regional Nepstar companies to the directors representing Nepstar Pharmaceutical, to the extent permitted by applicable PRC laws, rules and regulations. The same provision is also contained in the equity pledge agreements described below;
- Unanimous approval of the shareholders must be obtained before a regional Nepstar company may distribute dividends and with such approval, dividends may be distributed in accordance with the shareholders' respective equity interests or as otherwise agreed to by the shareholders;
- Nepstar Pharmaceutical, in its sole discretion, has an exclusive option to require each of Nepstar IT Service and Nepstar Management Consulting to sell to Nepstar Pharmaceutical or its designated persons all or part of their equity interests in the regional Nepstar companies, when and to the extent permitted by PRC law, at a price equal to the respective purchase price initially paid by Nepstar IT Service and Nepstar Management Consulting, subject

to any requirements under applicable PRC laws, rules and regulations. The same provision is also contained in the equity pledge agreements described below; and

- Nepstar Pharmaceutical, in its sole discretion, has an exclusive option to require the respective shareholders of Nepstar IT Service and Nepstar Management Consulting to sell to Nepstar Pharmaceutical or its designated persons all or part of the equity interests in Nepstar IT Service and Nepstar Management Consulting owned by such shareholders, when and to the extent permitted by PRC law, at a price equal to the registered capital of Nepstar IT Service and Nepstar Management Consulting, respectively, as represented by the purchased equity interest, subject to any requirements under applicable PRC laws, rules and regulations. The same provision is also contained in the equity pledge agreements described below.

Equity Pledge Agreements

Under the equity pledge agreement dated June 22, 2007 among Nepstar Pharmaceutical, Liping Zhou and Feng Tu, each of Liping Zhou and Feng Tu has pledged his or her respective equity interest in Nepstar IT Service and Nepstar Management Consulting to Nepstar Pharmaceutical to secure: (i) the obligations of Nepstar IT Service and Nepstar Management Consulting under the loan agreements, and (ii) the obligations of each regional Nepstar company under the logistics service and information technology support agreements, the trade name license agreements and the supply agreements described above. In addition, neither Liping Zhou nor Feng Tu will transfer, sell, pledge, dispose of or create any encumbrance on their respect equity interest in Nepstar IT Service and Nepstar Management Consulting.

Under the equity pledge agreement dated June 22, 2007 among Nepstar Pharmaceutical, Nepstar IT Service and Nepstar Management Consulting, each of Nepstar IT Service and Nepstar Management Consulting has pledged its respective equity interest in each of the regional Nepstar companies to Nepstar Pharmaceutical to secure: (i) the obligations of Nepstar IT Service and Nepstar Management Consulting under the loan agreements; and (ii) the obligations of each regional Nepstar company under the logistics service and information technology support agreements, the trade name license agreements and the supply agreements described above. In addition, neither Nepstar IT Service nor Nepstar Management Consulting may transfer, sell, pledge, dispose of or create any encumbrance on their equity interests in the regional Nepstar companies, or engage in any business or operations other than holding equity interests in the regional Nepstar companies. All amounts received by Nepstar IT Service and Nepstar Management Consulting from the regional Nepstar companies, including dividends and other distributions on equity interests, shall be deemed as security for the loans and be deposited in a designated bank account, payable to Nepstar Pharmaceutical upon its request in respect of the outstanding loans. Without prior consent of Nepstar Pharmaceutical, these amounts may not be distributed.

Under the supplemental agreement dated August 18, 2009 and the supplemental agreement dated May 28, 2010, we amended the equity pledge agreement dated June 22, 2007 among Nepstar Pharmaceutical, Liping Zhou and Feng Tu to include Fuzhou Nepstar and Nepstar E-Commerce, respectively, in the appendix of regional Nepstar companies, in order to secure in accordance with the terms of the equity pledge agreement dated June 22, 2007: (i) the obligations of Nepstar IT Service and Nepstar Management Consulting under the loan agreements; and (ii) the obligations of Fuzhou Nepstar and Nepstar E-Commerce, respectively, under the logistics service and information technology support agreements, the trade name license agreements and the supply agreements described above.

All the above equity pledge agreements have been registered with the relevant government authorities to render the security interests under such agreements effective. The equity pledge agreements will expire after the regional Nepstar companies, Fuzhou Nepstar, Nepstar E-Commerce, Nepstar IT Service, Nepstar Management Consulting and their respective shareholders, as the case may be, have fully performed their respective obligations under the logistics service and information technology support agreements, the trade name license agreements, the supply agreements and the loan agreements described above.

FINANCIAL INFORMATION

A. Consolidated Statements and Other Financial Information

See “Item 18. Financial Statements.”

Legal and Administrative Proceedings

We are currently not a party to any material legal or administrative proceedings, and we are not aware of threatened material legal or administrative proceedings against us. We may from time to time become a party to various legal or administrative proceedings arising in the ordinary course of our business.

Dividend Policy

Our board of directors has complete discretion on whether to pay dividends. On January 18, 2011, our Board of Directors declared a special cash dividend of US$0.30 per ADS. The special dividend was paid on or around February 28, 2011 to shareholders of record as of the close of business on January 31, 2011. On April 27, 2012, our Board of Directors declared a special cash dividend of US$0.60 per ADS. The special dividend was paid on or around May 24, 2012 to shareholders of record as of the close of business on May 7, 2012. On November 26, 2013, our Board of Directors declared a cash dividend of US$0.32 per ADS. The dividend was paid on or around January 24, 2014 to shareholders of record as of the close of business on December 20, 2013.

Our ability to pay dividends depends substantially on the payment of dividends to us by our consolidated PRC entities. In particular, each of our consolidated PRC entities may pay dividends only out of its accumulated distributable profits, if any, determined in accordance with its articles of association, and the accounting standards and regulations in China. Moreover, pursuant to applicable PRC laws, rules and regulations, 10% of after-tax profits of each of our consolidated PRC entities are required to be set aside in a statutory surplus reserve fund annually until the reserve balance reaches 50% of such PRC entity's registered capital. As of December 31, 2013, the accumulated balance of our statutory reserve funds totaled RMB99.4 million (US$16.4 million). Our restricted reserves are not distributable as cash dividends. Allocations to these statutory reserves may only be used for specific purposes and are not distributable to us in the form of loans, advances, or cash dividends. Furthermore, if any of our subsidiaries and controlled affiliates incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other payments to us.

If we pay any dividends, we will pay our ADS holders to the same extent as holders of our ordinary shares, subject to the terms of the deposit agreement, including the fees and expenses payable thereunder. Cash dividends on our ordinary shares, if any, will be paid in U.S. dollars.

Exchange Controls

Pursuant to the Foreign Currency Administration Rules promulgated in 1996, as amended, and various regulations issued by the SAFE and other relevant PRC government authorities, the Renminbi is convertible without prior approval from SAFE only to the extent of current account items, such as trade-related receipts and payments, interest and dividends and after complying with certain procedural requirements. Capital account items, such as direct equity investments, loans and repatriation of investments, require the prior approval from the SAFE or its local counterpart for conversion of Renminbi into a foreign currency, such as U.S. dollars, and remittance of the foreign currency outside the PRC.

Payments for transactions that take place within the PRC must be made in Renminbi. Foreign-invested enterprises may retain foreign exchange in accounts with designated foreign exchange banks subject to limitations set by the SAFE or its local counterpart. Unless otherwise approved, domestic enterprises must convert all of their foreign currency receipts into Renminbi.

Pursuant to the SAFE's Notice on Relevant Issues Concerning Foreign Exchange Administration for PRC Residents to Engage in Financing and Inbound Investment via Overseas Special Purpose Vehicles, or the SAFE Circular No. 75, issued on October 21, 2005: (i) a PRC citizen or resident shall register with the local branch of the SAFE before it establishes or controls an overseas special purpose vehicle, or overseas SPV, for the purpose of overseas equity financing (including convertible debt financing); (ii) when a PRC citizen or resident contributes the assets of or its equity interests in a domestic enterprise into an overseas SPV, or engages in overseas financing after contributing assets or equity interests to an overseas SPV, such PRC citizen or resident shall register his or her interest in the overseas SPV and the change thereof with the local branch of the SAFE; and (iii) when the overseas SPV undergoes a material event outside of China, such as change in share capital or merger and acquisition, the PRC resident shall, within 30 days from the occurrence of such event, register such change with the local branch of the SAFE. On May 29, 2007, the SAFE issued relevant guidance to its local branches for the implementation of the SAFE Circular No. 75. This guidance standardizes more specific and stringent supervision on the registration requirement relating to the SAFE Circular No. 75, and further requires PRC residents holding any equity interests or options in SPVs, directly or indirectly, controlling or nominal, to register with the SAFE.

Our beneficial owners who are PRC citizens or residents have registered with the local branch of the SAFE as required under SAFE Circular No. 75.

Under the Implementing Rules of Measures for the Administration of Individual Foreign Exchange, or the Implementation Rules, issued by the SAFE on January 5, 2007, PRC citizens who are granted shares or share options by an overseas listed company according to its share incentive plan are required, through a qualified PRC agent or the PRC subsidiary of such overseas listed company, to register with the SAFE and complete certain other procedures related to the share incentive plan. Foreign exchange income received from the sale of shares or dividends distributed by the overseas listed company must be remitted into a foreign currency account of such PRC citizen or be exchanged into Renminbi. Our PRC citizen employees who have been granted share options, or PRC option holders, have been subject to the Implementation Rules upon the listing of our ADSs on the New York Stock Exchange. If we or our PRC citizen employees fail to comply with these rules and regulations, we or our PRC option holders may be subject to fines and legal or administrative sanctions.

Taxation

Cayman Islands Taxation

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. No Cayman Islands stamp duty will be payable unless an instrument is executed in, brought to, or produced before a court of the Cayman Islands. The Cayman Islands is not a party to any double tax treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

We have, pursuant to Section 6 of the Tax Concessions Law (1999 Revision) of the Cayman Islands, obtained an undertaking from the Governor-in-Council that, for 20 years from September 7, 2004:

- no law which is enacted in the Cayman Islands imposing any tax to be levied on profits, income or gains or appreciations shall apply to us or our operations; and
- the aforesaid tax or any tax in the nature of estate duty or inheritance tax shall not be payable on our ordinary shares, debentures or other obligations.

People's Republic of China Taxation

Our PRC subsidiaries are incorporated in the PRC and are governed by applicable PRC income tax laws and regulations. The CIT Law was enacted on March 16, 2007 and became effective on January 1, 2008. The implementation regulations under the CIT Law issued by the PRC State Council became effective January 1, 2008. Under the CIT Law and the implementation regulations, the PRC has adopted a uniform tax rate of 25% for all enterprises (including foreign-invested enterprises) and has revoked the previous tax exemption, reduction and preferential treatments applicable to foreign-invested enterprises. However, there is a transition period for certain enterprises, whether foreign-invested or domestic, that were registered on or before March 16, 2007 and received preferential tax treatments granted by relevant tax authorities prior to January 1, 2008. Some enterprises that were subject to an enterprise income tax rate lower than 25% prior to January 1, 2008 continued to enjoy the lower rate and gradually transitioned to the new tax rate during the five-year period after the effective date of the CIT Law.

The CIT Law provides that enterprises established outside of China whose "de facto management bodies" are located in China are considered "resident enterprises" and are generally subject to the uniform 25% enterprise income tax rate on their worldwide income. In addition, a circular issued by the State Administration of Taxation on April 22, 2009 regarding the standards used to classify certain Chinese-invested enterprises controlled by Chinese enterprises or Chinese group enterprises and established outside of China as "resident enterprises" clarified that dividends and other income paid by such "resident enterprises" will be considered to be PRC source income, subject to PRC withholding tax, generally at a rate of 10%, when recognized by non-PRC enterprise shareholders. This circular also subjects such "resident enterprises" to various reporting requirements with the PRC tax authorities. Under the implementation regulations to the CIT Law, a "de facto management body" is defined as a body that has material and overall management and control over the manufacturing and business operations, personnel and human resources, finances and properties of an enterprise. In addition, the circular mentioned above details that certain Chinese-invested enterprises controlled by Chinese enterprises or Chinese group enterprises will be classified as "resident enterprises" if all of the following are located or resident in China: senior management personnel and departments that are responsible for daily production, operation and management; financial and personnel decision making bodies; key properties, accounting books, company seal, and minutes of board meetings and shareholders' meetings; and half or more of the directors with voting rights or senior management. However, as this circular only applies to enterprises established outside of China that are controlled by PRC enterprises or groups of PRC enterprises, it remains unclear how the tax authorities will determine the location of "de facto management bodies" for overseas incorporated enterprises that are controlled by individual PRC residents like us and some of our subsidiaries. As a result, although substantially all of our management of PRC companies is currently located in the PRC, it remains unclear whether the PRC tax authorities would require or permit our overseas registered entities to be treated as PRC resident enterprises. If the PRC tax authorities determine that we are a "resident enterprise," we may be subject to enterprise income tax at a rate of 25% on our worldwide income. The CIT Law provides that a maximum income tax rate of 10% is applicable to dividends payable to non-PRC investors that are "non-resident enterprises," which do not have an establishment or place of business in the PRC, or which have such establishment or place of business but the relevant income is not effectively connected with the establishment or place of business, to the extent such dividends are derived from sources within the PRC.

We are a Cayman Islands holding company and substantially all of our income is derived from the operations of our operating subsidiaries located in the PRC. In addition, under the CIT Law, the Notice of the State Administration of Taxation on Overview of Treaty Dividends Withholding Tax Rates, or Notice 112, which was issued on January 29, 2008, the Arrangement between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion, or the Double Taxation Arrangement (Hong Kong), which was effective on January 1, 2007 in the PRC, and the Notice of the State Administration of Taxation Regarding Interpretation and Recognition of Beneficial Owners under Tax Treaties, which was issued on October 27, 2009, dividends from our PRC subsidiaries paid to us may be subject to withholding tax at a reduced rate of 5% if we are considered as a "beneficial owner" that is generally engaged in substantial business activities and entitled to treaty benefits under the Double Taxation Arrangement (Hong Kong). Furthermore, the ultimate tax rate may be determined under an applicable income tax treaty between the PRC and the jurisdiction of which the holder of the relevant PRC subsidiary is tax resident. Although we are a Cayman Islands company, in 2009 we received from the relevant tax authorities in Hong Kong a certification of resident status and were considered as a Hong Kong tax resident and subject to Hong Kong Profits Tax on income arising in or derived from Hong Kong. In February 2014, the Company was denied its Hong Kong tax residency that applied to the year ended December 31, 2013 by the Hong Kong Inland Revenue Department. The Company is therefore now subject to a standard withholding tax rate of

10%, rather than a reduced tax rate of 5% under the tax treaty previously applied by the Company, for dividends to be paid or appropriated from the Company's PRC subsidiaries.

Certain U.S. Federal Income Tax Consequences

The following summary describes certain U.S. federal income tax consequences of the ownership of our ordinary shares and ADSs as of the date hereof. This summary applies only to U.S. Holders (defined below) that are beneficial owners of ADSs or ordinary shares, that hold the ADSs or ordinary shares as capital assets and that have U.S. dollars as their functional currency. This discussion is based on the provisions of the Internal Revenue Code of 1986, as amended, or the Code, as in effect on the date of this annual report and on U.S. Treasury regulations in effect or, in some cases, proposed, as of the date of this annual report, as well as judicial and administrative interpretations thereof available on or before such date. All of the foregoing authorities are subject to change, which change could apply retroactively and could affect the tax consequences described below.

The following discussion does not deal with the tax consequences to any particular investor or to persons in special tax situations such as:

- dealers in securities or currencies;
- financial institutions;
- insurance companies;
- a regulated investment company;
- a real estate investment trust;
- broker dealers;
- U.S. expatriates;
- traders that elect to mark to market;
- tax-exempt entities;
- persons liable for alternative minimum tax;
- persons holding ADSs or ordinary shares as part of a constructive sale, straddle, hedging, conversion or integrated transaction;
- persons that actually or constructively own 10.0% or more of our voting stock; or
- persons holding ADSs or ordinary shares through partnerships or other pass-through entities for U.S. federal income tax purposes.

For the purpose of this discussion, "U.S. Holders" refers to any beneficial owner of our ordinary shares or ADSs that is, for U.S. federal income tax purposes:

- an individual citizen or resident of the United States;
- a corporation (or other entity taxable as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state thereof or the District of Columbia;
- an estate whose income is subject to U.S. federal income taxation regardless of its source; or
- a trust that (1) is subject to the primary supervision of a court within the United States and one or more U.S. persons have the authority to control all substantial decisions of the trust or (2) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

If you are a partner in a partnership or other entity taxable as a partnership that holds ADSs or ordinary shares, your tax treatment generally will depend on your status and the activities of the partnership. If you are a partner in a partnership or other entity taxable as a partnership that holds ADSs or ordinary shares, you should consult your own tax advisors.

The discussion below assumes that the representations contained in the deposit agreement are true and that the obligations in the deposit agreement and any related agreement will be complied with in accordance with their terms. If you hold ADSs, you generally will be treated as the holder of the underlying ordinary shares represented by those ADSs for U.S. federal income tax purposes. Exchanges of ordinary shares for ADSs and ADSs for ordinary shares generally will not be subject to U.S. federal income tax.

Taxation of Dividends and Other Distributions on the ADSs or Ordinary Shares

Subject to the discussion under "—Passive Foreign Investment Company" below, the gross amount of all our distributions to you (including amounts withheld to reflect any PRC withholding taxes) with respect to the ADSs or ordinary shares generally will be included in your gross income as foreign source dividend income on the date of actual or constructive receipt by the depositary, in the case of ADSs, or by you, in the case of ordinary shares, but only to the extent that the distribution is paid out of our current or accumulated earnings and profits (as determined under U.S. federal income tax principles). The dividends will not be eligible for the dividends-received deduction allowed to corporations under the Code in respect of dividends received from other U.S. corporations.

With respect to non-corporate U.S. Holders (including individuals), certain dividends received from a qualified foreign corporation may be subject to reduced rates of taxation. A foreign corporation is treated as a qualified foreign corporation with respect to dividends paid by that corporation on shares (or ADSs represented by such shares) that are readily tradable on an established securities market in the United States. U.S. Treasury Department guidance indicates that our ADSs (which are listed on the New York Stock Exchange), but not our ordinary shares, are readily tradable on an established securities market in the United States. Thus, we believe that dividends we pay on our ordinary shares that are represented by ADSs, but not on our ordinary shares that are not represented by ADSs, currently meet the readily tradable requirement for the reduced tax rates. There can be no assurance that our ADSs will be considered readily tradable on an established securities market in later years. A qualified foreign corporation also includes a foreign corporation that is eligible for the benefits of certain income tax treaties with the United States. In the event that we are deemed to be a PRC “resident enterprise” under PRC tax law (see discussion under “Taxation — People’s Republic of China Taxation”), we may be eligible for the benefits of the income tax treaty between the United States and the PRC, and, if we are eligible for such benefits, dividends we pay on our ordinary shares, regardless of whether such ordinary shares are represented by ADSs, would be subject to the reduced rates of taxation if we are not a PFIC in the applicable years, as discussed below. Non-corporate U.S. Holders that do not meet a minimum holding period requirement during which they are not protected from the risk of loss or that elect to treat the dividend income as “investment income” pursuant to Section 163(d)(4) of the Code will not be eligible for the reduced rates of taxation regardless of our status as a qualified foreign corporation. In addition, the rate reduction will not apply to dividends if the recipient of a dividend is obligated to make related payments with respect to positions in substantially similar or related property. This disallowance applies even if the minimum holding period has been met. You should consult your own tax advisors regarding the application of these rules to your particular circumstances.

Non-corporate U.S. Holders will not be eligible for the reduced rates of taxation on any dividends received from us if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year.

In the event that we are deemed to be a PRC “resident enterprise”, under PRC tax law you may be subject to PRC withholding taxes on dividends paid to you with respect to the ADSs or ordinary shares if the dividends paid by us are deemed to be derived from sources within the PRC. In that case, subject to certain conditions and limitations, PRC withholding taxes on dividends, if any, may be treated as foreign taxes eligible for credit against your U.S. federal income tax liability. For purposes of calculating the foreign tax credit, dividends paid on the ADSs or ordinary shares will be treated as income from sources outside the United States and will generally constitute passive category income, but could, in certain circumstances, be general category income. The rules governing the foreign tax credit are complex. You are urged to consult your tax advisors regarding the availability of the foreign tax credit under your particular circumstances.

To the extent that the amount of the distribution exceeds our current and accumulated earnings and profits for a taxable year, as determined under U.S. federal income tax principles, it will be treated first as a tax-free return of your tax basis in your ADSs or ordinary shares, and to the extent the amount of the distribution exceeds your tax basis, the excess will be taxed as capital gain. However, we do not intend to calculate our earnings and profits in accordance with U.S. federal income tax principles. Therefore, a U.S. Holder should expect that a distribution will generally be treated as a dividend (as discussed above).

Taxation of Disposition of ADSs or Ordinary Shares

For U.S. federal income tax purposes, and subject to the discussion under “—Passive Foreign Investment Company” below, you will recognize taxable gain or loss on any sale, exchange or other taxable disposition of each ADS or ordinary share equal to the difference between the amount realized for the ADS or ordinary share and your tax basis in the ADS or ordinary share. The gain or loss generally will be capital gain or loss. If you are a non-corporate U.S. Holder, including an individual U.S. Holder, who has held the ADS or ordinary share for more than one year, you will be eligible for reduced tax rates. The deductibility of capital losses is subject to limitations. Any such gain or loss that you recognize will generally be treated as U.S. source income or loss for foreign tax credit limitation purposes. However, in the event that we are deemed to be a PRC “resident enterprise” under PRC tax law, we may be eligible for the benefits of the income tax treaty between the United States and the PRC. Under that treaty, if any PRC tax were to be imposed on any gain from the disposition of the ADSs or shares, the gain may be treated as PRC-source income. You are urged to consult your tax advisors regarding the tax consequences if a foreign withholding tax is imposed on a disposition of ADSs or ordinary shares, including the availability of the foreign tax credit under your particular circumstances.

Passive Foreign Investment Company

Based on the quarterly average valuation of our assets, including goodwill for the taxable year ended on December, 31, 2013, we do not believe that we were a PFIC for our taxable year ended on December 31, 2013, although there can be no certainty in this regard due to the complex nature of the applicable rules. Under the Code, the determination of whether we are a PFIC is made annually after the close of the taxable year. Accordingly, our PFIC status for any taxable year cannot be determined until after the close of such taxable year. In particular, our PFIC status may be determined in large part based on the market price of our ADSs and ordinary shares, which is likely to fluctuate. Fluctuations in the market price of the ADSs and ordinary shares may result in our being a PFIC in the current or any future taxable year. In addition, although the law in this regard is unclear, we treat the regional Nepstar companies and Nepstar E-Commerce as being owned by us for U.S. federal income tax purposes, not only because we retain control over their management decisions but also because we retain the economic risks and rewards of these entities. If it were determined, however, that we are not the owner of the regional Nepstar companies and Nepstar E-Commerce for U.S. federal income tax purposes, we would be more likely to be treated as a PFIC for any taxable year. If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares, you will be subject to special tax rules discussed below.

In general, we will be a PFIC for any taxable year in which:

- at least 75% of our gross income for the taxable year is passive income, or
- at least 50% of the value (determined based on a quarterly average) of our assets held during the taxable year is attributable to assets that produce or are held for the production of passive income.

For this purpose, passive income generally includes dividends, interest, royalties and rents (other than royalties and rents derived in the active conduct of a trade or business and not derived from a related person). If we, directly or indirectly, own at least 25% (by value) of the stock of another corporation, we will be treated, for purposes of the PFIC tests, as owning our proportionate share of the other corporation's assets and receiving our proportionate share of the other corporation's income.

If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares and unless you make a mark-to-market election as discussed below, you will be subject to special tax rules with respect to any "excess distribution" received and any gain realized from a sale or other disposition, including a pledge, of our ADSs or ordinary shares. Distributions received in a taxable year that are greater than 125% of the average annual distributions received during the shorter of the three preceding taxable years or your holding period for the ADSs or ordinary shares will be treated as excess distributions. Under these special tax rules:

- the excess distribution or gain will be allocated ratably over your holding period for the ADSs or ordinary shares;
- the amount allocated to the current taxable year, and any taxable year prior to the first taxable year in which we were a PFIC, will be treated as ordinary income; and
- the amount allocated to each other year will be subject to tax at the highest tax rate in effect for that year and the interest charge generally applicable to underpayments of tax will be imposed on the resulting tax attributable to each such year.

In addition, non-corporate U.S. Holders (including individuals) will not be eligible for reduced rates of taxation on any dividends received from us, if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year. You generally will be required to file Internal Revenue Service Form 8621 (or any other form subsequently specified by the U.S. Treasury) on an annual basis if you hold our ADSs or ordinary shares in any year in which we are classified as a PFIC, subject to certain exceptions based on the value of PFIC stock held.

If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares and any of our non-U.S. subsidiaries is also a PFIC, a U.S. Holder would be treated as owning a proportionate amount (by value) of the shares of the lower-tier PFIC for purposes of the application of these rules. You are urged to consult your tax advisors about the application of the PFIC rules to any of our subsidiaries.

In certain circumstances, in lieu of being subject to the excess distribution rules discussed above, you may make an election to include gain on the stock of a PFIC as ordinary income under a mark-to-market method, provided that such stock is regularly traded on a qualified exchange. Under current U.S. tax law, the mark-to-market election may be available to holders of ADSs because the ADSs are listed on the New York Stock Exchange, which constitutes a qualified exchange, although there can be no assurance that the ADSs will be "regularly traded" for purposes of the mark-to-market election. It should also be noted that only our ADSs and not our ordinary shares are listed on the New York Stock Exchange. Consequently, if you are a holder of ordinary shares that are not represented by the ADSs, you generally will not be eligible to make a mark-to-market election. If you make an effective mark-to-market election, the excess distribution rules describe above would not apply to you. Instead, you will include in each year as ordinary income the excess of the fair market value of your ADSs at the end of the year over your adjusted tax basis in the ADSs. You will be entitled to deduct as an ordinary loss each year the excess of your adjusted tax basis in the ADSs over their fair market value at the end of the year, but only to the extent of the net amount previously included in your income as a result of the mark-to-market election. If you make an effective mark-to-market election, any gain you recognize upon the sale or other disposition of your ADSs will be treated as ordinary income and any loss will be treated as ordinary loss, but only to the extent of the net amount previously included in income as a result of the mark-to-market election.

Your adjusted tax basis in the ADSs will be increased by the amount of any income inclusion and decreased by the amount of any deductions under the mark-to-market rules. If you make a mark-to-market election, it will be effective for the taxable year for which the election is made and all subsequent taxable years unless the ADSs are no longer regularly traded on a qualified exchange or the Internal Revenue Service consents to the revocation of the election. A mark-to-market election generally must be made for the first taxable year in which a U.S. Holder holds stock in a PFIC, and is made by filing Internal Revenue Service Form

8621 with such U.S. Holder's original or amended U.S. federal income tax return on or before the due date (including extensions) of the return. You are urged to consult your tax advisor about the availability of the mark-to-market election, and whether making the election would be advisable in your particular circumstances.

Alternatively, a U.S. investor can avoid the rules described above with respect to the stock of a PFIC by electing to treat such PFIC as a "qualified electing fund" under Section 1295 of the Code. This option is not available to you because we do not intend to comply with the requirements necessary to permit you to make this election. You are urged to consult your tax advisors concerning the U.S. federal income tax consequences of holding ADSs or ordinary shares if we are considered a PFIC in any taxable year.

If you held our ADSs or Ordinary Shares in any taxable year in which we were a PFIC and did not make a timely mark-to-market election, you will generally continue to be treated as owning an interest in a PFIC even if we are no longer a PFIC in the current or a future taxable year unless you make a "deemed sale" election to recognize any gain in your ADSs or ordinary Shares as of the last day of the last taxable year in which we were a PFIC. You are urged to consult your tax advisor concerning the availability and advisability of making a deemed sale election in your particular circumstances.

Information Reporting and Backup Withholding

Dividend payments with respect to ADSs or ordinary shares and proceeds from the sale, exchange or redemption of ADSs or ordinary shares paid to you within the United States (and in certain cases, outside the United States) may be subject to information reporting to the Internal Revenue Service, unless you are an exempt recipient. However, backup withholding will not apply to a U.S. Holder who furnishes a correct taxpayer identification number and makes any other required certification or who is otherwise exempt from backup withholding. U.S. Holders who are required to establish their exempt status generally must provide such certification on Internal Revenue Service Form W-9. You are urged to consult your tax advisors regarding the application of the U.S. information reporting and backup withholding rules.

Backup withholding is not an additional tax. Amounts withheld as backup withholding may be credited against your U.S. federal income tax liability, and you may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the Internal Revenue Service and furnishing any required information.

U.S. Holders that hold certain foreign financial assets (which may include our ADSs or ordinary shares) are required to report information related to such assets, subject to certain exceptions. You are urged to consult your tax advisor regarding the effect, if any, of this requirement on your ownership and disposition of our ADSs or ordinary shares.

You may read and copy this annual report, including the exhibits incorporated by reference in this annual report, at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 and at the SEC's regional offices in New York, New York and Chicago, Illinois. You can also request copies of this annual report, including the exhibits incorporated by reference in this annual report, upon payment of a duplicating fee, by writing information on the operation of the SEC's Public Reference Room.

The SEC also maintains a website at www.sec.gov that contains reports, proxy statements and other information regarding registrants that file electronically with the SEC. Our annual report and some of the other information submitted by us to the SEC may be accessed through this web site.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

Our financial statements have been prepared in accordance with U.S. GAAP.

We will furnish our shareholders with annual reports, which will include a review of operations and annual audited consolidated financial statements prepared in conformity with U.S. GAAP.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Exchange Risk

Substantially all of our revenues, costs and expenses are denominated in Renminbi. As a result, fluctuations in the value of the Renminbi may affect the price competitiveness of our products as compared to competing products from multinational pharmaceutical companies. Although the conversion of the Renminbi is highly regulated in China, the value of the Renminbi against the value of the U.S. dollar or any other currency nonetheless may fluctuate and be affected by, among other things, changes in China's political and economic conditions. Under the currency policy in effect in China today, the Renminbi is permitted to fluctuate in value within a narrow band against a basket of certain foreign currencies. China is currently under significant international pressures to liberalize this government currency policy, and if such liberalization were to occur, the value of the Renminbi could appreciate or depreciate against the U.S. dollar.

We use the Renminbi as the reporting currency for our financial statements. Our company's functional currency is the U.S. dollar and the functional currency of our subsidiaries is the Renminbi. All of our subsidiaries' transactions in currencies other than the Renminbi during the year are recorded at the exchange rates prevailing on the relevant dates of such transactions. Monetary assets and liabilities of our subsidiaries existing at the balance sheet date denominated in currencies other than the Renminbi are re-measured at the exchange rates prevailing on such date. Exchange differences are recorded in our consolidated statements of comprehensive income. The values of our company's assets and liabilities are translated into Renminbi using the exchange rate on the balance sheet date. Revenues and expenses of our company are translated at average rates prevailing during the year. Gains and losses resulting from translation of our financial statements from U.S. dollars into Renminbi are recorded in other comprehensive loss within equity. Fluctuations in exchange rates may also affect our consolidated financial statements and operations. For example, to the extent that we need to convert U.S. dollars into Renminbi for our operations, appreciation of Renminbi against the U.S. dollar would have an adverse effect on the amount of Renminbi that we receive from the conversion. Conversely, if we decide to convert Renminbi into U.S. dollars for the purpose of making payments for dividends on our ordinary shares or ADSs or for other business purposes, appreciation of the U.S. dollar against the Renminbi would have a negative effect on the U.S. dollar amounts available to us. As of December 31, 2013, we had U.S. dollar-denominated bank deposits of US$9.7 million. If there was a further 1.0% appreciation of Renminbi against the U.S. dollar, our cash balance would have been decreased by RMB0.6 million (US$0.1 million), which would have resulted in an increase in the accumulated other comprehensive loss by such amount.

We do not believe that we currently have any significant direct foreign exchange risk and have not used any derivative financial instruments to hedge exposure in foreign exchange risk.

Interest Rate Risk

We have not been, nor do we anticipate being, exposed to material risks due to changes in interest rates. Our risk exposure to changes in interest rates relates primarily to the interest income generated by cash deposited in interest-bearing savings accounts. As of December 31, 2013, we had no interest-bearing bank loan balances. We have not used, and do not expect to use in the future, any derivative financial instruments to hedge any interest risk exposure.

American Depositary Shares

As set forth in the Deposit Agreement dated November 17, 2007 among us, JPMorgan Chase Bank, N.A., as depositary, and the holders from time to time of the ADRs, the depositary collects its fees for issuance and cancellation of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depositary collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deduction from cash distributions, or by directly billing investors, or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fees for those services are paid.

ADR holders will be charged a fee for each issuance of ADSs, including issuances resulting from distributions of shares, rights and other property, and for each surrender of ADSs in exchange for deposited securities. The fee in each case is US$5.00 for each 100 ADSs (or any portion thereof) issued or surrendered.

The following additional charges shall be incurred by the ADR holders, by any party depositing or withdrawing shares or by any party surrendering ADSs or to whom ADSs are issued (including, without limitation, issuance pursuant to a share dividend or share split declared by us or an exchange of share regarding the ADSs or the deposited securities or a distribution of ADSs), whichever is applicable:

- a fee of US$0.02 or less per ADS (or portion thereof) for any cash distribution made pursuant to the deposit agreement;
- a fee of US$0.02 per ADS (or portion thereof) per calendar year for services performed by the depositary in administering our ADR program (which fee may be charged on a periodic basis during each calendar year (with the aggregate of such fees not to exceed the amount set forth above) and shall be assessed against holders of ADRs as of the record date or record dates set by the depositary during each calendar year and shall be payable in the manner described in the next succeeding provision); provided that the depositary may adjust this fee with our consent, such consent not to be unreasonably withheld;
- any other charge payable by any of the depositary, any of the depositary's agents, including, without limitation, the custodian, or the agents of the depositary's agents in connection with the servicing of our shares or other deposited securities (which charge shall be assessed against registered holders of our ADRs as of the record date or dates set by the depositary and shall be payable at the sole discretion of the depositary by billing such registered holders or by deducting such charge from one or more cash dividends or other cash distributions);
- a fee for the distribution of securities (or the sale of securities in connection with a distribution), such fee being in an amount equal to the fee for the execution and delivery of ADSs which would have been charged as a result of

the deposit of such securities (treating all such securities as if they were shares) but which securities or the net cash proceeds from the sale thereof are instead distributed by the depositary to those holders entitled thereto;

- share transfer or other taxes and other governmental charges;
- cable, telex and facsimile transmission and delivery charges incurred;
- transfer or registration fees for the registration of transfer of deposited securities on any applicable register in connection with the deposit or withdrawal of deposited securities;
- expenses of the depositary in connection with the conversion of foreign currency into U.S. dollars; and
- such fees and expenses as are incurred by the depositary (including without limitation expenses incurred in connection with compliance with foreign exchange control regulations or any law or regulation relating to foreign investment) in delivery of deposited securities or otherwise in connection with the depositary's or its custodian's compliance with applicable laws, rules or regulations.

We will pay all other charges and expenses of the depositary and any agent of the depositary (except the custodian) pursuant to agreements from time to time between us and the depositary. The fees described above may be amended from time to time.

We completed our initial public offering of 47,437,500 ordinary shares, in the form of ADSs, at US$16.20 per ADS in November 2007, after our ordinary shares and American Depositary Receipts were registered under the Securities Act. The aggregate price of the offering amount registered and sold was US$384.2 million, of which we received net proceeds of US$357.3 million. The effective date of our registration statement on Form F-1 (File number: 333-146767) was November 8, 2007.

In 2012, we used approximately RMB419.4 million (US$67.3 million) from the net proceeds received from our initial public offering for the repurchase of our ordinary shares and dividends payment. In 2013, we used approximately RMB191.2 million (US$31.6 million) from the net proceeds received from our initial public offering for dividends payment.

As of December 31, 2013, we had total cash, cash equivalents, bank deposits and restricted cash in the amount of RMB622.8 million (US$102.9 million).

CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in reports filed by the Company under the Securities Exchange Act of 1934 ("the Exchange Act"), as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d-15(e) promulgated under the Exchange Act. Based on that evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Management's Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) under the Exchange Act, for our company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements in accordance with U.S. GAAP and includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of a company's assets, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that a company's receipts and expenditures are being made only in accordance with authorizations of a company's management and directors, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of a company's assets that could have a material effect on the consolidated financial statements.

Due to its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance with respect to consolidated financial statement preparation and presentation and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As required by Section 404 of the Sarbanes-Oxley Act of 2002 and related rules as promulgated by the SEC, management assessed the effectiveness of the our internal control over financial reporting as of December 31, 2013 using criteria established in Internal Control-Integrated Framework *(1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this assessment, management concluded that the our internal control over financial reporting was effective as of December 31, 2013 based on the criteria established in Internal Control-Integrated Framework *(1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Attestation Report of Independent Registered Public Accounting Firm

The effectiveness of our internal control over financial reporting as of December 31, 2013 has been audited by KPMG, an independent registered public accounting firm, as stated in their report dated April 22, 2014 appearing herein.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
China Nepstar Chain Drugstore Ltd.:

We have audited China Nepstar Chain Drugstore Ltd.'s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control – Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). China Nepstar Chain Drugstore Ltd.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, China Nepstar Chain Drugstore Ltd. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control – Integrated Framework (1992)* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of China Nepstar Chain Drugstore Ltd. and subsidiaries as of December 31, 2012 and 2013, and the related consolidated statements of comprehensive income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2013, and our report dated April 22, 2014 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG
Hong Kong, China
April 22, 2014

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes in our internal control over financial reporting that occurred during the year ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that Alistair Laband qualifies as “audit committee financial expert” as defined in Item 16A of Form 20-F. Each of the members of the Audit Committee is an “independent director” within the meaning of NYSE Manual Section 303A(2) and meet the criteria for independent set forth in Section 10A(m)(3) of the Exchange Act.

CODE OF ETHICS

Our board of directors has adopted a code of ethics that applies to our directors, officers, employees and agents, including certain provisions that specifically apply to our chief executive officers, chief financial officer, chief operating officer, chief technology officer, vice presidents and any other persons who perform similar functions for us. We have filed our code of business conduct and ethics as an exhibit to our registration statement on Form F-1 (File No. 333-146767). We hereby undertake to provide to any person without charge, a copy of our code of business conduct and ethics within ten working days after we receive such person’s written request.

PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by KPMG, our independent registered public accounting firm, for the periods indicated. We did not pay any other fees to KPMG during the periods indicated below.

	For the Year Ended December 31,		
	2011	2012	2013
	(in millions of RMB)		
Audit Fees	6.5	5.9	5.7
Audit-related Fees	—	—	—
Tax Fees	0.1	—	—

The policy of our audit committee is to pre-approve all audit and non-audit services provided by our independent registered public accounting firm, including audit services, audit-related services, tax services and all other services as described above. During 2013, all services rendered by KPMG were approved by our audit committee.

PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

On August 19, 2011, our board of directors approved a share repurchase program, under which we were authorized to repurchase up to US$20.0 million worth of our issued and outstanding ADSs from the open market from time to time and before August 23, 2012. As of December 31, 2012, we have purchased 8,215,142 of our ordinary shares in the form of ADSs for a total purchase price of approximately US$9.6 million. We did not purchase any of our ordinary shares during 2013. All of the repurchased ordinary shares have been retired. The repurchases were made on the open market at prevailing market prices or in block trades and subject to restrictions relating to volume, price and timing. The following table sets forth certain information related to purchases made by us of our ADSs under the program:

Period	Total number of ADSs purchased	Average price paid per ADS [(1)]	Total number of ADSs purchased as part of publicly announced program	Approximate dollar value of ADSs that may yet be purchased under the program
		US$		US$
August 2011	152,223	2.4661	152,223	19,624,603.97
September 2011	362,880	2.5467	515,103	18,700,453.39
October 2011	321,378	2.2640	836,481	17,972,868.04
November 2011	276,956	2.4016	1,113,437	17,307,741.26
December 2011	308,978	1.8822	1,422,415	16,726,170.70
January 2012	463,056	2.3800	1,885,471	15,624,103.17
February 2012	280,318	2.5169	2,165,789	14,918,564.68
March 2012	275,688	2.2905	2,441,477	14,287,103.62
April 2012	229,813	2.2870	2,671,290	13,761,528.31

Period	Total number of ADSs purchased	Average price paid per ADS (1)	Total number of ADSs purchased as part of publicly announced program	Approximate dollar value of ADSs that may yet be purchased under the program
		US$		US$
May 2012	570,721	2.4751	3,242,011	12,348,925.62
June 2012	481,005	2.3299	3,732,016	11,228,251.00
July 2012	212,528	2.1845	3,935,544	10,763,985.96
August 2012	172,027	2.0441	4,107,571	10,412,346.07

(1) The average price paid per ADS is calculated using the execution price for each repurchase excluding commissions paid to brokers.

CORPORATE GOVERNANCE

We are a "foreign private issuer" (as such term is defined in Rule 3b-4 under the Exchange Act), and our ADSs, each representing two ordinary shares, are listed on the New York Stock Exchange, or NYSE. Under Section 303A of the NYSE Listed Company Manual, NYSE-listed companies that are foreign private issuers are permitted to follow home country practice in lieu of the corporate governance provisions specified by the NYSE with limited exceptions. The following summarizes some significant ways in which our corporate governance practices differ from those followed by domestic companies under the listing standards of the NYSE.

- The NYSE standards for domestic companies require that non-management directors meet at regularly scheduled executive sessions without management. We are not subject to this requirement under the Cayman Islands law and have decided to follow Cayman Islands practice on this matter.
- The NYSE standards for domestic companies require that the audit committee of the board of directors must have a minimum of three members. As a foreign private issuer, we are not required to comply with such requirement. As of the date of this annual report, our audit committee consists of three members, each of whom satisfies the "independence" requirements of Section 303A of the NYSE Listed Company Manual and Rule 10A-3 under the Exchange Act, and one such member qualifies as an "audit committee financial expert" under applicable SEC rules.

CHINA NEPSTAR CHAIN DRUGSTORE LTD.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
China Nepstar Chain Drugstore Ltd.

We have audited the accompanying consolidated balance sheets of China Nepstar Chain Drugstore Ltd. and its subsidiaries, as of December 31, 2012 and 2013, and the related consolidated statements of comprehensive income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2013. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of China Nepstar Chain Drugstore Ltd. and its subsidiaries as of December 31, 2012 and 2013, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with U.S. generally accepted accounting principles.

The accompanying consolidated financial statements as of and for the year ended December 31, 2013 have been translated into United States dollars solely for the convenience of the reader. We have audited the translation and, in our opinion, such consolidated financial statements expressed in Renminbi have been translated into United States dollars on the basis set forth in Note 2(c) to the consolidated financial statements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), China Nepstar Chain Drugstore Ltd.'s internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control – Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated April 22, 2014 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Hong Kong, China
April 22, 2014

CHINA NEPSTAR CHAIN DRUGSTORE LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2012 AND 2013

(Amounts in thousands, except share data)

	Note	December 31, 2012	December 31, 2013	December 31, 2013
		RMB	RMB	USD (Note 2(c))
ASSETS				
Current assets:				
Cash and cash equivalents	3	371,256	361,146	59,657
Short-term bank time deposits	3	237,100	184,440	30,467
Restricted cash	2(e)	36,000	37,000	6,112
Accounts receivable, net of allowance for doubtful accounts	4	114,601	131,984	21,802
Amounts due from related parties	22	8,254	379	63
Prepaid expenses, deposits and other current assets	5	147,252	169,210	27,952
Inventories	6	478,483	551,783	91,148
Deferred tax assets	12	1,704	6,330	1,045
Total current assets		1,394,650	1,442,272	238,246
Property and equipment, net	7	120,237	123,183	20,348
Long-term bank time deposits	3	20,000	40,256	6,650
Rental deposits		38,236	41,946	6,929
Cost method investments		12,638	12,638	2,088
Intangible assets, net	9	2,868	2,509	414
Goodwill	8,9	51,819	51,819	8,560
Deferred tax assets	12	3,056	11,723	1,937
Accrued interest income		507	769	127
TOTAL ASSETS		1,644,011	1,727,115	285,299
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities:				
Accounts payable		356,095	403,558	66,663
Bills payable		20,534	4,334	716
Amounts due to related parties	22	18,381	29,247	4,831
Accrued expenses and other payables	13	105,503	123,065	20,329
Deferred income	14	14,327	22,477	3,713
Income tax payable		40,967	34,567	5,710
Dividend payable	17	—	191,246	31,592
Total current liabilities		555,807	808,494	133,554
Deferred income	14	18,365	17,391	2,873
Deferred tax liabilities	12	7,499	16,541	2,732
Other non-current liabilities	12	36,237	39,163	6,469
Total liabilities		617,908	881,589	145,628
Shareholders' equity:				
Share capital – ordinary shares USD 0.0001 par value:				
360,000,000 shares authorized; 197,446,940 shares issued and outstanding as of December 31, 2012 and 2013	15	158	158	26
Treasury stock at cost				
Nil shares as of December 31, 2012 and as of December 31, 2013	15	—	—	—
Additional paid-in capital		832,811	640,341	105,777
Accumulated other comprehensive loss		(41,688)	(41,623)	(6,876)
Retained earnings	16	234,822	246,650	40,744
Total shareholders' equity		1,026,103	845,526	139,671
Commitments and contingencies	2(v)	—	—	—
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		1,644,011	1,727,115	285,299

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013

(Amounts in thousands, except per share data)

	Note	Year ended December 31, 2011	2012	2013	2013
		RMB	RMB	RMB	USD (Note 2(c))
Revenue	18,22	2,491,290	2,549,856	2,699,103	445,860
Cost of goods sold		(1,302,653)	(1,369,312)	(1,520,796)	(251,218)
Gross profit		1,188,637	1,180,544	1,178,307	194,642
Sales, marketing and other operating expenses		(1,015,165)	(1,011,695)	(1,026,798)	(169,615)
General and administrative expenses		(120,671)	(115,734)	(121,542)	(20,077)
Impairment losses of property and equipment	7	(14,164)	(7,649)	(6,984)	(1,154)
Other income	11	—	1,480	—	—
Income from operations		38,637	46,946	22,983	3,796
Interest income		23,154	16,435	15,713	2,596
Dividend income from cost method investments		3,616	4,528	5,232	865
Equity in income of an equity method investee	10	1,552	1,337	—	—
Gain on disposal of an equity method investee	10	—	68,440	—	—
Income before income tax expense		66,959	137,686	43,928	7,257
Income tax expense	12	(31,026)	(47,594)	(32,100)	(5,303)
Net income attributable to China Nepstar Chain Drugstore Ltd.		35,933	90,092	11,828	1,954
Earnings per ordinary share:					
Basic	21	0.17	0.45	0.06	0.01
Diluted	21	0.17	0.45	0.06	0.01
Other comprehensive income, net of tax:					
Foreign currency translation adjustments		430	(555)	65	11
Comprehensive income attributable to China Nepstar Chain Drugstore Ltd.		36,363	89,537	11,893	1,965

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013

(Amounts in thousands, except share data)

	Ordinary shares						
	Number of Shares	Par Value Amount	Treasury Stock at Cost	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Total Shareholders' Equity
		RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2011	207,785,938	164	—	1,501,809	(41,563)	108,797	1,569,207
Net income	—	—	—	—	—	35,933	35,933
Other comprehensive income					430		430
Repurchase of ordinary shares (Note 15)	—	—	(45,522)	—	—	—	(45,522)
Retirement of ordinary shares (Note 15)	(5,142,102)	(3)	43,786	(43,783)	—	—	—
Issuance of ordinary shares upon exercise of employee share options (Note 15)	139,644	—	—	554	—	—	554
Share-based compensation expense reversal (Note 19)	—	—	—	(1,195)	—	—	(1,195)
Dividends (Note 17)	—	—	—	(205,172)	—	—	(205,172)
Income from disposal of subsidiary to parent company (Note 22(f))	—	—	—	19	—	—	19
Balance as of December 31, 2011	202,783,480	161	(1,736)	1,252,232	(41,133)	144,730	1,354,254

See accompanying notes to consolidated financial statements.

	Ordinary shares						
	Number of Shares	Par Value Amount	Treasury Stock at Cost	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Total Shareholders' Equity
		RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2012	202,783,480	161	(1,736)	1,252,232	(41,133)	144,730	1,354,254
Net income	—	—	—	—	—	90,092	90,092
Other comprehensive loss	—	—	—	—	(555)	—	(555)
Repurchase of ordinary shares (Note 15)	—	—	(40,899)	—	—	—	(40,899)
Retirement of ordinary shares (Note 15)	(5,704,700)	(3)	42,635	(42,632)	—	—	—
Issuance of ordinary shares upon exercise of employee share options (Note 15)	368,160	—	—	1,683	—	—	1,683
Dividends (Note 17)	—	—	—	(378,472)	—	—	(378,472)
Balance as of December 31, 2012	197,446,940	158	—	832,811	(41,688)	234,822	1,026,103

See accompanying notes to consolidated financial statements.

	Ordinary shares						
	Number of Shares	Par Value Amount	Treasury Stock at Cost	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Total Shareholders' Equity
		RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2013	197,446,940	158	—	832,811	(41,688)	234,822	1,026,103
Net income	—	—	—	—	—	11,828	11,828
Other comprehensive income	—	—	—	—	65	—	65
Dividends (Note 17)	—	—	—	(192,470)	—	—	(192,470)
Balance as of December 31, 2013	197,446,940	158	—	640,341	(41,623)	246,650	845,526
Balance as of December 31, 2013 (USD)		26	—	105,777	(6,876)	40,744	139,671

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013

(Amounts in thousands)

	Year ended December 31,			
	2011	2012	2013	2013
	RMB	RMB	RMB	USD
Cash flows from operating activities:				
Net income	35,933	90,092	11,828	1,954
Adjustments to reconcile net income to net cash provided by operating activities:				
Share-based compensation expense reversal	(1,195)	—	—	—
Depreciation and amortization	58,913	45,135	36,711	6,064
Allowance for doubtful accounts	—	2,276	140	23
Loss / (gain) on disposal of property and equipment	3,605	(268)	1,028	170
Loss on disposal of intangible asset	—	—	359	59
Gain on disposal of an equity method investee	—	(68,440)	—	—
Equity in income of an equity method investee	(1,552)	(1,337)	—	—
Dividend income from an equity method investee	—	13,825	—	—
Deferred income tax benefit	(4,776)	(2,022)	(4,251)	(702)
Inventory write-downs	9,379	9,072	11,926	1,970
Impairment losses of property and equipment	14,164	7,649	6,984	1,154
Changes in operating assets and liabilities:				
Accounts receivable	(19,215)	(13,940)	(17,523)	(2,895)
Amounts due from related parties	7,709	(3,605)	7,875	1,301
Prepaid expenses, deposits and other current assets	4,063	(20,551)	(25,930)	(4,283)
Inventories	(13,173)	(50,497)	(85,226)	(14,078)
Deferred income	(17,156)	2,841	7,176	1,185
Accounts payable	38,613	3,709	47,463	7,840
Bills payable	—	20,534	(16,200)	(2,676)
Amounts due to related parties	(6,292)	212	10,866	1,795
Accrued expenses and other payables	(7,843)	(11,018)	17,131	2,830
Income tax payable and other non-current liabilities	6,975	17,709	(3,474)	(574)
Net cash provided by operating activities	108,152	41,376	6,883	1,137
Cash flows from investing activities:				
Release / (placement) of restricted cash	5,000	(36,000)	(1,000)	(165)
Purchase of property and equipment	(28,089)	(35,014)	(47,197)	(7,796)
Proceeds from disposal of property and equipment, and land use right	9,717	2,870	536	88
Proceeds from disposal of an equity method investee	—	81,480	—	—
Dividend income from an equity method investee	—	11,175	—	—
Investment in time deposits with original maturity over three months	(708,000)	(88,100)	(325,696)	(53,801)
Proceeds from maturity of time deposits with original maturity over three months	1,009,000	43,000	358,100	59,154
Effect of deconsolidation of a subsidiary	19	—	—	—
Refund of acquisition deposit	—	1,000	—	—
Net cash provided by / (used in) investing activities	287,647	(19,589)	(15,257)	(2,520)
Cash flows from financing activities:				
Proceeds from issuance of ordinary shares upon exercise of employee share options	554	1,683	—	—
Payment for repurchase of ordinary shares	(45,522)	(40,899)	—	—
Dividends paid	(205,172)	(378,472)	—	—
Net cash used in financing activities	(250,140)	(417,688)	—	—

	Year ended December 31,			
	2011	2012	2013	2013
	RMB	RMB	RMB	USD
Effect of foreign currency exchange rates on cash	(4,570)	(728)	(1,736)	(287)
Net increase / (decrease) in cash	141,089	(396,629)	(10,110)	(1,670)
Cash and cash equivalents at beginning of the year	626,796	767,885	371,256	61,327
Cash and cash equivalents at end of the year	767,885	371,256	361,146	59,657
Supplemental disclosure of cash flow information:				
Income taxes paid	(30,141)	(36,144)	(44,725)	(7,271)
Accounts payable for purchase of property and equipment	4,720	3,664	4,593	759

See accompanying notes to consolidated financial statements.

(Amounts in thousands, except per share data)

1 PRINCIPAL ACTIVITIES, ORGANIZATION AND BASIS OF PRESENTATION

(a) Principal activities

China Nepstar Chain Drugstore Ltd. (the "Company") and its subsidiaries (collectively with the Company, the "Group") are principally engaged in the business of operating retail drugstores in the People's Republic of China (the "PRC"). The Group's drugstores provide pharmacy services and sell prescription drugs, non-prescription or over-the-counter drugs, nutritional supplements, herbal products, personal and family care products and convenience products such as snack food and beverages. As of December 31, 2013, the Company, through its subsidiaries, was the owner and operator of 2,066 retail drugstores in 77 cities in Guangdong, Jiangsu, Zhejiang, Liaoning, Shandong, Hunan, Fujian, Sichuan, Hubei, Anhui and Jilin provinces and Shanghai, Tianjin and Beijing municipalities of the PRC under the name of "China Nepstar". All of the Group's operations and customers are located in the PRC.

The following list contains the particulars of subsidiaries and an equity method investee which principally affected the consolidated results of operations and financial position of the Company.

Name of subsidiary/investee	Principal activities	Percentage of controlling interest as of December 31,		
		2011	2012	2013
Shenzhen Nepstar Pharmaceutical Co., Ltd. ("Nepstar Pharmaceutical")	Procurement of merchandise for the Group	100%	100%	100%
Weifang Nepstar Pharmaceutical Co., Ltd. ("Weifang Nepstar")	Procurement of merchandise for the Group	100%	100%	100%
Shenzhen Nepstar Group Siping Northeast Co., Ltd. ("Siping Nepstar")	Procurement of merchandise for the Group	—	—	100%
Shanghai Nepstar Chain Co., Ltd. ("Shanghai Nepstar")	Operation of retail drugstores	100%	100%	100%
Guangzhou Nepstar Chain Co., Ltd. ("Guangzhou Nepstar")	Operation of retail drugstores	100%	100%	100%
Ningbo Nepstar Chain Co., Ltd. ("Ningbo Nepstar")	Operation of retail drugstores	100%	100%	100%
Sichuan Nepstar Chain Co., Ltd. ("Sichuan Nepstar")	Operation of retail drugstores	100%	100%	100%
Jiangsu Nepstar Chain Co., Ltd. ("Jiangsu Nepstar")	Operation of retail drugstores	100%	100%	100%
Dalian Nepstar Chain Co., Ltd. ("Dalian Nepstar")	Operation of retail drugstores	100%	100%	100%
Hangzhou Nepstar Chain Co., Ltd. ("Hangzhou Nepstar")	Operation of retail drugstores	100%	100%	100%
Shandong Minkang Nepstar Chain Co., Ltd. ("Shandong Nepstar")	Operation of retail drugstores	100%	100%	100%
Shenzhen Nepstar Chain Co., Ltd. ("Shenzhen Nepstar")	Operation of retail drugstores	100%	100%	100%
Qingdao Nepstar Chain Co., Ltd. ("Qingdao Nepstar")	Operation of retail drugstores	100%	100%	100%
Tianjin Nepstar Chain Co., Ltd. ("Tianjin Nepstar")	Operation of retail drugstores	100%	100%	100%
Yunnan Jian Zhijia Chain Drugstore Ltd. ("Yunnan Nepstar")	Operation of retail drugstores (Note 1(a)(i))	40%	—	—

Name of subsidiary/investee	Principal activities	Percentage of controlling interest as of December 31,		
		2011	2012	2013
Fuzhou Nepstar Chain Co., Ltd. (“Fuzhou Nepstar”)	Operation of retail drugstores	100%	100%	100%
Hubei Nepstar Chain Co., Ltd. (“Hubei Nepstar”)	Operation of retail drugstores	100%	100%	100%
Beijing Nepstar Chain Co., Ltd. (“Beijing Nepstar”)	Operation of retail drugstores	100%	100%	100%
Shenyang Nepstar Chain Co., Ltd. (“Shenyang Nepstar”)	Operation of retail drugstores	100%	100%	100%
Shenzhen Nepstar E-commerce Co., Ltd. (“Nepstar E-commerce”)	Online retail sales of merchandise	100%	100%	100%
Zaozhuang Nepstar Chain Co., Ltd. (“Zaozhuang Nepstar”)	Operation of retail drugstores	100%	100%	100%
Wenzhou Nepstar Chain Co., Ltd. (“Wenzhou Nepstar”)	Operation of retail drugstores (Note (i))	100%	100%	—
Hunan Nepstar Health Chain Co., Ltd. (“Hunan Nepstar”)	Operation of retail drugstores	100%	100%	100%
Wuhan Nepstar Drugstore Co., Ltd. (“Wuhan Nepstar”)	Operation of retail drugstores	—	100%	100%

Note (i)

Yunnan Nepstar was 40% owned by Nepstar Pharmaceutical and 60% owned by Yunnan Jianzhijia Holding Co., Ltd. (“JZJ Holding”), a company 100% beneficially owned by a director of Yunnan Nepstar. On December 28, 2012, the Group completed the sales of its 40% equity ownership in Yunnan Nepstar to JZJ Holding. In accordance with the terms of the agreement entered into by the Group and JZJ Holding in connection with the transaction, JZJ Holding has acquired the Group’s 40% equity ownership in Yunnan Nepstar for a total cash consideration of RMB81,480. As of December 31, 2012, Yunnan Nepstar was no longer an equity method investee of the Group. See Note 10.

On December 20, 2013, Wenzhou Nepstar was dissolved.

(b) Significant concentrations and risks

As of December 31, 2012 and 2013, the Group held US dollar denominated bank deposits of USD9,943 and USD9,745 (equivalent to RMB61,948 and RMB58,996) respectively, which were placed with financial institutions in the Hong Kong Special Administrative Region (“HKSAR”) of the PRC. Apart from the bank deposits in HKSAR, all of the Group’s bank deposits are with financial institutions in the mainland of the PRC.

(c) Organization

The Company was incorporated in the Cayman Islands in August 2004 as part of the reorganization of Shenzhen Nepstar Health Chain Drugstore Co., Ltd., a PRC company that operated the retail drugstore business of Shenzhen Neptunus Group Co., Ltd. (“Neptunus Group”), to facilitate the raising of capital from investors outside of the PRC and the Company’s initial public offering (the “Reorganization”). On November 9, 2007, the Company completed its initial public offering of shares in the form of American Depositary Shares (“ADSs”). The Company’s ADSs are traded on New York Stock Exchange under the symbol “NPD”.

In May 2007, the Company carried out a group reorganization whereby it transferred 51% equity interest in each of Shanghai Nepstar, Guangzhou Nepstar, Ningbo Nepstar, Sichuan Nepstar, Jiangsu Nepstar, Dalian Nepstar, Hangzhou Nepstar, Shandong Nepstar, Shenzhen Nepstar, Qingdao Nepstar and Tianjin Nepstar (collectively the “Pre-2009 Regional Companies”) to two PRC companies (the “Transferee Companies”). The Transferee Companies are legally held under the name of the Group’s employees in order to comply with certain PRC rules and regulations in relation to foreign ownership of companies in the PRC engaging in the retail drugstore businesses. The Transferee Companies paid an aggregate consideration of RMB31,794 to the Company for the 51% equity interest in the Pre-2009 Regional Companies, which was financed by loans provided by the Nepstar Pharmaceutical. In August 2009, Nepstar Pharmaceutical and the Transferee Companies established Fuzhou Nepstar, each holding 49% and 51% equity interests, respectively. The Transferee Companies paid the initial capital contribution of RMB1,530 with the loans provided by Nepstar Pharmaceutical.

In December 2009, Shenzhen Nepstar E-commerce Co., Ltd. (“Nepstar E-commerce”) was set up with 100% of equity interest owned by Nepstar Pharmaceutical to operate the online retail sales of merchandise. Under the PRC regulations, foreign investors are not allowed to own more than 50% of the equity interest in any “value-added telecommunications services” provider, or an entity conducting an internet content distribution business. As a result, in May 2010, Nepstar Pharmaceutical transferred its entire equity interest in Nepstar E-commerce to the two Transferee Companies. In return for the equity transfer, the Transferee Companies paid a total consideration of RMB10,000 (equal to the initial investment by Nepstar Pharmaceutical) to Nepstar Pharmaceutical. The cash of RMB10,000 was financed by a loan from Nepstar Pharmaceutical.

In order to have the same unilateral control and economic risks and rewards as direct legal ownership of the Pre-2009 Regional Companies, Fuzhou Nepstar and Nepstar E-commerce (collectively referred to as “Regional Companies” hereafter), Nepstar Pharmaceutical entered into certain contractual arrangements (the “Contractual Agreements”) with the Regional Companies, the Transferee Companies and their individual legal owners. The terms of the Contractual Agreements are summarized as follows:

Agreements that Retain Control over the Regional Companies

Under the shareholders agreements (namely the Shareholders Agreements and Equity Pledge Agreements) among Nepstar Pharmaceutical and the Transferee Companies, the Transferee Companies are not allowed to transfer their equity interests in the Regional Companies to a third party, nor are the Transferee Companies allowed to pledge, dispose of or create any encumbrance on such equity interests, without the prior written consent of Nepstar Pharmaceutical. In addition, the Transferee Companies agree to delegate all voting power rights as legal shareholders of the Regional Companies to persons designated by Nepstar Pharmaceutical, and agree to delegate their voting rights in the Board of Directors of the Regional Companies to Nepstar Pharmaceutical. The terms of these agreements are indefinite. Further, in accordance with the PRC Property Rights Law, the Equity Pledge Agreements are required to be registered with the relevant government authority. The Company completed the registration of the Equity Pledge Agreements in July 2007.

Agreements that Retain Economic Risks and Rewards of the Regional Companies

Under the Logistics Service and Information Technology Support Agreements, the Trade Name License Agreements entered into between Nepstar Pharmaceutical and each of the Regional Companies, Nepstar Pharmaceutical provides logistic, information technology support and consulting services to the Regional Companies, and allows these companies to use the trade names and trademarks for their operations, in exchange for annual service fees and license fees calculated based on each Regional Company’s gross profit. Under the Supply Agreements entered into between Nepstar Pharmaceutical and each of the Regional Companies, Nepstar Pharmaceutical is a supplier of products sold by these companies’ retail drugstores and the use of other suppliers of products sold by these companies’ retail drugstores requires authorization and approval by Nepstar Pharmaceutical. Nepstar Pharmaceutical has the right to adjust the purchase price at its sole discretion. These agreements will expire on May 27, 2017, and are automatically renewed for additional one-year term on an annual basis unless Nepstar Pharmaceutical gives prior written notice to the respective Regional Companies regarding its decision not to renew these agreements. These agreements allow the Regional Companies’ profits to be transferred to the Company through Nepstar Pharmaceutical.

The respective shareholders agreements referred to above stipulate that unanimous approval of shareholders must be obtained before each of the Regional Companies may distribute dividends and with such approval, dividends may be distributed in accordance with the shareholders’ respective equity interest or in a ratio as otherwise agreed to by the shareholders. In addition, any amounts received by the Transferee Companies from the Regional Companies, including dividends and other distributions on equity interest, shall be deposited in a designated bank account managed by Nepstar Pharmaceutical as security for the loans by Nepstar Pharmaceutical to the two Transferee Companies. The loans have an initial term of one year and are renewable indefinitely at the option of Nepstar Pharmaceutical. Without prior consent of Nepstar Pharmaceutical, these amounts cannot be distributed to the Transferee Companies’ shareholders. Further, Nepstar Pharmaceutical has an exclusive option to acquire all or part of the Transferee Companies’ equity interest in the Regional Companies at a price equal to the respective purchase price initially paid by the Transferee Companies. Nepstar Pharmaceutical also has an exclusive option to acquire all or part of the equity interests in the Transferee Companies from their shareholders at a price equal to the registered capital of these companies.

In the opinion of management, based on consultation with the Company’s PRC legal counsel, the above contractual arrangements are legally binding and enforceable and do not violate current PRC laws and regulations.

According to the Contractual Agreements, the Transferee Companies agree to delegate all the rights to exercise their voting power as shareholders of the Regional Companies to Nepstar Pharmaceutical, and thus the Company has a unilateral controlling financial interest in the Regional Companies. Furthermore, the transfer of 51% legal ownership in the Regional Companies lacked substance for accounting purpose, as the purpose of the transfer was to allow the Company to comply with certain PRC rules and regulations in relation to foreign ownership of companies in the PRC engaging in retail drugstore business. Through the Contractual Agreements, the Company has exclusive authority over all decision-making related to the Regional Company’s major operations and employee compensation and has 100% financial interest (either through dividend distribution or provision of logistic, information technology support and consulting services) in the Regional Companies. As a result, the Regional Companies are consolidated by the Company.

(d) *Basis of presentation*

The accompanying consolidated financial statements have been prepared in accordance with US generally accepted accounting principles ("US GAAP").

2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) *Principles of consolidation*

The accompanying consolidated financial statements include the financial statements of the Company and its subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

The Contractual Agreements provide the Company with the legal and unilateral financial control of the Regional Companies and allow the Company to share in all economic risks and rewards of ownership as though the Regional Companies were held through direct legal ownership. Accordingly, the Company has consolidated the Regional Companies as though the entities were wholly-owned subsidiaries. The loans and advance to the Transferee Companies are fully eliminated in consolidation.

(b) *Use of estimates*

The preparation of the consolidated financial statements in conformity with US GAAP requires management of the Company to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the year. Significant items subject to such estimates and assumptions include the realizability of inventories, the useful lives and salvage values of property and equipment and intangible assets, the recoverability of the carrying amount of property and equipment, goodwill, intangible assets and investments, the realization of deferred tax assets, the collectability of accounts receivable, the fair values of financial instruments, and accruals of contingencies. These estimates are often based on complex judgments and assumptions that management believes to be reasonable but are inherently uncertain and unpredictable. Actual results may differ from those estimates.

(c) *Foreign currency transactions and translation*

The Group's reporting currency is the Renminbi ("RMB"). The functional currency of the Company is the US dollar ("USD"), whereas the functional currency of the Company's subsidiaries in the PRC is the RMB since the PRC is the primary economic environment in which the PRC subsidiary entities operate. Transactions denominated in currencies other than the functional currency are converted into the functional currency at the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are converted into the functional currency using the applicable exchange rates at the balance sheet dates.

Assets and liabilities of the Company are translated into RMB using the exchange rate on the balance sheet date. Revenues and expenses of the Company are translated at average rates prevailing during the year. Gains and losses resulting from translation of the Company's financial statements are recorded as a separate component of accumulated other comprehensive loss within shareholders' equity. In addition, gains and losses on inter-company foreign currency transactions that are of a long-term investment nature are reported as other comprehensive income or loss in the same manner as translation adjustments.

For the convenience of the readers, the December 31, 2013 RMB amounts included in the accompanying consolidated financial statements have been translated into US dollars at the rate of US$1.00=RMB 6.0537, being the noon buying rate for US dollars in effect on December 31, 2013 for cable transfers in RMB per US dollar as certified for custom purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into US dollars at that rate or at any other rate on December 31, 2013 or at any other date.

Since RMB is not a fully convertible currency, all foreign exchange transactions involving RMB must take place either through the People's Bank of China (the "PBOC") or other institutions authorized to buy and sell foreign exchange. The exchange rates adopted for the foreign exchange transactions are the rates of exchange quoted by the PBOC, which are determined largely by supply and demand.

(d) *Cash and cash equivalents*

Cash and cash equivalents, include interest-bearing time deposits at banks with original maturity within three months.

(e) *Restricted cash*

Cash that is restricted as to withdrawal or usage is reported as restricted cash in the consolidated balance sheets and is not included in the beginning or ending balance of cash and cash equivalents in the consolidated statements of cash flows.

Restricted cash of RMB36,000 (USD5,947) as of December 31, 2013 represented short-term pledged bank deposits placed with a bank, which were designated as security for bank acceptance bills granted by the financial institution, and will be released upon termination of the agreement with the financial institution. The remaining restricted cash of RMB1,000 (USD165) represented the government grant deposited at the designated bank account. The usage of the amount in this designated bank account requires the respective governmental bureaus' approval.

(f) Accounts receivable

Accounts receivable are recorded at the invoiced amount and do not bear interest. Accounts receivable represent amounts due from banks relating to retail sales that are paid or settled by the customers' debit or credit cards, amounts due from governmental social security bureaus relating to retail sales of drugs and prescription medicine that are paid or settled by the customers' medical insurance cards, and amounts due from non-retail customers for sales of merchandise. Accounts receivable are stated net of an allowance for doubtful accounts. The Group maintains and records an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The allowance for doubtful accounts is based on a review of specifically identified accounts and aging data. Judgments are made with respect to the collectability of accounts receivable based on customer specific facts and current economic conditions. Accounts receivable are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Group does not have any off-balance sheet credit exposure related to its customers.

(g) Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method for all inventories. The Group carries out physical inventory counts on a quarterly basis at each store and warehouse location and records write-downs to inventories for shrinkage losses and damaged merchandise that are identified during the inventory counts. Write-downs due to shrinkage losses and damaged merchandise for the years ended December 31, 2011, 2012 and 2013 were RMB9,379, RMB9,072, and RMB11,926 respectively, and are included in cost of goods sold.

(h) Long-lived assets

Property and equipment

Property and equipment are stated at cost, net of accumulated depreciation or amortization. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets, taking into consideration the assets' estimated salvage value. Leasehold improvements are amortized over the shorter of the original lease term or the estimated useful life of the assets. The estimated useful lives of the Group's property and equipment, other than leasehold improvements, are as follows:

Store buildings	20 years
Store fixture and equipment	5 years
Motor vehicles	5 years
Software	10 years

Goodwill

Goodwill represents the excess of the aggregate purchase price over the fair value of the net assets acquired in business combinations, which are not individually identified and separately recognized.

Intangible assets

The Group's intangible assets represent operating rights acquired in business combinations (see Note 8). Operating rights are indefinite-lived intangible assets, which are not amortized but are reviewed for impairment annually or when events or circumstances indicate that the asset may be impaired.

Impairment of long-1ived assets

Long-lived assets, including property and equipment and intangible assets that are subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset group exceeds the fair value of the asset group. Impairment of long-lived assets of RMB14,164 , RMB7,649 and RMB6,984 was recognized for the years ended December 31, 2011, 2012 and 2013 respectively (see Note 7).

Goodwill is reviewed for impairment at least annually. In September 2011, the FASB issued ASU 2011-08, Testing Goodwill for Impairment, which provides an entity the option to perform a qualitative assessment to determine whether it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount prior to performing the two-step goodwill impairment test. If this is the case, the two-step goodwill impairment test is required. If it is more-likely-than-not that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The Company adopted ASC 2011-08 in 2012 and did not elect to use the qualitative assessment option.

If the two-step goodwill impairment test is required, first, the fair value of the reporting unit is compared with its carrying amount (including goodwill). If the fair value of the reporting unit is less than its carrying amount, an indication of goodwill impairment exists for the reporting unit and the enterprise must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. If the fair value of the reporting unit exceeds its carrying amount, step two does not need to be performed.

The Group performs annual impairment review of goodwill at December 31, and when a triggering event occurs between annual impairment tests. No impairment of goodwill was recognized for the years ended December 31, 2011, 2012 and 2013.

(i) Cost and equity method investments

Investments in the stock of an investee where the fair value of the equity security is not readily determinable and the Group does not have the ability to exercise significant influence over the operating and financial policies of the investees are accounted for under the cost method. Under the cost method of accounting, the Group records an investment in the equity of an investee at cost, and recognizes in income the amount of dividends received or receivable that are distributed from net accumulated earnings of the investee since the date of acquisition.

Investments in the stock of an investee, where the Group does not have a controlling financial interest, but has the ability to exercise significant influence over the operating and financial policies of the investee, are accounted for using the equity method of accounting. Under the equity method of accounting, the Group's share of the investee's results of operations is reported as equity in income (loss) of an equity method investee in the consolidated statements of comprehensive income.

The Group recognizes an impairment loss when a series of operating losses of an investee or other factors may indicate that a decline in value below the carrying amount of the investment has occurred which is other than temporary. The process of assessing and determining whether impairment on a particular equity investment is other-than-temporary requires significant judgment. To determine whether an impairment is other-than-temporary, management considers whether the Group has the ability and intent to hold the investment until recovery and considers whether evidence indicating the carrying value of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the decline in value, any change in value subsequent to year end, and forecasted performance of the investee. Based on management's evaluation, no impairment charges related to the Group's investments were recognized for any of the periods presented.

Sales of investment in an investee is accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the investment sold.

(j) Land use right

Land use right represents the cost of the right to use land in the PRC. The land use right is carried at cost and charged to expense on a straight-line basis over a period of the right of 50 years.

(k) Income taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax loss and tax credit carry forwards. Deferred tax assets are reduced by a valuation allowance to the extent management concludes it is more likely than not that the deferred tax assets will not be realized. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Group recognizes in the consolidated financial statements the impact of a tax position if , based on the technical merits of the position, that position is more likely than not of being sustained upon examination. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. The Group's accounting policy is to accrue interest and penalties related to unrecognized tax benefits as interest expense and a component of general and administrative expenses, respectively, in the consolidated statements of comprehensive income.

(l) Revenue recognition

Revenue from sales of prescription medicine at the drugstores is recognized when the prescription is filled and the customer picks up and pays for the prescription. Revenue from sales of other merchandise at the drugstores is recognized at the point of sale, which is when the customer pays for and receives the merchandise. Revenue from sales of merchandise to non-retail customers is recognized when the following conditions are met: 1) persuasive evidence of an arrangement exists (sales agreements and customer purchase orders are used to determine the existence of an arrangement); 2) delivery of goods has occurred and risks and benefits of ownership have been transferred, which is when the goods are received by the customer at its designated location in accordance with the sales terms (Customer acceptance notes provide evidence of delivery); 3) the sales price is fixed or determinable; and 4) collectability is reasonably assured. Historically, sales returns were immaterial.

The Group's revenue is recognized net of value added tax ("VAT") collected on behalf of tax authorities in respect of the sale of merchandise. VAT collected from customers, net of VAT paid for purchases, is recorded as a liability in the balance sheet until it is paid to the tax authorities.

The Group has introduced a Nepstar shopper's card program (the "Program"). Under the Program, the Group's retail customers deposit certain amount of cash into the pre-paid cards issued by the Group for future purchases of merchandise at the Group's drugstores, and receive free products (which are in the form of low-value products sold at the Group's stores) or a cash coupon to be used as a credit for a future purchase. The unused portion of the pre-paid cards as of the balance sheet date is recorded as deferred income, and recognized as revenue when a customer uses the card for subsequent purchase of merchandise. At the point of sale of the pre-paid cards, the fair value of the free products to be redeemed by customers and the fair value of the cash coupon are both recorded as deferred income and recognized as revenue upon redemption or usage. For all the years presented, the total amount of the free products and cash coupons recognized in the consolidated statements of comprehensive income was immaterial.

(m) Advertising and promotion costs

Advertising and promotion costs are expensed as incurred. Advertising and promotion costs amounted to RMB9,904 , RMB14,504 and RMB14,142 for the years ended December 31, 2011, 2012 and 2013, respectively and are included in sales, marketing and other operating expenses in the consolidated statements of comprehensive income.

(n) Store opening costs

Expenditures related to the opening of new drugstores, other than expenditures for property and equipment, are expensed when incurred.

(o) Vendor allowances

Vendor allowances are recorded as a reduction to the carrying value of inventories and subsequently recognized in cost of goods sold when the inventories are sold, unless the allowances are specifically identified as reimbursements for advertising, promotion and other services, in which case the allowances are recognized as a reduction of the related advertising and promotion costs.

For the years ended December 31, 2011, 2012 and 2013, the Company recognized vendor allowances of RMB76,067 , RMB87,338 and RMB104,714 in cost of goods sold, and RMB10,387, RMB13,131 and RMB16,759 as a reduction of advertising and promotion costs, respectively.

(p) Warehouse, buying and distribution costs

Warehouse and buying costs represent primarily rental expenses for warehouses, staff cost and other expenses incurred in warehousing and purchasing activities. Distribution costs represent the costs of transporting the merchandise from warehouses to stores. Warehouse, buying and distribution costs are expensed as incurred and are included in sales, marketing and other operating expenses. Warehouse and buying costs amounted to RMB36,225, RMB37,757 and RMB39,172 and distribution costs amounted to RMB11,707, RMB11,208 and RMB11,042 for the years ended December 31, 2011, 2012 and 2013, respectively.

(q) ***Operating leases***

The Group leases premises for retail drugstores, warehouses and offices under non-cancelable operating leases. Operating lease payments are expensed on a straight-line basis over the term of lease. A majority of the Group's retail drugstore leases have a 5-year term with a renewal option upon the expiry of the lease. The Group has historically been able to renew a majority of its drugstores leases. Under the terms of the lease agreements, the Group has no legal or contractual asset retirement obligations at the end of the lease.

(r) ***Retirement and other postretirement benefits***

Contributions to defined contribution retirement plans are charged to the consolidated statements of comprehensive income as and when the related employee service is provided. The Group does not have any defined benefit retirement plans.

(s) ***Share-based payments***

The Group measures the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and recognizes that cost over the period the employee is required to provide service in exchange for the award, which generally is the vesting period.

(t) ***Earnings per share***

Basic earnings per share is computed by dividing net income attributable to the Group by the weighted average number of ordinary shares outstanding during the period.

Diluted earnings per share reflects the potential dilution that would occur upon the exercise of outstanding options and the vesting of non-vested shares granted. Ordinary share equivalents are excluded from the computation of the diluted earnings per share when their effect would be anti-dilutive.

(u) ***Treasury stock***

Treasury stock is recorded at acquisition cost and is presented as a reduction from total equity. On cancellation of treasury stock, any excess of the carrying amount over the par value is charged to additional paid-in capital.

(v) ***Commitments and contingencies***

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and other sources are recorded when it is probable that a liability has been incurred and the amount can be reasonably estimated. Historically, the Group has experienced no product liability claims.

(w) ***Segment reporting***

The Group's chief operating decision maker has been identified as its Chief Executive Officer. The Group has one reportable operating segment, which is the retail drugstore business. Geographic information is not presented because all of the Group's operations and customers are located in the PRC.

(x) ***Fair value measurements***

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Group considers the principal or most advantageous market in which it would transact and the assumptions that market participants would use when pricing the asset or liability.

The Group applies a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Fair value is an exit price, defined as a market-based measurement that represents the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Fair value measurements are based on one or more of the following three valuation techniques:

Market

This approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Income

This approach uses valuation techniques to convert future amounts to a single present value amount based on current market expectations.

Cost

This approach is based on the amount that would be required to replace the service capacity of an asset.

FASB ASC Subtopic 820 establishes three levels of inputs that may be used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The Group did not have any financial assets and liabilities or nonfinancial liabilities that are measured at fair value on a recurring or nonrecurring basis as of December 31, 2012 and 2013.

The following table presents fair value measurements of assets that are measured at fair value on a nonrecurring basis at December 31, 2013:

Description	Year ended December 31, 2013	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total gains (losses)
	RMB	RMB	RMB	RMB	RMB
Property and equipment.................................	123,183	—	123,183	—	(6,984)

(y) Recently issued accounting standards

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. ASU 2013-02 does not change the requirements for reporting net income or other comprehensive income in financial statements. The new standard is effective for reporting periods beginning after December 15, 2013. The Company will implement the provisions of ASU 2013-02 as of January 1, 2014.

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 requires an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The new standard is to be applied prospectively but retrospective application is permitted. The Company will implement the provisions of ASU 2013-11 as of January 1, 2014.

3 CASH, CASH EQUIVALENTS AND BANK DEPOSITS

As of December 31, 2012 and 2013, the amount of cash and cash equivalents and bank deposits by original maturity was as follows:

	December 31,	
	2012	2013
	RMB	RMB
Cash and cash equivalents	371,256	361,146
Short-term time deposits with maturity over three months but within one year	237,100	184,440
Long-term time deposits with maturity between one and two years	20,000	40,256

As of December 31, 2012 and 2013, cash and cash equivalents include US Dollar denominated bank deposits of USD9,943 and USD9,745 (equivalent to RMB61,948 and RMB58,996), respectively.

As of December 31, 2013, the interest rate of time deposits range from 3.05% to 4.4% per annum with a weighted average original maturity of 12.1 months. The Group places its cash in financial institutions with sound credit rating.

4 ACCOUNTS RECEIVABLE, NET OF ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable consist of the following:

	December 31,	
	2012	2013
	RMB	RMB
Accounts receivable due from:		
Banks	770	1,182
Social security bureaux	100,249	112,884
Non-retail customers	14,229	18,105
	115,248	132,171
Less: allowance for doubtful accounts	(647)	(187)
Accounts receivable, net	114,601	131,984

The following table presents the movement of allowance for doubtful accounts for the years ended December 31, 2011, 2012 and 2013.

	December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Balance at the beginning of the year	156	—	647
Provision for the year	—	2,276	140
Reversal of bad debt expense	—	—	—
Write-off of accounts receivable	(156)	(1,629)	(600)
Balance at the end of the year	—	647	187

5 PREPAID EXPENSES, DEPOSITS AND OTHER CURRENT ASSETS

Prepaid expenses, deposits and other current assets consist of the following:

	December 31, 2012	December 31, 2013
	RMB	RMB
Prepaid rental	91,787	101,337
Rental deposits	695	244
Prepayments for purchases of merchandise	14,486	25,359
Advances to employees	2,021	3,077
Deferred tax charge on unrealized profits on inter-company sales	11,437	16,337
Store consumables and supplies	9,929	12,235
Accrued interest income	10,905	4,445
Other prepaid expenses and deposits	5,992	6,176
	147,252	169,210

6 INVENTORIES

Inventories consist of the following:

	December 31, 2012	December 31, 2013
	RMB	RMB
Merchandise in stores	324,947	408,216
Merchandise in warehouses	153,536	143,567
	478,483	551,783

7 PROPERTY AND EQUIPMENT, NET

Property and equipment consist of the following:

	December 31, 2012	December 31, 2013
	RMB	RMB
Store buildings	14,617	18,087
Leasehold improvements	183,872	184,419
Store fixture and equipment	145,048	146,106
Software	34,933	36,714
Motor vehicles	14,731	14,572
	393,201	399,898
Less: Accumulated depreciation and amortization	(272,964)	(276,715)
	120,237	123,183

Total depreciation and amortization expense of property and equipment for the years ended December 31, 2011, 2012 and 2013 was RMB58,722, RMB44,916 and RMB36,711, respectively, of which RMB48,665, RMB34,526 and RMB27,063 was recorded in sales, marketing and other operating expenses and RMB10,057, RMB10,390 and RMB9,648 was recorded in general and administrative expenses. No depreciation and amortization expense was included in cost of goods sold for the years presented because the Company's business does not involve manufacturing of merchandise and the amount of depreciation and amortization of property and equipment relating to warehousing and transporting the merchandise to store locations is not material.

The Group recognized impairment losses of RMB14,164, RMB7,649 and RMB6,984 for the years ended December 31, 2011, 2012 and 2013 respectively in respect of leasehold improvements and store fixture of certain loss-making drugstores. The Group determined that the carrying amounts of these leasehold improvements and store fixture would not be recoverable through future cash flows. The fair value of the property and equipment was based on the discounted estimated cash flows expected to generate from the use and eventual disposal of these assets.

8 ACQUISITIONS

As of December 31, 2010, acquisition deposits of RMB2,000 related to the amount paid to Shanghai Riye for the proposed acquisition of the remaining two stores. The proposed acquisition of one store from Shanghai Riye was completed in the first quarter of 2011. The proposed acquisition of the other store is not executed according to the terms of acquisition agreement and the related deposit of RMB1,000 was refunded in full in March 2012.

The Group accounted for the Shanghai Riye business combination using the acquisition method of accounting. The purchase price of RMB1,000 was allocated to the identifiable assets acquired and liabilities assumed based on their fair value as of the respective acquisition dates with an amount of RMB730 being recognized as goodwill. Acquisition related costs were expensed as incurred and included in general and administrative expenses in the consolidated statements of comprehensive income.

The primary purpose of these acquisitions was to gain presence in new geographic areas or increase market share in existing geographic areas so as to gain regional operational synergy in drugstore operations.

9 GOODWILL AND OTHER INTANGIBLE ASSETS

(a) Intangible assets, net

	December 31,	
	2012	2013
	RMB	RMB
Amortized intangible assets		
Favorable lease contracts		
Cost	3,692	—
Less: Accumulated amortization	(3,692)	—
	—	—
Unamortized intangible assets		
Operating rights (Note 8)	2,868	2,509
Total intangible assets	2,868	2,509

As of December 31, 2012, the Group's amortized intangible assets represented favorable lease contracts acquired in business combinations. The Group amortizes these favorable lease contracts on a straight-line basis over the remaining lease term ranging from 2 to 6 years from the date of acquisition. As of December 31, 2012, the favorable lease contracts was fully amortized.

Amortization expense for intangible assets was RMB191, RMB219 and nil for the years ended December 31, 2011, 2012 and 2013, respectively and was included in general and administrative expenses.

Operating right represents the legal right acquired in business combination to operate drugstores in certain areas where only one drugstore is permitted to operate according to governmental regulations. Management believes there is no foreseeable limit on the period of time over which the operating right is expected to contribute to the cash flow of the Group. As a result, the operating right is considered to have an indefinite life.

During the year ended December 31, 2013, one of the four stores acquired by Shanghai Nepstar was closed down and the related intangible asset of RMB0.4 million was written off accordingly.

(b) Goodwill

The changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2013 were as follows:

	December 31,	
	2012	2013
	RMB	RMB
Gross goodwill as of January 1	51,819	51,819
Accumulated impairment losses	—	—
Net goodwill as of December 31	51,819	51,819

10 EQUITY METHOD INVESTMENT

The equity in income of the equity method investee in 2012 of RMB1,337 was the equity income recognized for the 40% equity investment in Yunnan Nepstar. In 2012, Yunnan Nepstar declared and paid a cash dividend of RMB25,000 to Nepstar Pharmaceutical. For the purposes of the consolidated statement of cash flows, the amount of dividend received in 2012 of RMB11,175 that represents returns of the Company's investment has been reported as cash flows from investing activities.

In 2012, the Company's Board of Director approved the sale of the Group's 40% equity ownership in Yunnan Nepstar to JZJ Holding for a total cash consideration of RMB81,480. A gain of RMB68,440 was recognized from disposal of an equity method investee upon completion of the sale. The gain was measured as the difference between cash consideration received and the carrying amount of the investment at the time of completion of the sales. The cash consideration of the transaction was received by the Company on December 28, 2012.

11 OTHER INCOME

In December 2012, the Company completed the sales of eight drugstores and related assets of Wenzhou Nepstar to Wenzhou Buyi Pharmacy Co., Ltd. ("Buyi") for a total cash consideration of RMB2,200. A gain of RMB1,480 was recognized in other income upon completion of the sales. The gain was measured as the difference between cash consideration received and the carrying amount of these assets at the time of completion of the sales.

12 INCOME TAXES

Cayman Islands Tax

Under the current law of the Cayman Islands, the Company is not subject to tax on its income or capital gains.

PRC Corporate Income Tax

Each of the Company's PRC subsidiaries files stand-alone tax returns and the Group does not file a consolidated tax return.

Effective from January 1, 2008, the Company's PRC subsidiaries are subject to income tax at the statutory income tax rate of 25% under the Corporate Income Tax Law of the PRC ("CIT"), unless otherwise specified.

The CIT and its relevant regulations provide transitional rates for entities operating in the Shenzhen and Zhuhai Special Economic Zones, which are 24% and 25% for 2011 and 2012 onwards, respectively. The Company's PRC subsidiaries and division operating in the Shenzhen and Zhuhai Special Economic Zones are subject to these transitional rates.

Under the CIT and its implementation rules, a withholding tax at 10%, unless reduced by a tax treaty or arrangement, is applied on dividends received by non-PRC-resident corporate investors from PRC-resident enterprises, such as the Company's PRC subsidiaries. Undistributed earnings prior to January 1, 2008 are exempt from such withholding tax. Under the China-HK Tax Arrangement and the relevant regulations, a qualified Hong Kong tax resident which is the "beneficial owner" and holds 25% equity interests or more of a PRC enterprise is entitled to a reduced withholding rate of 5%. The Company has determined that it has qualified for the 5% withholding tax rate for the years ended December 31, 2011 and 2012. The Company ceased to maintain its Hong Kong tax residency for 2013 and is therefore subject to a standard withholding tax rate of 10% for 2013.
The Group's income before income tax expense consist of:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
PRC	67,004	138,755	44,129
Non-PRC	(45)	(1,069)	(201)
Income before income tax expense	66,959	137,686	43,928

Income tax expense in the consolidated statements of comprehensive income consists of:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Current tax expense	35,802	49,616	36,351
Deferred tax benefit	(4,776)	(2,022)	(4,251)
Income tax expense	31,026	47,594	32,100

The reconciliation between actual income tax expense and the amount that results by applying the PRC statutory tax rate of 25% for the years ended December 31, 2011, 2012 and 2013, to income before income tax expense is as follows:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Computed "expected" tax expense	16,740	34,422	10,982
Effect of tax rate differential	(1,345)	(33)	50
PRC dividend withholding tax	680	4,598	2,351
Change in tax rate	—	—	8,659
Non-deductible expenses:			
- Disallowed rental expenses	8,527	14,190	13,333
- Penalty charged by the pricing authority	—	—	1,419
- Bad debt write-off	—	569	194
- Disallowed entertainment expense	405	441	457
- Deemed profit method differential	(171)	396	328
- Others	196	642	555
Reversal of deferred tax liabilities on equity method investment	—	(6,250)	—
Non-taxable income	(872)	(1,132)	(1,308)
Effect of deemed interest income	624	—	—
Unrealized tax benefits in inter-company transactions	—	—	1,601
Investment loss on the dissolve of Wenzhou Nepstar	—	—	(1,250)
Release of unrecognized tax benefits due to expiration of the statute of limitations	(2,421)	(2,785)	(4,584)
Change in valuation allowance	8,663	2,536	(687)
Actual income tax expense	31,026	47,594	32,100

In 2012, dividends of RMB25,000 was received from Yunnan Nepstar, an equity method investee (see Note 10). Consequently, deferred tax liabilities of RMB6,250 arising from the recognition of the equity method investment was reversed.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 2012 and 2013 are presented below.

	December 31,	
	2012	2013
	RMB	RMB
Deferred tax assets:		
- Tax loss carryforwards	34,590	40,621
- Inventories	1,960	3,971
- Impairment of property and equipment	2,834	2,625
- Accrual for membership reward program	788	411
- Accrual for government grant	—	250
- Accrued expenses	107	53
- Others	1,745	2,016
Total gross deferred tax assets	42,024	49,947
Valuation allowance	(37,264)	(31,894)
Total deferred tax assets	4,760	18,053
Deferred tax liabilities:		
- PRC dividend withholding taxes	(6,782)	(15,914)
- Intangible assets	(717)	(627)
Total deferred tax liabilities	(7,499)	(16,541)
Net deferred tax (liabilities)/assets	(2,739)	1,512
Classification on consolidated balance sheets:		
Deferred tax assets:		
- Current	1,704	6,330
- Non-current	3,056	11,723
Deferred tax liabilities:		
- Non-current	(7,499)	(16,541)

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Valuation allowance:			
Balance as of January 1	32,015	37,405	37,264
Addition	10,774	10,115	9,893
Deduction	(2,111)	(7,579)	(10,580)
Reversal on expiration of tax loss	(3,273)	(2,677)	(4,683)
Actual income tax expense	37,405	37,264	31,894

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Group will realize the benefits of the deferred tax assets, net of the existing valuation allowance as of December 31, 2012 and 2013. As of December 31, 2013, the Group recognized net deferred tax assets of RMB18,053, of which RMB11,260 relates to a subsidiary that is in cumulative loss position as of December 31, 2013. The net deferred tax assets recognized by this subsidiary include RMB9,221 relating to RMB36,885 tax loss carryforwards which expire in varying amounts between 2014 and 2018. The realization of these tax benefits is dependent on the generation of sufficient taxable income prior to expiration of the tax loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the net deferred tax asset will be realized. The amounts of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

As of December 31, 2013, the tax loss carryforwards of the Group amounted to RMB162,484, of which RMB7,182, RMB24,598, RMB22,564, RMB30,999 and RMB77,141 will expire, if unused, by end of 2014, 2015, 2016 ,2017 and 2018 respectively.

A reconciliation of the beginning and ending amount of unrecognized tax benefits in the PRC for the years ended December 31, 2011, 2012 and 2013 is as follows:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Balance as at January 1	25,194	31,015	36,237
Additions based on tax positions related to current year	8,242	8,007	14,190
Expiration of the statute of limitations	(2,421)	(2,785)	(4,584)
Balance as at December 31	31,015	36,237	45,843

The unrecognized tax benefits as of December 31, 2011, 2012 and 2013 are the potential benefits that, if recognized, would affect the effective tax rate. The unrecognized tax benefits mainly represent rental expenses taken on the tax returns in which the deductibility of such expenses does not meet the more likely than not threshold. As of December 31, 2013, the unrecognized tax benefits of RMB6,680 was presented as a reduction of the deferred tax asset for tax loss carryforwards of certain subsidiaries since the uncertain tax position would reduce the tax loss carryforwards under the tax law. The Company does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months. No interest and penalty expenses were recorded for the years ended December 31, 2011, 2012 and 2013.

According to the PRC Tax Administration and Collection Law, the statute of limitations is three years if the underpayment of taxes is due to computational errors made by the taxpayer or the withholding agent. The statute of limitations is extended to five years under special circumstances where the underpayment of taxes is more than RMB100 (USD15). In the case of transfer pricing issues, the statute of limitations is ten years. There is no statute of limitations in the case of tax evasion. The tax returns of the Company's PRC subsidiaries for the tax years beginning in 2008 are subject to examination by the relevant tax authorities.

13 ACCRUED EXPENSES AND OTHER PAYABLES

Accrued expenses and other payables consist of the following:

	December 31,	
	2012	2013
	RMB	RMB
Accrued payroll and employee benefits	62,661	67,824
Other accrued expenses (Note (a))	19,380	26,258
Payable for purchases of property and equipment	3,664	4,593
Deposits received (Note (b))	2,315	2,801
VAT and other taxes payable	17,483	21,589
	105,503	123,065

Notes:

(a) Amounts represent primarily accrued rental, utilities, advertising and other sundry expenses.

(b) Amounts represent primarily guarantee deposits from constructors for renovation and construction projects.

14 DEFERRED INCOME

Deferred income consists of the following:

	December 31, 2012	December 31, 2013
	RMB	RMB
Deferred revenue arising from Shopper's Card Program (Note 2(l)) and others	14,327	22,477
Deferred rebate income	18,365	17,391
	32,692	39,868

15 ORDINARY SHARES

The Company's Memorandum and Articles of Association, as amended, authorizes the Company to issue 360,000,000 shares with a par value of USD0.0001 per share.

For the years ended December 31, 2011, 2012 and 2013, the Company issued 119,644, 368,160 and nil ordinary shares, respectively, to employees upon the exercise of vested share options.

On March 2, 2010, the Company granted and issued an aggregate of 150,000 fully vested ordinary shares to its three independent directors. The grant of the shares to the independent directors was made in exchange for their forfeiture of 150,000 options granted in November 2007 (See Note 19). The Company also issued 30,000 and 20,000 ordinary shares, respectively, in the years ended December 31, 2010 and 2011 upon vesting of non-vested ordinary shares granted to an executive officer on March 2, 2010 (see Note 19). The non-vested shares vest in five equal installments on each of the first, second, third, fourth and fifth quarters after the date of grant, which was on March 2, 2010.

On August 13, 2010, the Board of Directors of the Company authorized a share repurchase program ("The 2010 Program"). The 2010 Program allows the Company, from time to time and during a 12-month period starting from August 13, 2010, to purchase up to USD20,000 of its outstanding ordinary shares in the form of ADS from the open market. On August 19, 2011, the Board of Directors of the Company authorized another share repurchase program ("The 2011 Program"). The 2011 Program allows the Company, from time to time and during a 12-month period starting from August 19, 2011, to purchase up to USD20,000 of its outstanding ordinary shares in the form of ADS from the open market. During the years ended December 31, 2011, 2012 and 2013, the Company repurchased 5,476,490, 5,370,312 and nil of its ordinary shares for a total purchase price of USD7,233 (equivalent to RMB45,522), USD6,565 (equivalent to RMB40,899) and nil, respectively. As of December 31, 2012, all of the repurchased shares had been retired.

16 STATUTORY RESERVES

Under the PRC rules and regulations, the Company's PRC subsidiaries are required to transfer 10% of the net profit, as determined in accordance with the relevant PRC laws and regulations, to a statutory surplus reserve until the reserve balance reaches 50% of the subsidiary's registered capital. The transfer to this reserve must be made before distribution of dividends to shareholders can be made. The statutory surplus reserve can be used to make good previous years' losses, if any, and may be converted into share capital by issuance of new shares to shareholders in proportion to their existing shareholdings or by increasing the par value of the shares currently held by the shareholders, provided that the balance after such issuance is not less than 25% of the registered capital.

The Company's PRC subsidiaries made appropriations to the statutory surplus reserve of RMB23,062 and RMB4,178, respectively for the years ended December 31, 2011 and 2012, and reversed RMB23 for the year ended December 31, 2013. The accumulated balance of the statutory surplus reserve as of December 31, 2012 and 2013 was RMB99,377 and RMB99,354, respectively. No equivalent amounts were appropriated by the Company.

17 DIVIDEND

On January 18, 2011, the Board of Directors of the Company declared a special cash dividend of USD0.15 per ordinary share, totaling USD31,168 (equivalent to RMB205,172 at the exchange rate on January 18, 2011), to the ordinary shareholders on record as of close of business on January 31, 2011. As approved by the Board of Directors of the Company, the entire amount of the special dividends was paid out of additional paid-in capital. The special dividends were fully paid during the year ended December 31, 2011.

On April 27, 2012, the Board of Directors of the Company declared a special cash dividend of USD0.3 per ordinary share, totaling USD59,986 (equivalent to RMB378,472 at the exchange rate on April 27, 2012), to the ordinary shareholders on record as of close of business on April 26, 2012. As approved by the Board of Directors of the Company, the entire amount of the special dividends was paid out of additional paid-in capital. The special dividends were fully paid during the year ended December 31, 2012.

On November 26, 2013, the Company's Board of Directors declared a cash dividend of USD0.16 per ordinary share, totaling USD31,591 (equivalent to RMB192,470 at the exchange rate on November 26, 2013), to the ordinary shareholders on record as of close of business on December 20, 2013. The cash dividend has not been paid as of the year ended December 31, 2013 and was fully paid during January 2014.

18 REVENUE

Revenue by each major product categories is analyzed as follows:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Prescription drugs	495,352	519,557	601,934
Over-the-counter drugs	911,412	997,997	1,059,154
Nutritional supplements	450,714	399,397	392,009
Herbal products	99,627	100,419	109,284
Other product sales	534,185	532,486	536,722
	2,491,290	2,549,856	2,699,103

Certain pharmaceuticals sold in the PRC, primarily those included in the PRC's published Medical Insurance Catalogue and those pharmaceuticals whose production or trading are deemed to constitute monopolies by the PRC government, are subject to retail price controls in the form of fixed prices or price ceilings. The fixed prices or the price ceilings of such pharmaceuticals are published by the national and provincial price administration authorities from time to time. The controls over retail prices could have a corresponding effect on Group's pricing strategy. The prices of pharmaceuticals that are not subject to price controls are determined freely at the Group's discretion, and in certain cases subject to notification to the provincial pricing authorities. Certain of the Group's pharmaceutical merchandise are subject to price controls and accordingly, the price of such products could not be increased at the Group's discretion above the relevant controlled price ceiling without prior governmental approval. In addition, the price of such products may also be adjusted downward by the relevant government authorities in the future. Such price controls, especially downward price adjustment, may negatively affect the Group's revenue and profitability. For the years ended December 31, 2011, 2012 and 2013, approximately 30%, 30% and 31%, respectively of the Group's revenue was generated from products that are subject to government pricing controls.

None of the Group's customers contributed 10% or more of the Group's revenue for the years ended December 31, 2011, 2012 and 2013.

19 SHARE-BASED PAYMENTS

Pre-IPO Option Scheme

On August 30, 2005, the Company's Board of Directors ("Board") and shareholders approved and adopted a share option plan, which was subsequently amended and restated on March 20, 2006 (the "Pre-IPO Option Scheme"). Under such scheme, the directors may, at their discretion, grant options to the directors and employees of the Group (each a "Grantee") to subscribe for ordinary shares of the Company. The Pre-IPO Option Scheme shall be valid and effective for a period commencing on August 30, 2005 and ending on the day immediately prior to the listing date on which trading in the Company's shares first commence on a stock exchange approved by the Board (the "Listing Date").

On August 30, 2005, the Board granted 1,000,000 options with a grant-date fair value of approximately USD0.40 per option, or USD400 (RMB3,245) in aggregate, to certain directors, officers and employees to acquire ordinary shares of the Company. Each of these options allows the Grantee to acquire one ordinary share of the Company at an exercise price of USD0.075 per share. 25% of the options granted on August 30, 2005 vested immediately on the date of grant. The remaining 75% of the options vested over a three year period in twelve equal three-monthly installments.

On March 20, 2006, the Board granted 6,680,000 options with a grant-date fair value of approximately USD0.11 per option, or USD735 (RMB6,063) in aggregate, to certain directors, officers and employees to acquire ordinary shares of the Company. On September 1, 2006, the Board granted 1,000,000 options with a grant-date fair value of approximately USD0.14 per option, or USD140 (RMB1,144) in aggregate, to a senior officer to acquire ordinary shares of the Company. Each of the options granted in 2006 allowed the Grantee to acquire one ordinary share of the Company at an exercise price of USD0.75 per share. 25% of the options granted in 2006 vested immediately on the respective dates of the grant. The remaining 75% of the options vested over a four year period in eight equal six-monthly installments.

All of the share options under the Pre-IPO Scheme have been vested by the year ended December 31, 2011 and the Company did not have any unrecognized share-based compensation expense related to unvested options issued under the Pre-IPO Scheme for the year ended December 31, 2012 and 2013.

2007 Share Incentive Plan

On June 30, 2007, the Company's shareholders adopted the 2007 Share Incentive Plan (the "2007 Plan"). The 2007 Plan authorizes the Company to issue up to 8,680,000 shares of the Company's ordinary shares in the form of share options, share appreciation rights and other share-based awards to its employees, directors or consultants. Under the 2007 Plan, the exercise price of the option shall not be less than the fair market value of Company's ordinary share on the date of grant.

On November 9, 2007, the Company granted 200,000 share options with a grant date fair value of approximately USD2.86 per option or USD573 (RMB4,250) in aggregate, to four newly appointed independent directors. The exercise price of such options is USD8.10 per share, which was equal to the IPO price of the Company's ordinary shares. The share options vest and become exercisable in three equal annual installments on the first, second and third anniversaries of the date of grant. The share options shall expire on the tenth anniversary of the date of grant.

On January 5, 2009, the Company granted 600,000 share options with a grant date fair value of approximately USD0.78 per option or USD469 (RMB3,203) in aggregate, to a newly appointed senior management employee. The exercise price of such options is USD2.40 per share. The share options vest and become exercisable in three equal annual installments on the first, second and third anniversaries of the date of grant. The share options shall expire on the tenth anniversary of the date of grant.

On January 5, 2010, the Company granted 800,000 share options with a grant date fair value of approximately USD0.91 per option or USD728 (RMB4,976) in aggregate, to an executive officer. The exercise price of such options is USD3.725 per share. The options vest and become exercisable in four equal annual installments on the first, second, third and fourth anniversaries of the date of grant. The share options shall expire on the tenth anniversary of the date of grant.

On January 5, 2010, the Company granted 200,000 share options with a grant date fair value of approximately USD0.92 per option or USD184 (RMB1,256) in aggregate, to an executive officer. The exercise price of such options is USD3.725 per share. The options vest and become exercisable on the third anniversaries of the date of grant. The share options shall expire on the tenth anniversary of the date of grant.

On March 2, 2010, the Company granted an aggregate of 150,000 fully vested ordinary shares with a grant date fair value of USD3.63 per ordinary share or USD545 (RMB3,188) in aggregate, to its three independent directors. The grant of the shares to the independent directors was made in exchange for their forfeiture of 150,000 options granted in November 2007 ("modification"). In connection with the modification, the Company recorded incremental share-based compensation expense resulting from the modification amounting to RMB3,436 in general and administrative expenses for the year ended December 31, 2010.

On March 2, 2010, the Company granted 50,000 non-vested ordinary shares with a grant date fair value of USD3.49 per ordinary share or USD174 (RMB1,191) in aggregate, to an executive officer. The non-vested shares will vest in five equal installments on each of the first, second, third, fourth and fifth quarters after the date of grant.

The fair value of options granted under the 2007 Plan was estimated on the date of the grant using the Binomial option pricing model. The Binomial model takes into account variables such as volatility, dividend yield rate, and risk free interest rate. In addition, the Binomial model considers the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life, and the probability of termination or retirement of the option holder in computing the value of the option.

The fair value of the above share options granted under the 2007 Plan was estimated based on following assumptions at the date of grant:

	Share options granted on November 9, 2007	*Share options granted on January 5, 2009*	*Share options granted on January 5, 2010*
Expected dividend yield	1.67%	2.54%	6.43%
Expected volatility	40.74%	41.76%	35.67%
Risk-free interest rate	4.23%	2.54%	3.86%
Option life (in years)	10	10	10
Forfeiture rate	0	0	0
Suboptimal exercise factor	1.5	1.5	1.5

For share options granted on November 9, 2007 and January 5, 2009, since the Company's ordinary shares have a limited trading history, the Company estimated the volatility of its ordinary shares at the date of grant based on the historical volatility of four comparable companies in the drugstore industry for a period equal to the option life for the share options. The suboptimal exercise factors applied in the valuations of share options granted were estimated based on the early exercise behavior of employees with share options. The risk-free rates applied in the valuations of the share options were based on the 10-year U.S. Treasury yield curve rates as of the grant dates on November 9, 2007 and January 5, 2009, respectively.

For share options granted during 2010, the Company estimated the historical volatility of its ordinary shares at the date of grant based on the historical volatility of the Company from the date the Company was listed to the valuation date and the historical volatility of the other four comparable companies in the drugstore industry for a period equal to the option life for the share options. The risk-free rate applied in the valuations of the share options was based on the 10-year U.S. Treasury yield curve rates as of the grant date in 2010. The suboptimal exercise factors applied in the valuations of share options granted were estimated based on the early exercise behavior of employees with share options.

The fair value of the fully vested and non-vested ordinary shares granted to the employee was determined by management based on the closing trading stock price of the Company on the date of grant.

In connection with the share options and ordinary shares granted under the 2007 Plan during the years ended December 31, 2009 and 2010, the Company recorded share-based compensation expense of RMB5,712 in general and administrative expenses for years ended December 31, 2010. During the year ended December 31, 2010, 600,000 unvested share options granted to an executive officer were forfeited. No share-based compensation costs was recognized in previous years for these unvested share options. During the year ended December 31, 2011, 600,000 unvested share options granted to an executive officer were forfeited. Consequently, the corresponding share-based compensation costs recognized in previous year for the unvested share options were reversed and an amount of RMB1,195 was credited to general and administrative expenses for the year ended December 31, 2011. All share options and ordinary shares granted under 2007 Plan were vested or forfeited before December 31, 2011. No share-based compensation expense was recognized or reversed during the year ended December 31, 2012 and 2013.

A summary of the Company's option activities for the years ended December 31, 2011, 2012 and 2013 is presented below:

	Number of options	*Weighted average exercise price*	*Weighted average remaining contractual term*	*Aggregate intrinsic value (USD millions)*
Outstanding as of January 1, 2011	1,339,750	USD 2.51		
Exercised	(119,644)	USD 0.71		
Forfeited	(610,356)	USD 3.67		
Outstanding as of December 31, 2011	609,750	USD 1.71		
Exercised	(368,160)	USD 0.72		
Forfeited	(241,590)	USD 3.21		
Outstanding as of December 31, 2012	—	—		
Exercised	—	—		
Forfeited	—	—		
Outstanding as of December 31, 2013	—	—	—	—
Exercisable as of December 31, 2013	—	—	—	—

The total intrinsic value of share options exercised during the years ended December 31, 2011 and 2012 was USD98 and USD122, respectively. The intrinsic value is calculated as the difference between the market value of shares on the date of exercise and the exercise price of the shares.

20 PENSION AND OTHER POST RETIREMENT BENEFITS

Pursuant to the relevant PRC regulations, the Company's PRC subsidiaries are required to make contributions at rates ranging from 10% to 22% of their employees' salaries and wages to a defined contribution retirement scheme organized by the local social security bureaus. The amount of contributions charged to general and administrative expenses and sales, marketing and other operating expenses in the consolidated statements of comprehensive income was RMB34,422, RMB37,824 and RMB39,152 for the years ended December 31, 2011, 2012 and 2013, respectively.

The Group has no other obligation to make payments in respect of retirement benefits of the employees.

21 EARNINGS PER SHARE

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Numerator:			
Net income attributable to China Nepstar Chain Drugstore Ltd. ordinary shareholders	35,933	90,092	11,828
Denominator:			
Basic weighted average number of ordinary shares	206,127,305	199,198,962	197,446,940
Dilutive effect of outstanding share options and non-vested shares	250,377	64,402	—
Dilutive weighted average number of ordinary shares	206,377,682	199,263,364	197,446,940
Basic earnings per ordinary share	0.17	0.45	0.06
Diluted earnings per ordinary share	0.17	0.45	0.06

In the calculation of diluted earnings per share, the Company excluded 200,000, nil and nil potential ordinary shares issuable upon exercise of employee share options for the year ended December 31, 2011, 2012 and 2013, respectively, as their effect would be anti-dilutive.

22 RELATED PARTY BALANCES AND TRANSACTIONS

For the periods presented, the principal related party transactions and amounts due from and due to related parties are summarized as follows:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Purchases from related parties (Notes 22(a))	105,154	92,906	138,835
Sales to related parties (Note 22(b))	2,207	5,454	2,490
Lease of property from a related party (Note 22(d))	1,082	1,082	1,082
Disposal of a subsidiary to a related party (Note 22(f))	20,000	—	—

	December 31,	
	2012	2013
	RMB	RMB
Amounts due from related parties (Note 22(c))	8,254	379
Amounts due to related parties (Note 22(e))	18,381	29,247

Notes:

(a) The Group purchased merchandise from Neptunus Group and its affiliates in the normal course of business.

The payment terms offered by the related parties to the Group for purchase of merchandise ranged from 60 to 90 days. For the periods presented, none of the Group's suppliers accounted for 10% or more of the Group's purchases of merchandise.

(b) In the normal course of business, the Group sold merchandise to the following related parties as follows:

	Year ended December 31,		
	2011	2012	2013
	RMB	RMB	RMB
Neptunus Group and its affiliates	2,207	5,454	2,490
	2,207	5,454	2,490

(c) The amounts due from related parties represent the following:

	December 31,	
	2012	2013
	RMB	RMB
Amount due from Neptunus Group and its affiliates related to:		
Sales of merchandise (Note 22(b))	7,304	335
Expenses paid on behalf of related parties	950	44
	8,254	379

Expenses paid on behalf of related parties related to miscellaneous expenses paid by the Group on behalf of Neptunus Group.

(d) The Group rented a property from Neptunus Group under an operating lease arrangement that was entered in November 2008. The monthly rental is approximately RMB90 and the lease agreement was renewed since November 1, 2013 and will expire in October 2015.

(e) The balances represent amounts due to Neptunus Group and its affiliates in connection with the purchase of merchandise as described in Note 22(a) above.

(f) In August 2011, the Group disposed of its 100% equity interest in a subsidiary, Nepstar Industrial Co., Ltd., to Neptunus Group at a total cash consideration of RMB20 million. The difference between consideration received and the carrying amount of the net assets of the subsidiary amounting to RMB19 was recognized in additional paid-in capital. As Neptunus Group held over 50% of the Company's equity interests, the transaction is considered a transaction with entity under common control. Nepstar Industrial Co., Ltd. has not conducted any operations since its establishment in 2009. The purpose of the transaction is to simplify corporate structure and the divestment has not adversely affected the Group's financial position or business operation.

23 COMMITMENTS AND CONTINGENCIES

Operating lease commitments

Future minimum lease payments under non-cancelable operating lease agreements as of December 31, 2013 are as follows. The Group's leases do not contain any contingent rental payments terms.

Years ending December 31,	*Store premises* RMB	*Warehouses and office premises* RMB	*Total* RMB
2014	203,465	15,157	218,622
2015	214,026	11,987	226,013
2016	139,121	9,361	148,482
2017	92,496	8,450	100,946
2018	43,700	7,865	51,565
Thereafter	18,850	16,560	35,410
Total	711,658	69,380	781,038

The Group's rental expenses under operating leases amounted to RMB375,626, RMB370,292 and RMB375,999 for the years ended December 31, 2011, 2012 and 2013, respectively.

24 FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties. The carrying amounts of the Group's financial assets and liabilities, such as cash, bank deposits, long-term bank time deposits, accounts and other receivables, amounts due from/to related parties and accounts and other payables, approximate their fair values because of the nature or the short maturity of these instruments.

Quality assurance   Professional service   Customer satisfaction

China Nepstar Chain Drugstore Ltd.
Add: Floor 6, Block B, Xinnengyuan Building, Nanhai Road,
Nanshan District, Shenzhen, CHINA (518054)
Tel: 86 755 26433366
Fax: 86 755 26430889
Email: office@nepstar.cn