



品质保证
Quality assurance

专业服务
Professional service

顾客满意
Customer satisfaction



NPD
LISTED
NYSE

China Nepstar Chain Drugstore

2009 Annual Report



TABLE OF CONTENTS

PAGE

2	LETTER FROM CHAIRMAN
3	CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT
4	INTRODUCTION AND SELECTED FINANCIAL INFORMATION
6	HISTORY AND DEVELOPMENT OF THE COMPANY
17	OPERATING AND FINANCIAL REVIEW AND PROSPECTS
34	DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES
41	MISCELLANEOUS
47	CONSOLIDATED FINANCIAL STATEMENTS



LETTER FROM CHAIRMAN

Dear Shareholders,

While 2009 was the year China returned to the center stage of the global economy, the lime light was clearly cast upon Chinese healthcare sector. As the size of Chinese middle class continues to expand, overall consumer spending on healthcare products has increased. On the macroeconomic side, the Chinese government has continued to demonstrate its commitment to healthcare reform by raising reimbursement budgets, increasing coverage in rural markets and introducing the Essential Drug System.

We were pleased to see steady progress in our growth along with the recovery of the economy in 2009. Our same store sales growth for the year increased 2.6% compared to 2008. This improvement was accomplished by expanding product offerings, adjusting price ranges, streamlining store operation and enhancing marketing campaigns.

We continued to exercise financial discipline on cost controls and cash flow management. And our ability to generate strong free cash flow demonstrates that our financial health strengthened throughout the economic recovery.

On the merger and acquisition front, we made our first foray into Beijing, a major market where purchasing power stays strong but service quality remains low. We also expanded our coverage in other affluent geographic markets by completing roll-ups in second-tier cities.

As of December 31, 2009, we had 2,479 directly operated stores across 71 cities, one headquarter distribution center and 12 regional distribution centers in China. We continue to focus on building our brand equity as the trusted neighborhood pharmacy with great convenience and consistent services.

On behalf of China Nepstar's over 16,000 employees, we thank our shareholders for their devoted support. We will increase our store growth activity by opening and acquiring stores in areas where economic trends are favorable. Balanced expansion can not only further lift our revenue, but also help accelerate industry-wide consolidation of smaller-sized competitors who have been struggling with margin erosion under the pressure of healthcare reform. We intend to continue implementing effective marketing programs to increase sales to existing customers and attract foot traffic from potential customers. With all of these efforts, we believe China Nepstar is well positioned as the leader of the China's pharmaceutical retail industry.

Sincerely,

A handwritten signature in black ink, appearing to read '张思民' (Zhang Simin).

Simin Zhang
Chairman
China Nepstar Chain Drugstore

CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT

Unless otherwise indicated, references in this annual report on Form 20-F to:

- “ADRs” are to the American depositary receipts, which evidence our ADSs;
- “ADSs” are to our American depositary shares, each of which represents two ordinary shares;
- “China” and the “PRC” are to the People’s Republic of China, excluding, for the purposes of this annual report only, Taiwan and the special administrative regions of Hong Kong and Macau;
- “China Nepstar” is to China Nepstar Chain Drugstore Ltd.;
- “JZJ” is to Yunnan Jianzhijia Chain Drugstore Ltd., our 40.0% owned affiliate that operates drugstores in Yunnan province under the trade name Jianzhijia. In January 2009, our board of directors approved the termination of a voting rights agreement which assigned to us an additional 30% of the total voting rights of Yunnan Jianzhijia Chain Drugstore Ltd. As a result, beginning in the first quarter of 2009, JZJ is no longer our consolidated subsidiary and the financial results of JZJ have been accounted for under the equity method since then;
- “Nepstar group companies,” “we,” “us,” “our company” and “our” are to China Nepstar, its predecessor entities and its consolidated entities;
- “ordinary shares” are to our ordinary shares, par value US\$0.0001 per share;
- “regional Nepstar companies” are to the PRC incorporated companies that operate Nepstar drugstores in their respective regions under the trade name Nepstar and whose operating results are consolidated with our operating results;
- “RMB” and “Renminbi” are to the legal currency of China;
- “Series A redeemable convertible preferred shares” are to our Series A redeemable convertible preferred shares, par value US\$0.0001 per share;
- “US\$” and “U.S. dollars” are to the legal currency of the United States.

Names of certain companies provided in this annual report are translated from their original Chinese legal names.

Discrepancies in any table between the amounts identified as total amounts and the sum of the amounts listed therein are due to rounding.

This annual report on Form 20-F includes our audited consolidated financial statements for the years ended December 31, 2007, 2008 and 2009 and as of December 31, 2008 and 2009.

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.”

INTRODUCTION

This annual report includes our audited consolidated financial statements for the years ended December 31, 2009, as well as December 31, 2007 and 2008.

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 income data for the years ended December 31, 2007, 2008 and 2009 and selected consolidated balance sheet data as of December 31, 2008 and 2009 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The following selected consolidated statement of income data for the years ended December 31, 2005 and 2006 and selected consolidated balance sheet data as of December 31, 2005, 2006 and 2007 have been derived from our audited consolidated financial statements, which are 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,					
	2005	2006	2007	2008	2009	2009
	RMB	RMB	RMB	RMB	RMB	US\$
	(in thousands, except share and per share data)					
Consolidated Statement of Income Data						
Revenue.....	1,313,153	1,732,433	1,954,683	2,396,642	2,217,613	324,882
Gross profit	381,180	608,212	862,672	1,138,890	1,074,215	157,373
Sales, marketing and other operating expenses ⁽¹⁾	(348,297)	(517,047)	(606,340)	(898,019)	(858,072)	(125,708)
General and administrative expenses ⁽¹⁾	(45,480)	(62,556)	(75,514)	(99,495)	(105,652)	(15,478)
(Loss)/Income from operations	(12,597)	28,609	180,818	141,376	110,491	16,187
Net (loss)/income attributable to China Nepstar Chain Drugstore Ltd.	(17,953)	13,602	148,165	192,746	139,976	20,507
Accretion to Series A redeemable convertible preferred shares redemption value	(10,551)	(16,592)	(15,135)	-	-	-
Net (loss)/income attributable to China Nepstar Chain Drugstore Ltd. ordinary shareholders.....	(28,504)	(2,990)	133,030	192,746	139,976	20,507
Net (loss)/earnings per share						
Basic.....	(0.25)	(0.03)	0.80	0.90	0.67	0.10
Diluted.....	(0.25)	(0.03)	0.80	0.88	0.66	0.10
Shares used in computation						
Basic.....	115,000,000	115,000,000	128,976,023	212,984,310	208,215,802	208,215,802
Diluted.....	115,000,000	115,000,000	130,091,840	218,286,251	210,655,820	210,655,820

- (1) Sales, marketing and other operating expenses and general and administrative expenses in 2007 include share-based compensation expenses of RMB1.8 million and RMB6.9 million, respectively, that were realized upon completion of our initial public offering in 2007. Sales, marketing and other operating expenses and general and administrative expenses in 2008 included share-based compensation expenses of RMB0.5 million and RMB3.7 million, respectively. Sales, marketing and other operating expenses and general and administrative expenses in 2009 included share-based compensation expenses of approximately RMB73,000 and RMB2.9 million, respectively.

	As of December 31,					
	2005	2006	2007	2008	2009	2009
	RMB	RMB	RMB	RMB	RMB	US\$
	(in thousands)					
Consolidated Balance Sheet Data						
Cash, cash equivalents and other bank deposits	110,851	82,996	2,168,911	1,197,884	666,012	97,571
Restricted cash	—	—	—	—	765,000	112,074
Held-to-maturity investment securities	—	—	600,000	641,000	400,000	58,600
Inventories	228,452	271,362	285,307	373,689	369,775	54,172
Accounts receivable, net of allowance for doubtful accounts	28,534	40,155	54,753	88,136	72,561	10,630
Prepayments for purchase of merchandise paid to related parties	—	—	4,452	70,306	38,102	5,582
Total current assets	425,615	465,267	3,225,051	2,572,476	2,469,817	361,830
Property and equipment, net	121,820	146,978	172,171	240,396	204,710	29,990
Total assets	577,305	642,227	3,438,541	3,498,773	2,820,576	413,217
Accounts payable	223,292	244,034	233,425	267,250	313,794	45,972
Amounts due to related parties	52,505	55,628	50,544	64,200	12,533	1,836
Total current liabilities	352,448	399,051	464,432	490,699	995,202	145,798
Series A redeemable convertible preferred shares	217,940	234,532	—	—	—	—
Total shareholders' equity/(deficit)	698	(2,392)	2,955,145	2,959,474	1,777,732	260,439

Exchange Rate Information

This annual report on Form 20-F contains translations of certain RMB 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 a rate of RMB6.8259 to US\$1.00, the noon buying rate in the City of New York for cable transfers in Renminbi per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York, or the noon buying rate, in effect as of December 31, 2009. 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. See “Item 3. Key Information — D. Risk Factors — Risks Related to Doing Business in China — 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 23, 2010, the noon buying rate was RMB6.8270 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.

	As of December 31,					
	2005	2006	2007	2008	2009	2009
	RMB	RMB	RMB	RMB	RMB	US\$
	(in thousands)					
Consolidated Balance Sheet Data						
Cash, cash equivalents and other bank deposits	110,851	82,996	2,168,911	1,197,884	666,012	97,571
Restricted cash	—	—	—	—	765,000	112,074
Held-to-maturity investment securities	—	—	600,000	641,000	400,000	58,600
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Total current liabilities	352,448	399,051	464,432	490,699	995,202	145,798
Series A redeemable convertible preferred shares	217,940	234,532	—	—	—	—
Total shareholders' equity/(deficit)	698	(2,392)	2,955,145	2,959,474	1,777,732	260,439

(1) For all periods prior to January 1, 2009, the exchange rate refers to the noon buying rate as reported by the Federal Reserve Bank of New York. For periods beginning on or after January 1, 2009, the exchange rate refers to the exchange rate as set forth in the H.10 statistical release of the Federal Reserve Board.

(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. Primarily through organic growth, Nepstar Health had become the largest drugstore chain in China in terms of total stores operated directly by the end of 2004. 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 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. Nepstar Pharmaceutical currently operates its drugstore business in China through a series of contractual arrangements it has entered into with Nepstar IT Service, Nepstar Management Consulting and their shareholders so as to retain control over the regional Nepstar companies and to retain economic risks and rewards of these entities. See "Item 4. Information on the Company — C. Organizational Structure." 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. 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 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. See "Item 3. Key Information — D. Risk Factors — Risks Related To Our Corporate Structure — If the PRC regulatory bodies determine that the agreements that establish the structure for operating our business in China do not comply with PRC regulatory restrictions on foreign investment in the drugstore industry, we could be subject to severe penalties."

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% 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. As a result of the termination of the voting rights agreement, beginning in the first quarter of 2009, JZJ is no longer a consolidated subsidiary of China Nepstar and is accounted for under the equity method of accounting. See note 11 of our audited consolidated financial statements included in this annual report.

In 2007, 2008 and 2009, our capital expenditures totaled RMB68.4 million, RMB187.8 million and RMB81.7 million (US\$12.0 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 information management systems in China. We estimate that our capital expenditures in 2010 will range from approximately RMB100 million to RMB200 million, which we plan to use to open new stores, acquire additional drugstores and build new distribution centers in China.

Business Overview

We are the largest retail drugstore chain in China, with a network of 2,479 directly operated stores spanning 71 cities across 14 provinces and direct-controlled municipalities in China as of December 31, 2009.

We believe that we have the leading market position in a number of the most developed cities in China, including Shenzhen, Guangzhou, Dalian, Hangzhou, Ningbo, and Suzhou, in terms of store count. According to the China Drugstore Magazine, a leading trade publication for the drugstore industry in China, we had the highest revenue among all directly operated retail drugstore chains in China in 2007, 2008 and 2009.

The drugstore industry in China remains highly fragmented. According to the statistics quoted by the PRC Ministry of Commerce, in December, 2009, there were approximately 360,000 drugstore outlets in China. We estimate that our share of the retail market of pharmaceutical products in China was less than 2% of the total transaction value in 2009.

We provide our customers with high-quality, professional and convenient pharmacy services and a wide variety of other merchandise, including OTC 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 1,524 private label products as of December 31, 2009. Sales of our private label products accounted for 29.0% of our revenue and 43.3% of our gross profit in 2009.

Our Store Network

We are the largest retail drugstore chain in China based on the number of directly operated stores, with a store network comprised of 2,479 directly operated stores as of December 31, 2009. According to the China Drugstore Magazine, we had the highest revenue among all directly operated retail drugstore chains in China in 2007, 2008 and 2009. As the drugstore industry in China is highly fragmented, we estimate that our share of the retail market of pharmaceutical products in China was less than 2% of the total transaction value in each of these three years.

We believe we have succeeded in building a national retail drugstore chain with an extensive footprint in China by operating a store network spanning 71 cities across 14 provinces and direct-controlled municipalities. We believe that we have the leading market position in a number of the most economically developed cities in China, including Shenzhen, Guangzhou, Dalian, Hangzhou, Ningbo and Suzhou, in terms of store count.

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 71 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, 2009:

City	As of December 31,		
	2007	2008	2009
Shenzhen	311	433	428
Hangzhou	144	188	195
Dalian	174	194	192
Ningbo	96	178	186
Guangzhou	161	175	171
Dongguan	94	140	138
Tianjin	66	105	114
Qingdao	24	82	105
Suzhou	70	86	92
Nanjing	60	82	84
Others	802	1,046	774
Total	2,002	2,709	2,479

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

	As of December 31,		
	2007	2008	2009
Number of stores at the beginning of the period	1,446	2,002	2,709
Effect of deconsolidation of JZJ	—	—	355*
Acquired stores during the period	—	144	7
Stores closed during the period	38	75	113
New stores opened during the period	594	638	231
Number of stores at the end of the period	2,002	2,709	2,479

* Effective January 5, 2009, we terminated a voting rights agreement, which assigned 30% of the total voting rights of JZJ to us. As a result, JZJ is no longer our consolidated subsidiary and has been accounted for under the equity method of accounting since January 2009. As of December 31, 2008, JZJ had 355 drugstore outlets, all of which were located in the Yunnan Province.

Our stores are typically between 80 to 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 OTC 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 OTC 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 1,800 to 2,350 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. We offer our customers a broader range of choices in two respects. First, we offer a wide range of complementary products in each therapeutic category so that customers have more choices to suit their needs. For example, a customer looking for a cough remedy will be able to find a wide variety of choices including different OTC drugs, nutritional supplements and herbal products. In addition, our staff will sometimes recommend a combination of products to enhance the treatment. Second, for products with the same therapeutic purpose, we offer choices in each of the high, medium and low price ranges to suit the needs of customers with different spending power. In each therapeutic category, we also offer high-margin private label products. See “— Product Offerings — Private Label Products.”

Product Offerings

Our merchandise can be broadly classified into the following categories:

Prescription Drugs. We offer approximately 3,000 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 23.2% of our revenue in 2009.

OTC Drugs. We offer approximately 3,000 OTC drugs, including western medicines and traditional Chinese medicines, for the treatment of common diseases. Sales of OTC drugs accounted for 36.9% of our revenue in 2009.

Nutritional Supplements. We offer approximately 600 nutritional supplements, including a variety of healthcare supplements, vitamins, minerals and dietary products. Nutritional supplements normally generate higher gross margins than prescription and OTC drugs. Sales of nutritional supplements accounted for 20.6% of our revenue in 2009.

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 OTC drugs. Sales of herbal products accounted for 3.6% of our revenue in 2009.

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, and other consumables, cleaning agents and stationery. Our other products also include seasonal and promotional items tailored to local consumer demand for convenience and quality. We believe offering these products increases customer visits by increasing the shopping convenience for our customers. Sales of other products accounted for 15.7% of our revenue in 2009.

Private Label Products

We launched our first private label product in September 2005, and since then our private label portfolio has increased to 1,524 products marketed under 131 private labels, covering all categories of products we offer. In 2009, private label products accounted for approximately 29.0% of our revenue and 43.3% 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.

Some of our successful private labels include “Qianlong,” which we introduced in January 2006 to market a variety of OTC drugs including gastrointestinal and dermatological products, and “Wisconsin,” which we introduced in November 2006 to market 20 different types of nutritional supplements manufactured in the United States.

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.

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" scheme in 1999. As of December 31, 2009, this program had more than 12.0 million members, approximately 5.0 million of whom were active customers of our stores, which are defined as customers who make purchase from our stores at least once a year and whose contact information is available in our database. Our member customers are entitled to receive free healthcare circulars published by our stores and gain one loyalty point for every RMB1.0 spent on our products. Loyalty points may be used to exchange for gifts as well as used as discounts for future purchases. At the end of each calendar year, unutilized loyalty points are forfeited and cannot be carried forward.

We maintain a database of our loyalty scheme membership, including customer profiles and purchasing records, which helps us to tailor our promotional programs to meet our customers' specific needs. On average, members of our loyalty scheme spend approximately 1.4 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 58.6% of our revenue in 2009.

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

	As of December 31,		
	2007	2008	2009
	(In thousands)		
Members.....	7,075	10,250	11,988*
Active members.....	3,643	5,190	4,980*

* Does not include the loyalty scheme members that belonged to JZJ, which is no longer our consolidated subsidiary and has been accounted for under the equity method of accounting since January 2009.

We have partnered with a number of retailers in Shenzhen, Guangzhou and Dalian to offer promotional benefits to our loyalty scheme members when they purchase products or services from these other retailers. Our promotional partners include stores selling food, eye glasses, shoes and other consumer products and shops providing dry cleaning, health examination and other services. From time to time, we also launch joint promotional campaigns with our loyalty scheme partners by providing free gifts to members. We believe these joint promotional efforts not only enhance the attractiveness of our loyalty program, but also widen our customer base.

We run advertisements periodically in selected newspapers to promote our brand and the products carried in our stores. Under our agreements with certain newspapers, we run one-page weekly or monthly advertisements in these newspapers, and the newspapers publish healthcare-related feature articles relating to the products we advertise near the dates of our advertisements. In selected cities, we promote our brand and products using billboards and on the passenger compartments of subway trains. In most cases the advertising expenses are borne by the manufacturers of the products being advertised. Our advertisements are designed to promote our brand, our corporate image and the promotions of products available for sale in our stores.

In November 2008, we entered into a definitive agreement with China Merchants Bank and Lakala Beijing Billing Service Co., Ltd. or Lakala, to install the Xinfu Tong electronic payment terminals in all of our stores. By the end of 2009, Xinfu Tong terminals were installed in over 1,500 of our stores. The installation of Xinfu Tong terminals was intended to increase foot traffic in the stores, as Xinfu Tong terminals enable consumers to make payments on their credit card bills, utility bills and mobile phone bills.

In November 2009, we entered into a strategic cooperation agreement with ATMU (China) Technology Co., Ltd., a subsidiary of ATMU Inc., one of the largest ATM operators in China, to install ATMs in our stores. ATMU plans to complete initially 1,000 ATM installations in our existing stores by the end of 2010.

Customers

During 2009, our stores served an average of approximately 171,940 customers per day. 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 OTC 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% of our revenue in each of 2008 and 2009. We do not allow product returns for our sales to our non-retail customers.

Our sales to retail customers are paid by cash or 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 on a monthly basis. See “— Regulation — Reimbursement under the National Medical Insurance Program.” As of December 31, 2009, 861, or 34.7% of our stores are designated stores under the PRC national medical insurance program.

Procurement

We currently source our merchandise from approximately 1,580 suppliers, including 640 manufacturers and approximately 940 wholesalers. In 2009, 67.2% 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 3.0% of our total purchases in 2009. The transaction value of purchases from our largest five suppliers accounted for 13.0% of our total purchases in 2009. 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 in size 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 an increasing number of 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.

Distribution

Our stores are supported by our national distribution center located near our headquarters in Shenzhen and 12 regional distribution centers serving our drugstores located in 71 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, normally using our own vehicles. 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 integrated information system. This 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 integrated information management 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 information management system in real time. Cashiers scan the merchandise being sold and the data are recorded instantly. Our 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.

In 2009, we fine-tuned and adjusted our ERP, system, which integrates company-wide accounting and operating systems and helps improve inventory management and enhances data analysis capabilities. We are evaluating our ERP system before deciding on when to introduce the phase II implementation of the system.

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.

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. Our staff working in the stores perform daily reconciliation of sales record with the cash received. 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 294 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, earthquake, flood and a wide range of other disasters. We also maintain insurance policies covering our inventories in transit from our distribution centers to our stores. Our total insurance coverage totaled approximately RMB812.2 million in 2009 and we have paid approximately RMB0.6million 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 OTC pharmaceutical products, listed in the Essential Drug List and Reimbursement List without the presence of a certified in-store pharmacist. See “— Reimbursement under the National Medical Insurance Program.”

Restrictions on Foreign Ownership of Wholesale or Retail Pharmaceutical Business 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, and Nepstar Management Consulting and their shareholders.

Good Supply Practice Standards

GSP standards regulate wholesale and retail pharmaceutical product distributors to ensure the quality of distribution of pharmaceutical products in China. The current applicable GSP standards require pharmaceutical product distributors to implement strict controls on the distribution of medicinal 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.

All of our consolidated entities that engage in the retail pharmaceutical business, including the regional Nepstar companies, have obtained their GSP certificates. These GSP certificates currently have expiration dates varying from one to four years. We do not expect any difficulties in renewing these certifications upon their expiration.

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 PRC Ministry of Health, 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.

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 governmental authorities have ordered price reductions of thousands of pharmaceutical products. As of December 31, 2007, 2008 and 2009, 12.7%, 16.4% and 29.2% of the pharmaceutical products we offered were subject to price controls, respectively. In 2007, 2008 and 2009, approximately 4.9%, 4.0% and 7.7% 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.

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 OTC 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.

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 has following options:

- The trademark owner 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 SAIC's decision, he may institute civil proceedings against the infringer in court.
- The trademark owner may 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.

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, 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, 2009, the accumulated balance of our statutory reserve funds totaled RMB42.8 million (US\$6.3 million) and the accumulated profits of our consolidated PRC entities that were available for dividend distribution totaled RMB158.0 million (US\$23.1 million).

Property, Plant 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 headquarters and 12 regional distribution centers with a combined total of approximately 46,237 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, 2009, 900 leases (covering an aggregate gross floor area of approximately 107,990 square meters, equivalent to approximately 33.15% 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, 2009, we had 2,488 leased properties with an aggregate gross floor area of 326,002 square meters. Approximately 24.7% of these leased properties had defects in their legal titles. Of all of the properties with defects in legal titles, 80,585 square meters were used as drugstores, equivalent to approximately 29.8% 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 30,052 square meters, or approximately 11.1% of the total gross floor area of our drugstores and with the latter type of defects in title was 50,533 square meters, or approximately 18.7% of the total gross floor area of our drugstores. In addition, 57,261 square meters, or approximately 17.6% of our leased properties, including properties with defects in title, have not been registered as required by applicable PRC regulations.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Operating Results

Overview

Since our inception in 1995, we have rapidly expanded our operations, through organic growth and selective acquisitions of drugstores in China. Our directly operated drugstores increased from 2,002 as of December 31, 2007 to 2,709 as of December 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. As of December 31, 2008, JZJ had 355 drugstore outlets, all of which were located in Yunnan province in southwestern China. As a result of the termination of the voting rights agreement, beginning in the first quarter of 2009, JZJ was no longer a consolidated subsidiary of China Nepstar, and subsequently has been accounted for under the equity method. See note 11 to our audited consolidated financial statements included in this annual report. Furthermore, we no longer take into account the store count of JZJ in our total store count. As of December 31, 2009, we had a total of 2,479 directly operated drugstores, with the decrease in operated stores from that as of December 31, 2008 resulting principally from the deconsolidation of the JZJ stores.

In March, 2008, we completed the acquisition of all of the 68 drugstores (including inventory and store equipment) owned by Ningbo New Century Medical Ltd. for cash consideration of RMB31.7 million (US\$4.6 million). In the same month, we completed the purchase of all 18 of Dongguan Hui Ren Tang Pharmaceutical Co. Ltd.'s directly operated chain drugstores in Dongguan City, Guangdong Province for a cash consideration of RMB2.3 million (US\$0.3 million). In September, 2008, we completed the acquisition of all of the 40 drugstores (including inventory and store equipment) owned by Qingdao Kangjie Chain Drugstore Ltd. for cash consideration of RMB16.0 million (US\$2.3 million). In October 2008, we completed the acquisition of 16 drugstores from Chengdu Ruihua Medical Ltd. for a consideration of RMB7.5 million (US\$1.1 million). We accounted for these acquisitions using the purchase method of accounting under SFAS 141, *Business Combination*.

In 2009, we acquired a total of seven stores, consisting of five in Beijing from Beijing Zeruntong Medical Ltd. and two in Shanghai from Shanghai Riye Chain Co., Ltd. We also entered into definitive agreements to acquire six other stores from Shanghai Riye Chain Co., Ltd., six stores from Xiang Yun Kang Drugstore Chain in Beijing and eight stores from Ren Ren Hao Chain Drugstore in Wenzhou. 17 of these stores were integrated into our store network as of the date of this annual report with the remaining three stores from Shanghai Riye Chain Co., Ltd. to be integrated into our network pending regulatory approval. We accounted for these acquisitions using the acquisition method of accounting under SFAS 141 (R), *Business Combination*, included in FASB ASC Topic 805, *Business Combination*.

We believe that we have the leading market position in a number of the most developed cities in China, including Shenzhen, Guangzhou, Dalian, Hangzhou, Ningbo and Suzhou in terms of store count. Our total revenue was RMB1,954.7 million, RMB2,396.6 million and RMB2,217.6 million (US\$324.9 million) and our net income was RMB156.1 million, RMB199.2 million and RMB140.0 million (US\$20.5 million) in 2007, 2008 and 2009, respectively.

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 balance. 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 expand 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. However, the recent global financial crisis has caused, among other things, lower customer spending across China, as well as the closing of factories and other businesses

in the Pearl River Delta where a significant portion of our stores are located. As a result, sales at our stores located in these areas have declined due to the emigration of customers from these areas to other regions in China in search of employment or as customers decrease their purchases of our products as a result of worries about economic conditions or reduced incomes. 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.

The drugstore industry in China is highly fragmented. As the largest retail drugstore chain in China based on the number of directly operated stores, we had the highest revenue among all directly operated retail drugstore chains in China in 2007, 2008 and 2009, according to China Drugstore Magazine. We believe there is a significant potential for our future growth.

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 PRC Ministry of Health established the Essential Drug List, which contains 205 chemical drugs and 102 traditional Chinese medicines. In October 2009, the NDRC implemented pricing ceilings on 2,349 pharmaceutical products, including drugs or medicines which are on the Essential Drug and Reimbursement Lists, including 1,728 pharmaceutical products carried by our stores. Due in part of the implementation of these pricing ceilings, our gross margins experienced downward pressure in 2009 as compared to 2008. 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.

We expect regulatory changes to continue to have significant impact on the growth of retail pharmacies, and consequently the growth of drugstore chains like us in the long term.

As the largest retail drugstore chain in China with a proven track record of expansion, 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 the Effective Expansion of 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. In recent years, we have expanded our retail network rapidly 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,		
	2007	2008	2009
Number of stores at the beginning of the year.....	1,446	2,002	2,709
Number of stores at the end of the year.....	2,002	2,709	2,479*

* Does not include stores operated by JZJ, which was deconsolidated from our financial results in 2009. As of December 31, 2008, JZJ operated 355 stores.

We believe that store location is an important factor driving our average store sales. Our goal is to establish stores in clusters in well-developed cities in China's coastal and adjoining provinces. Within each major city, we aim to locate our stores in well-established residential communities. We plan to focus our near term expansion in our existing metropolitan markets, and in major cities where we have not had a presence and where we can leverage our existing distribution centers and other infrastructure. In 2009, in order to manage our store expansion more effectively and to improve the overall quality of store sales performance, we: (i) closed 113 stores, most of which are performing below our expectations; (ii) were more selective in acquiring new stores; and (iii) slowed the pace of new store openings, as new stores generally incur high initial costs, but generate lower revenues during their first two years of operations.

For our drugstores that had been opened prior to December 31, 2007, the average daily revenue per store increased from RMB2,867 in 2008, which figure does not include stores operated by JZJ which was deconsolidated from our financial results in 2009, to RMB2,941 (US\$430.9) in 2009. The increase was mainly due to our effective marketing campaigns, streamlining of store operations, further optimization of product mix, as well as the general recovery of the Chinese economy in 2009. The increase was also attributable to a higher level of prescription and OTC drug sales related to the H1N1 epidemic in the fourth quarter of 2009.

	Year Ended December 31,		
	2007	2008	2009
Number of stores at the beginning of the year.....	1,446	2,002	2,709
Number of stores at the end of the year.....	2,002	2,709	2,479*

(1) Does not include stores operated by JZJ which was deconsolidated from our financial results in 2009.

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,					
	2007		2008		2009	
	RMB	% of Revenue	RMB	% of Revenue	RMB	% of Revenue
	(in thousands, except percentages)					
Prescription drugs	456,986	23.4%	516,042	21.5%	515,471	23.2%
OTC drugs.....	696,651	35.6	863,624	36.1	818,914	36.9
Nutritional supplements.....	357,790	18.3	484,516	20.2	455,341	20.6
Herbal products.....	51,248	2.6	75,438	3.1	80,541	3.6
Other products ⁽¹⁾	392,008	20.1	457,022	19.1	347,331	15.7
Total	1,954,683	100.0%	2,396,642	100.0%	2,217,613	100.0%

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

Our ability to optimize product offerings is an important factor affecting our results of operations. By offering quality, choice and convenience to our customers, we are able to maintain and increase customer visits, store traffic and sales volume. As a result, it's essential for us to balance the brand name products, which are popular among customers, and private label products, which generate higher margin. As a result, we continuously review and refine our product offerings to respond to changing demographics, lifestyles, habits and preferences of customers. In 2010, 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 and OTC drugs. In particular, sales of prescription drugs accounted for 23.2% of our revenue in 2009, while sales of OTC drugs accounted for 36.9% of our revenue in 2009. Prescription and OTC drugs has accounted for a larger percentage of our revenue in 2009 compared to 2008, mainly due to a higher level of prescription and OTC drug sales related to the H1N1 epidemic in the fourth quarter of 2009. We plan to continue to increase our offering of nutritional supplements, herbal products and personal care, family care and convenience products, which we believe increases customer visits to our stores by increasing the shopping convenience for our customers. We expect revenue from non-pharmaceutical products to increase at a faster pace compared to those of our pharmaceutical products in future periods.

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 1,524 products marketed under 131 private labels as of December 31, 2009, 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 518 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 19 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, 2009, we have developed 1,524 private label products with these licensed trademarks. Private label products accounted for approximately 24.4% and 29.0% of our revenue, and 37.0% and 43.3% of our gross profit in 2008 and 2009, 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, 2009:

	Private Label Revenue as a Percentage of Revenue of the Category
Prescription drugs.....	19.0
OTC drugs.....	24.9
Nutritional supplements	48.6
Herbal products	19.5
Others ⁽¹⁾	30.0
Total ⁽²⁾	29.0

(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 approximately 1,580 suppliers, including 640 manufacturers and approximately 940 wholesalers. In 2009, 67.2% 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 3.0% of our total purchases in 2009. The transaction value of purchases from our largest five suppliers accounted for 13.0% of our total purchases in 2009. 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 2007, 2008 and 2009, we purchased merchandise from the Neptunus Group and its affiliates totaling RMB64.8 million, RMB130.4 million and RMB89.6 million (US\$13.1 million), respectively, and sold merchandise to the Neptunus Group and its affiliates totaling RMB9.4 million, RMB 1 million and RMB3.9 million (US\$0.6 million), respectively. These transactions include prepayments of RMB 132.9 million (US\$19.5 million) in April 2008 to the Neptunus Group for the procurement of merchandise. In addition, JZJ purchased in 2007 and 2008 certain merchandise from Yunnan Jianzhijia Medical Ltd., an affiliated entity of our former consolidated entity, JZJ, which were used solely by the 355 stores operated by JZJ, totaling RMB230.9 million and RMB279.9 million, respectively, which represented 20.0% and 21.4% of our total purchases and was our single largest supplier during each of these periods, respectively. As a result of the deconsolidation of JZJ, purchases by JZJ in 2009 and subsequent periods are no longer reflected as purchases by us in our consolidated financial statements.

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 affect 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 governmental authorities have ordered price reductions of thousands of pharmaceutical products. The latest price reduction occurred in December 2007 and affected 47 different pharmaceutical products, eight of which are carried in our stores. As of December 31, 2007, 2008 and 2009, 12.7%, 16.4% and 29.2%, respectively, of the pharmaceutical products we offered were subject to price controls. In 2007, 2008 and 2009, approximately 4.9%, 4.0% and 7.7%, respectively, of our revenue was derived from sales of pharmaceutical products that were subject to price controls. The gradual increase in the number of

pharmaceutical products we offered that were subject to price controls 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 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,		
	2007	2008	2009
Sales, marketing and other operating expenses	31.0%	37.5%	38.7%
General and administrative expenses	3.9	4.2	4.8
Total operating expenses	34.9%	41.7%	43.5%

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 increased from 31.0% in 2007 to 37.5% in 2008 and to 38.7% in 2009. This increase was mainly due to increased salary, rental and utility costs, as well as an increase in the proportion of newly opened stores in our store base, which, when compared to our other stores, generally generate lower revenue but incur similar or higher rental costs, labor costs, depreciation expenses and utility costs. We expect our total sales, marketing and other operating expenses to increase as we hire additional in-store pharmacists and other store staff, lease additional stores, construct additional distribution centers and incur other additional costs in connection with the expansion of our store network.

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 the growth of our business.

Other key factors affecting our operating expenses include the following:

- ***The amount of time required to open new stores and for new stores to become profitable.*** The amount of time required for us to open new stores, measured from date of initial occupation to commencement date of operations, lengthened from an average of 35 days in 2007 to 47 days in 2008, but decreased to 39 days in 2009. 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.
- ***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 2007, 2008 and 2009, our inventory turnover days, calculated as the average of inventory at the beginning of the year and inventory at the end of the year, divided by cost of goods sold for the year and then multiplied by 365, was 93 days, 96 days, and 111 days, respectively. The increases in inventory turnover days over the period were caused by the rapid increase in the number of newly opened stores which generally have slower inventory turnover rates. The increase in 2009 was also due to the weak sales performance of our stores in the first two quarters of the year.

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 20%, which is further reduced to 10% under the implementation rules, or applicable tax rate 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, we are considered to be a “non-resident enterprise” for PRC tax purposes, and 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. As a result, except for certain subsidiaries as discussed below, our operating subsidiaries were subject to the PRC enterprise income tax rate of 33% for periods prior to January 1, 2008. Certain subsidiaries and tax paying retail store entities located and conducting operations in the Shenzhen Special Economic Zones and the Yunnan Province in the PRC were subject to a preferential tax rate of 15% prior to January 1, 2008. Under the implementation rules of the CIT Law, companies that enjoyed preferential income tax rates prior to January 1, 2008 have a five-year period to transition to the 25% uniform tax rate. In particular, companies that were subject to a tax rate of 15% would be subject to tax rates of 18%, 20%, 22%, 24% and 25% in 2008, 2009, 2010, 2011 and 2012 onwards, respectively. Accordingly, our operating subsidiaries and retail store entities in Shenzhen were subject to 18% and 20% income tax rate in 2008 and 2009, respectively, and will be subject to 22% income tax rate in 2010. Our subsidiaries outside of Shenzhen are subject to the 25% uniform tax rate commencing on 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 statements of 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. We have not made any material changes in the methodology used in these accounting policies during the past three years.

Realization of Deferred Income Tax Assets

We provide 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 assessment of uncertain tax positions, projections of future taxable income from each tax-paying entities within the period during which temporary differences reverse or before our tax loss carry forwards expire, the market environment in which these entities operates and any available tax planning strategies. Sufficient negative evidence, such as cumulative net losses during a three-year period that includes the current year and the prior

two years, 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 RMB22.1 million has been provided for as of December 31, 2009. 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.

Share-Based Compensation

We account for share-based compensation in accordance with FASB ASC Topic 718 “*Compensation – Stock Compensation*”, or “ASC Topic 718”, under which we are required to measure the fair value of employee share options on the date of the option grant, and recognize share-based compensation expense in our consolidated statements of income over the period during which an employee is required to provide services in exchange for the award, which is generally the vesting period. In connection with the Pre-IPO Share Option Scheme, we granted 1,000,000 options, 6,680,000 options, and 1,000,000 options on August 30, 2005, March 20, 2006, and September 1, 2006, respectively. The exercise price was US\$0.075 per share for options granted on August 30, 2005 and US\$0.75 per share for options granted on March 20, 2006 and September 1, 2006. With respect to such options granted on August 30, 2005, 25.0% of such options vested immediately on the date of grant and the remaining 75.0% of the options shall vest over a three year period in 12 equal three-monthly installments. With respect to the options granted on March 20, 2006 and September 1, 2006, 25.0% of such options vested immediately on the respective dates of grant and the remaining 75.0% of such options vest over a four year period in eight equal six-monthly installments.

Since none of our employee share options outstanding as of December 31, 2005 and 2006 were exercisable until the consummation of a qualified initial public offering, and we believed that achievement of such performance condition was not probable prior to consummation of a qualified initial public offering, given the level of uncertainty and the fact that such event was, at least partly, outside of our control, no share-based compensation expenses were recorded prior to 2007 in accordance with ASC Topic 718. We recorded share-based compensation expense of RMB8.3 million in 2007 as the qualified initial public offering performance condition was met. The recognized share-based compensation expenses during this period were allocated to sales, marketing and other operating expenses and general and administrative expenses in the amounts of RMB1.8 million and RMB6.5 million, respectively. We recorded share-based compensation expense for these options of RMB1.8 million in 2008. The recognized share-based compensation expenses during this period were allocated to sales, marketing and other operating expenses and general and administrative expenses in the amounts of RMB0.5 million and RMB1.3 million, respectively. We recognized share-based compensation expense, which were allocated to sales, marketing and other operating expenses and general administrative expenses in the amount of approximately RMB73,000 (US\$10,000) and RMB13,000 (US\$2,000), respectively, in 2009. As of December 31, 2009, we had unrecognized share-based compensation expense of RMB0.1 million related to unvested options issued under the Pre-IPO Scheme, which is expected to be recognized over a weighted average period of six months.

We determined the fair value of employee share options granted under the Pre-IPO Share Option Scheme using the Black-Scholes option pricing model based on the assumptions shown in the table below. Under this option pricing model, certain assumptions, including the risk-free interest rate, the expected term of the options, the expected dividends on the underlying ordinary shares, and the expected volatility of the price of the underlying shares for the expected term of the options, are required in order to determine the fair value of the options. In addition, our ordinary share price on the date of the option grant affects the fair value of the options. Changes in these assumptions could significantly affect the option fair value and hence the amount of compensation expense we recognize in our consolidated financial statements.

	Awards granted on August 30, 2005	Awards granted on March 20, 2006	Awards granted on September 1, 2006
Expected dividend yield	0	0	0
Expected volatility	39.17%	36.80%	35.19%
Risk-free interest rate	4.69%	5.26%	5.27%
Expected life (in years)	4.85	4.59	4.30
Estimated fair value of underlying ordinary shares (US\$ per share)	0.46	0.49	0.57

On June 30, 2007, our shareholders adopted the 2007 Share Incentive Plan, or the “2007 Plan”. The 2007 Plan authorizes us to issue up to 8,680,000 shares of our 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 our ordinary share on the date of grant.

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. These share options 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\$0.8 per option or RMB3.2 million in aggregate, to our chief financial officer, 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. These share options expire on the tenth anniversary of the date of grant.

In connection with the share options granted under the 2007 Plan, we recorded share-based compensation expense of RMB0.4 million, RMB2.3 million and RMB2.9 million in general and administrative expenses in 2007, 2008 and 2009, respectively. As of December 31, 2009, we had unrecognized compensation expense of RMB1.7 million related to such unvested share options, which is expected to be recognized over a weighted average period of one year.

The fair value of the options granted under the 2007 Plan was determined using the binomial option pricing model based on following assumptions at the date of grant:

	Awards Granted On	
	November 9, 2007	January 5, 2009
Expected dividend yield	1.67%	2.54%
Expected volatility.....	40.74%	41.76%
Risk-free interest rate	4.23%	2.54%
Option life (in years)	10	10
Forfeiture rate.....	0%	0%
Suboptimal exercise factor	1.5	1.5

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 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 has been no change to the estimated useful lives and salvage values in 2007, 2008 and 2009.

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 did not recognize any impairment charges on our long-lived assets in 2007, 2008 and 2009.

Impairment of Goodwill

Our goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in the business combinations completed in 2008 and 2009. 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. A reporting unit for this purpose consists of stores established through organic growth and /or purchased stores operating in nearby geographical location. 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 Subtopic 805 "Business Combinations". The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. We determine fair value of the reporting unit using a discounted cash flow analysis, which requires significant judgment relating to forecast of revenues, operating costs and applicable discount rates so it contains uncertainty. These forecasts can be affected by a number of factors including, but not limited to, general economic conditions,

efforts of third party organizations to reduce their product costs, the continued efforts of competitors to gain market share and consumer spending patterns. We use all readily available information and consider historical trends in determining the amount that is considered to be reasonable approximation of revenues and operating costs for the forecast periods. We did not recognize any goodwill impairment loss in 2008 and 2009.

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 2007, 2008 and 2009 were RMB4.1 million, RMB13.5 million and RMB8.7 million (US\$1.3 million), respectively.

Results of Operations

The following table sets forth a summary of our statements of 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,					
	2007		2008		2009	
	RMB	% of Revenue	RMB	% of Revenue	RMB	% of Revenue
	(In thousands, except percentages and per share data)					
Revenue.....	1,954,683	100.0%	2,396,642	100.0%	2,217,613	100.0%
Cost of goods sold.....	(1,092,011)	(55.8)	(1,257,752)	(52.5)	(1,143,398)	(51.6)
Gross profit	862,672	44.1	1,138,890	47.5	1,074,215	48.4
Operating expenses:						
Sales, marketing and other operating expenses ⁽¹⁾	(606,340)	(31.0)	(898,019)	(37.5)	(858,072)	(38.7)
General and administrative expenses ⁽¹⁾	(75,514)	(3.9)	(99,495)	(4.2)	(105,652)	(4.8)
Income from operations	180,818	9.3	141,376	5.9	110,491	5.0
Net interest income ⁽²⁾	10,552	0.5	121,557	5.1	72,828	3.3
Dividend income from cost method investments	1,077	0.1	1,116	0.1	3,776	0.2
Equity in income of an equity method investee	-	-	-	-	5,128	0.2
Other income	-	-	113	-	8,927	0.4
Income tax expense	(36,354)	(1.9)	(64,922)	(2.7)	(61,174)	(2.8)
Net income attributable to noncontrolling interest	(7,928)	(0.4)	(6,494)	(0.3)	-	-
Net income attributable to China Nepstar Chain Drugstore Ltd.	148,165	7.6	192,746	8.1	139,976	6.3
Accretion to Series A redeemable convertible preferred shares redemption value	(15,135)	(0.8)	-	-	-	-
Net income attributable to China Nepstar Chain Drugstore Ltd. ordinary shareholders	133,030	6.8%	192,746	8.1%	139,976	6.3%
Earnings per ordinary share						
Basic	0.80		0.90		0.67	
Diluted	0.80		0.88		0.66	

- (1) Sales, marketing and other operating expenses and general and administrative expenses in 2007 include share-based compensation expenses of RMB1.8 million and RMB6.9 million, respectively, that were realized upon completion of our initial public offering in 2007. Sales, marketing and other operating expenses and general and administrative expenses in 2008 included share-based compensation expenses of RMB0.5 million and RMB3.7 million, respectively. Sales, marketing and other operating expenses and general and administrative expenses in 2009 included share-based compensation expenses of approximately RMB73,000 (US\$11,000) and RMB2.9 million (US\$0.4 million), respectively.
- (2) Net interest income includes “interest income” and “interest expense” set forth in our consolidated financial statements included elsewhere in this annual report.

Comparison of Years Ended December 31, 2008 and December 31, 2009

Revenue. Our revenue was RMB2,217.6 million (US\$324.9 million) in 2009 compared to RMB2,396.6 million in 2008. This decrease in revenue was principally the result of the deconsolidation of the financial results of JZJ from China Nepstar in 2009, as compared to revenue contribution from JZJ of RMB383.0 million in 2008. Without taking into account the revenue contribution from JZJ in 2008, our revenue increased by 10.1% in 2009, which was primarily due to higher sales of products we carry as a result of the continued increase in the number of our stores. The increase was also due to revenue growth from our existing stores that had been in operation for at least 12 months. The number of our directly operated stores was 2,479 as of December 31, 2009 as compared to 2,709 as of December 31, 2008 (which included 355 stores operated by JZJ). For our stores that had been opened prior to December 31, 2007, the average daily revenue per store increased from RMB2,423 in 2008,

(RMB2,867 without taking into account the 355 stores operated by JZJ, to RMB2,941 (US\$431) in 2009. The increase was mainly due to a series of measures we undertook beginning in the second quarter of 2009, including expanding product offerings, adjusting price ranges, streamlining store operations and enhancing marketing campaigns as well as increased demand for our products resulting from the H1N1 pandemic. Sales of OTC drugs accounted for 36.1% and 36.9% of our revenue in 2008 and 2009, respectively, sales of prescription drugs accounted for 21.5% and 23.2% of our revenue in 2008 and 2009, respectively, and sales of nutritional supplements accounted for 20.2% and 20.6% of our revenue in 2008 and 2009, respectively.

Gross Profit. Our gross profit was RMB1,074.2 million (US\$157.4 million) in 2009 compared to 1,138.9 million in 2008. Our gross margin was 48.4% in 2009 compared to 47.5% in 2008. The increase in gross margin was primarily due to the deconsolidation of JZJ's financial results in 2009, as stores operated by JZJ generally have lower gross margins than our other stores due to lower product procurement quantity by JZJ as compare to our other stores. JZJ's gross profit was RMB116.9 million in 2008, and without taking into account JZJ's financial results in 2008, our gross margin decreased from 50.8% in 2008 to 48.4% in 2009. This decrease was primarily due to the expansion of the breadth of our product offerings, more proactive marketing approach to maintain competitiveness and the implementation of pricing ceilings on drugs on the Essential Drugs and Reimbursement Lists by the NDRC in October 2009, which was partially offset by our further refined product selection, with higher percentage of high gross margin products, such as private label products, as well as better pricing terms from suppliers as result of our continued centralization of procurement and increased economies of scale realized by our larger network of stores. We expect our gross margin to stabilize or to decline slightly in the near term as we continue to focus on increasing our stores' customer visits through more competitive pricing and through increasing our offerings of non-pharmaceutical products, which is expected to generate lower gross margins compared to pharmaceutical products.

Operating Expenses. Our operating expenses were RMB963.7 million (US\$141.2 million) in 2009 as compared to RMB997.5 million in 2008. Operating expenses as a percentage of our revenue was 43.5% in 2009 compared to 41.6% in 2008. JZJ's operating expenses were RMB103.7 million, and, without taking into account JZJ's financial results in 2008, our operating expenses as a percentage of our revenue was 44.4% in 2008.

- **Sales, Marketing and Other Operating Expenses.** Our sales, marketing and other operating expenses were RMB858.1 million (US\$125.7 million) in 2009 as compared to RMB898.0 million in 2008. This decrease was primarily due to the deconsolidation of JZJ's financial results in 2009, which was partially offset by increased salaries and bonus payments in connection with increased headcount as a result of our continued expansion and increased rental expenses related to store expansion. Sales, marketing and other operating expenses as a percentage of our revenue was 38.7% in 2009 compared to 37.5% in 2008. JZJ's sales and marketing and other operating expenses were RMB99.6 million in 2008, and without taking into account JZJ's financial results, our sales, marketing and other operating expenses increased in absolute amount from 2008 to 2009 but decreased as a percentage of our revenue to 38.7% from 39.6% in 2008. This decrease as a percentage of our revenue was mainly due to the implementation of stringent cost control measures and efficiency enhancement, such as closure of some non-performing stores and streamlining staff allocation of our stores, which was partially offset by the hiring of additional staff associated with new store openings and increased rental expenses. In 2009, we experienced an approximately 10.0% increase in average rental expense for the 303 existing stores upon renewal of their existing leases in 2009. We expect our sales, marketing and other operation expenses will continue to grow as we continue to expand our store network.
- **General and Administrative Expenses.** Our general and administrative expenses increased by 6.2% to RMB105.6 million (US\$15.5 million) in 2009 from RMB99.5 million in 2008. The increase was primarily due to additional hiring of middle and senior management. General and administrative expenses as a percentage of our revenue was 4.8% in 2009 compared to 4.2% in 2008. JZJ's general and administrative expenses were RMB4.1 million in 2008, and without taking into account JZJ's financial results in 2008, our general and administrative expenses as a percentage of revenue was 4.7% in 2008.

Income from Operations. As a result of the foregoing, our income from operations was RMB110.5 million (US\$16.2 million) in 2009 compared to RMB141.4 million in 2008. Our operating margin was 5.0% in 2009 compared to 5.9% in 2008. Income from operations contributed by JZJ in 2008 was RMB13.2 million and without taking into account JZJ's financial results in 2008, our operating margin was 6.4% in 2008.

Net Interest Income. Our net interest income decreased significantly to RMB72.8 million (US\$10.7 million) in 2009 from RMB121.6 million in 2008. This decrease was principally a result of the decrease in our cash, cash equivalents, bank deposits and held-to-maturity investment securities resulting from our payment of cash dividends and, to a lesser extent, the low interest rate environment prevailing during this period. In 2008, we deposited a significant amount of the net proceeds from our initial public offering with various domestic PRC banks that offered guarantee of principal amounts and higher returns compared to ordinary bank deposits. These investments are accounted for as held-to-maturity investment securities in our financial statements. The average balance of our cash in interest-bearing savings accounts decreased to RMB1,031.9 million (US\$151.2 million) in 2009 from RMB1,783.4 million in 2008. We paid a cash dividend of US\$0.35 per ADS on or around May 18, 2009 to shareholders of record as of the close of business on April 16, 2009, and special cash dividend of US\$1.50 per ADS on or around December 31, 2009 to shareholders of record as of the close of business on September 25, 2009. The decrease in our net interest income was also due to an interest expense in 2009 of RMB2.5 million (US\$0.4 million) related to short-term bank loans obtained in November 2009. We did not have any interest expenses in 2008. We expect our net interest

income to decrease in 2010 largely as a result of our reduced cash balance resulting from the payment of a cash dividend of US\$0.28 per ADS on or around May 3, 2010 to shareholders of record as of the close of business on April 2, 2010.

Dividend Income from Cost Method Investments. Dividends received from our investments in companies accounted for under the cost method increased to RMB3.8 million (US\$0.6 million) in 2009 compared to RMB1.1 million in 2008 as a result of additional dividends received from our investments.

Income Tax Expense. Our income tax expense decreased to RMB61.2 million (US\$9.0 million) in 2009 from RMB64.9 million in 2008. Our effective tax rate increased from 24.6% in 2008 to 30.4% in 2009. The increase in our effective tax rate was primarily due to higher tax rates that certain of our subsidiaries became subject to under the new PRC corporate income tax law, as well as the RMB7.2 million (US\$1.0 million) deferred tax liability recognized as a result of the deconsolidation of JZJ's financial results in connection with the termination of our voting rights agreement with respect to JZJ in January 2009.

Net Income Attributable to Noncontrolling Interest. Our net income attributable to noncontrolling interest decreased to nil in 2009 from RMB6.5 million in 2008, as a result of the deconsolidation of JZJ from our financial results following the termination of our voting rights agreement with respect to JZJ in January 2009.

Net Income. As a result of the foregoing, our net income was RMB140.0 million (US\$20.5 million) in 2009 from RMB192.7 million in 2008.

Comparison of Years Ended December 31, 2007 and December 31, 2008

Revenue. Our revenue increased by 22.6% to RMB2,396.6 million in 2008 from RMB1,954.7 million in 2007. This increase was primarily due to higher sales of products we carry as a result of the increase in the number of our stores. The number of our directly operated stores increased to 2,709 as of December 31, 2008 from 2,002 as of December 31, 2007. For our stores that had been opened prior to December 31, 2006, the average daily revenue per store decreased from RMB3,947 in 2007 and to RMB3,509 in 2008. The decline was mainly due to our sales being affected by severe weather conditions including heavy snowstorms in the first quarter, severe rainstorm in the second quarter and government restricting stores from selling products with steroid ingredients during Olympic Games in the third quarter of 2008. We implemented a series measures to improve sales in our stores in the second half of 2008. We generated a substantial portion of our revenue from sales of prescription drugs and OTC drugs in both 2007 and 2008. Sales of OTC drugs accounted for 35.6% and 36.1% of our revenue in 2007 and 2008, respectively, and sales of prescription drugs accounted for 23.4% and 21.5% of our revenue in 2007 and 2008, respectively. The proportion of revenue contribution from prescription drugs has decreased over the past three years mainly due to PRC government's stricter enforcement of the requirement that prescription drugs can only be sold with valid prescriptions. The enforcement of this requirement is more beneficial to drugstores that are affiliated with hospitals. The decrease was also due to our focused efforts in growing sales of nutritional supplements, which normally generate higher gross margin than drugs. Sales of nutritional supplements accounted for 18.3% and 20.2% of our revenue in 2007 and 2008, respectively. The growing contribution of sales of nutritional supplements to revenue was largely due to our effort in improving the sales skills of our floor staff through trainings in their knowledge of nutritional supplements.

Gross Profit. Our gross profit increased by 32.0% to RMB1,138.9 million in 2008 from RMB862.7 million in 2007. Our gross margin increased to 47.5% in 2008 from 44.1% in 2007. The increase in our gross margin was primarily due to an increase in private label product sales and centrally procured product sales as a percentage of our revenue. Private label products accounted for 24.4% of our revenue and 37.0% of our gross profit in 2008, compared to 18.7% of our revenue and 30.7% of our gross profit in 2007. The increase of our gross margin was also a result of our improved product selection, which included a higher percentage of high gross margin products, as well as better pricing terms from suppliers as result of our centralization of procurement and increased economies of scale realized by our larger network of retail stores.

Operating Expenses. Our operating expenses increased by 46.3% to RMB997.5 million in 2008 from RMB681.9 million in 2007. Operating expenses as a percentage of our revenue increased to 41.7% in 2008 from 34.9% in 2007.

- **Sales, Marketing and Other Operating Expenses.** Our sales, marketing and other operating expenses increased by 48.1% to RMB898.0 million in 2008 from RMB606.3 million in 2007. This increase was primarily due to increased salaries and bonus payments in connection with increased headcount as a result of our continued expansion. Sales, marketing and other operating expenses as a percentage of our revenue increased to 37.5% in 2008 from 31.0% in 2007. This increase was mainly due to increased salary, rental and utility costs, along with the overall higher inflation rate in China in the first three quarters of 2008. The higher percentage was also due to an increase in the proportion of newly opened stores in our store base, which, compared to mature stores, generally generate lower revenue but incur similar or higher rental and labor costs. In 2008, we added 707 stores and recruited a number of new staff to operate these stores. Our new staffs are typically required to undergo three months on-the-job training in existing stores before they can start to work in new stores, which resulted in higher head count per store during 2008 with a peak of 6.7 staff per store in the third quarter. Salaries and bonuses relating to our in-store pharmacists and other store and distribution center staff increased by 57.9% to RMB415.5million in 2008 from RMB263.2 million in 2007. We also incurred higher rental and utility expenses for our stores and distribution centers, and increased depreciation for store and distribution center leasehold improvements and store

equipment, as we opened additional stores and additional distribution centers to accommodate our growth. The increase in rental cost in 2008 was also due to higher rental expenses for newly opened or acquired stores and the approximately 20% increase in average rental expense for 280 existing stores upon renewal of their existing leases. Rental and utility expenses for our stores and distribution centers increased by 50.4% to RMB360.0million in 2008 from RMB239.4 million in 2007. Depreciation for store and distribution center leasehold improvements and store equipment increased by 32.4% to RMB55.4 million in 2008 from RMB41.8 million in 2007.

- **General and Administrative Expenses.** Our general and administrative expenses increased by 31.8% to RMB99.5 million in 2008 from RMB75.5 million in 2007. General and administrative expenses as a percentage of our revenue increased to 4.2% in 2008 from 3.9% in 2007. This increase was primarily due to increased administrative and compliance costs related to being a publicly listed company.

Income from Operations. As a result of the foregoing, our income from operations decreased to RMB141.3 million in 2008 from RMB180.8 million in 2007. Our operating margin decreased to 5.9% in 2008 compared to 9.3% in 2007.

Net Interest Income. Our net interest income increased significantly to RMB121.6 million in 2008 from RMB10.6 million in 2007. This increase was principally due to a substantial increase in our cash balances resulting from our initial public offering in November 2007. We deposited a significant portion of proceeds from our initial public offering with various PRC banks that offered guarantee of principal amounts and higher returns compared to ordinary bank deposits. The average balance of our cash in interest-bearing savings accounts increased to RMB1,783.4 million in 2008 from RMB426.1 million in 2007.

Dividend Income from Cost Method Investments. Dividends received from our investments in companies accounted for under the cost method remained stable at RMB1.1 million in 2007 and 2008.

Income Tax Expense. Our income tax expense increased to RMB64.9 million in 2008 from RMB36.4 million in 2007. Our effective tax rate increased from 18.9% in 2007 to 24.6% in 2008. The increase of our effective tax rate in 2008 was primarily due to higher tax rates that certain of our subsidiaries becoming subject to under the new PRC corporate income tax law, the recognition of withholding taxes related to profit distribution from our PRC subsidiaries to the Cayman Islands holding company, and an increase in the deferred tax asset valuation allowance for tax loss carry forwards, the benefits of which we currently do not expect to be realizable. The valuation allowance on deferred tax assets increased by RMB10.2 million in 2008 compared to RMB1.0 million decrease in 2007.

Noncontrolling Interest. Our net income attributable to noncontrolling interest decreased to RMB6.5 million in 2008 from RMB7.9 million in 2007. This decrease was mainly due to a decrease of JZJ's after-tax profit attributable to noncontrolling interest.

Net Income. As a result of the foregoing, our net income increased to RMB192.7 million (US\$28.3 million) in 2008 from RMB148.2 million in 2007.

Liquidity and Capital Resources

Liquidity and Capital Resources

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

	Year Ended December 31,			
	2007	2008	2009	2009
	RMB	RMB	RMB	US\$
	(In thousands)			
Net cash provided by operating activities.....	171,057	66,269	295,280	43,258
Net cash (used in) / provided by investing activities...	(666,284)	(1,671,009)	652,720	95,624
Net cash provided by/(used in) financing activities.....	2,618,831	(206,955)	(814,891)	(119,381)
Net increase / (decrease) in cash	2,085,915	(1,816,027)	133,128	19,503
Cash and cash equivalents at end of the year	2,168,911	352,884	486,012	71,201

In 2007, 2008 and 2009, we were able to finance a significant portion of our operations and capital investments from our cash flows from operations. As of December 31, 2009, we had RMB486.0 million (US\$71.2 million) cash and cash equivalents. In addition, we have deposited significant amount of proceeds from our initial public offering with various domestic banks, enrolling in their various wealth management programs, which provide guarantee of principal amounts and higher returns compared to ordinary bank deposits. Such deposits are carried as held-to-maturity investment securities in our financial statements. As of December 31, 2009, our cash, cash equivalents and bank deposits amounted to RMB666.0 million (US\$97.6 million) and our restricted cash amounted to RMB765.0 million (US\$112.1 million). In addition, we have also obtained short-term bank loans and credit facilities in 2009 for working capital purposes. As of December 31, 2009, such short-term bank loan balance amounted to RMB470.0 million (US\$68.9 million). All outstanding short-term bank loans were repaid as of the date of this annual report.

We expect to continue to generate positive operating cash flow in 2010. 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.

As we expect the retail pharmaceutical market in China to continue to grow, we plan to continue expanding our drugstore network and centralizing our procurement, which we expect to result in better pricing terms from our suppliers. We will further refine our product selection to include a greater percentage of high gross margin products. As a result, we expect to generate a greater amount of revenue, income from operations and cash flows. However, 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 RMB295.3 million (US\$43.3 million) in 2009 compared to RMB66.3 million in 2008. Net cash provided by operating activities in 2009 was higher by comparison to 2008 primarily as a result of significant prepayments for purchase of merchandise paid to related parties in the second quarter of 2008 and higher payment of prepaid expenses, deposits and other current assets in 2008. The increase was also due to the refund in 2009 of unused portions of the prepayment made in 2008 as well as improved management of accounts payable.

Net cash provided by operating activities decreased to RMB66.3 million in 2008 from RMB171.1 million in 2007, primarily due to a significant prepayment for purchase of merchandise paid to related parties in the second quarter of 2008, which resulted in negative net cash flows from operations of RMB105.1 million for that quarter. Other than the second quarter, we reported positive operating cash flow between RMB46.0 million to RMB66.2 million for the remaining three quarters in 2008. In addition, our operating cash flow was negatively affected as we added more than 700 new stores in 2008. New stores normally generate much less revenue compared to other stores while incurring higher operating costs.

Investing Activities

Net cash provided by investing activities was RMB652.7 million (US\$95.6 million) in 2009 compared to net cash used in investing activities of RMB1,671.0 million in 2008 primarily as the result of fewer new store openings and fewer acquisitions in 2009 compared to 2008.

Net cash used in investing activities increased to RMB1,671.0 million in 2008 from RMB666.3 million in 2007. The increase was mainly due to increased investment in time deposits with original maturity over three months, investment in the 563 new stores and ERP system and acquisition of 144 stores through business combinations.

Financing Activities

Net cash used in financing activities was RMB814.9 million (US\$119.4 million) in 2009, which mainly consisted of dividends payments declared in March 2009 and August 2009 totaling RMB1,281.1 million (US\$187.8 million), which was partially offset by an increase of RMB470 million (US\$68.9 million) in short-term bank loans.

Net cash used in financing activities was RMB207.0 million in 2008, which mainly consisted of payments for repurchases of our ADSs totaling RMB116.4 million and dividends payment of RMB86.7 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, see “Item 3. Key Information — D. Risk Factors — Risks Related to Our Corporate Structure — 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,” “Item 3. Key Information — D. Risk Factors — Risks Related to Doing Business in China — 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” and “Item 3. Key Information — D. Risk Factors — Risks Related to Doing Business in China — Dividends we receive from our operating subsidiaries located in the PRC may be subject to PRC withholding tax.”

Capital Expenditures

In 2007, 2008 and 2009, our capital expenditures totaled RMB68.4 million, RMB187.8 million and RMB81.7 million (US\$12.0 million), respectively. In the past, our capital expenditures were used primarily to open additional stores, acquire stores through business combinations, set up distribution centers and install and upgrade our information management systems. We estimate that our capital expenditures in 2010 will range from approximately RMB100 million to RMB200 million, which we plan to use to open new stores, acquire additional stores and build new distribution centers.

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 (US\$60.1 million) and credit facilities in the aggregate amount of RMB250.0 million (US\$36.6 million). Time deposits that we had placed with such financial institutions in the amount of RMB500.0 million (US\$73.3 million) and RMB250.0 million (US\$36.6 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 interest 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. As of December 31, 2009, RMB470.0 million (US\$68.9 million) of such short-term borrowings was outstanding. RMB460.0 million (US\$67.4 million) of the short-term borrowings bear a fixed annual interest rate of 4.374% and RMB10.0 million (US\$1.5 million) of the short-term borrowings bear a fixed annual interest rate of 3.654%. All outstanding short-term borrowings were repaid in February and March 2010 and the relevant security interest were released in March 2010. The short-term borrowings were primarily obtained for the purpose of distributing special dividends to shareholders as certain portion of our funds were held in fixed deposits or held-to-maturity investments securities that had not yet matured at the time when the special dividends were distributed.

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 4.8% in 2007, 5.9% in 2008 and -0.7% in 2009. We have not in the past been materially affected by any such inflation, but we can provide no assurance that we will not be affected in the future.

Recently Issued Accounting Pronouncements

On January 1, 2009, we adopted SFAS 141(R), *Business Combinations*, included in FASB ASC Topic 805, *Business Combination*, or ASC Topic 805. ASC Topic 805 modifies the accounting for business combinations and requires, with limited exceptions, the acquirer in a business combination to recognize 100% of the assets acquired, liabilities assumed, and noncontrolling interest in the acquiree at the acquisition-date fair value. In addition, ASC Topic 805 requires the expensing of acquisition-related transaction and restructuring costs, and certain contingent acquired assets and liabilities, as well as contingent consideration, to be recognized at fair value. The initial adoption of the provisions of this standard did not have any impact on the our consolidated financial statements.

On January 1, 2009, we adopted Statement 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, included in FASB ASC Subtopic 810-10, *Consolidations – Overall*, or the FASB ASC Subtopic 810-10, which requires certain changes to the presentation of the financial statements. This amendment requires us to classify noncontrolling interests (previously referred to as “minority interest”) in the consolidated statements of income as part of consolidated net earnings (RMB7.9 million, RMB6.5 million and nil in 2007, 2008 and 2009, respectively) and to include the accumulated amount of noncontrolling interests in our consolidated balance sheets as part of shareholders' equity (RMB23.2 million and nil as of December 31, 2008 and 2009, respectively). The amount previously reported as net income is now presented as net income attributable to us. If a change in ownership of our consolidated subsidiary results in loss of control and deconsolidation, any retained ownership interests are re-measured with the gain or loss reported in net earnings. We accounted for the deconsolidation of JZJ in January 2009 under FASB ASC Subtopic 810-10.

In May 2009, the FASB updated its guidance in FASB Statement No. 165, *Subsequent Events*, which was primarily codified into FASB ASC Topic 855, *Subsequent Events*, or ASC Topic 855, establishing principles and requirements for subsequent events. In particular, ASC Topic 855 sets forth the period after the balance sheet date during which management shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity shall recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity shall make about events or transactions that occurred after the balance sheet date. This updated guidance is effective for interim periods ended after June 15, 2009. The adoption of ASC Topic 855 did not have a significant impact on our financial condition, results of operations or cash flows.

In June 2009, the FASB issued FASB ASC Topic 105, *Generally Accepted Accounting Principles*, or ASC Topic 105, and established the FASB ASC as the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (CITF), and related accounting literature. The FASB ASC is updated through the FASB's issuance of Accounting Standards Updates, or ASUs. ASC Topic 105 was effective for financial statements issued for interim and annual periods ending after September 15, 2009. Its adoption did

not have any impact on our consolidated financial statements. The FASB ASC is updated through the FASB's issuance of Accounting Standards Updates, or ASUs.

In January 2010, the FASB released Accounting Standards Update 2010-02 or ASU 2010-02, Accounting and Reporting for Decreases in Ownership of a Subsidiary - A Scope Clarification. The ASU 2010-02 specified that the guidance in ASC Subtopic 810-10 on accounting for decreases in ownership of a subsidiary applied to a subsidiary or group of assets that constitutes a business or nonprofit activity. ASU 2010-02 is effective for the first interim or annual reporting period ending on or after December 15, 2009 for us and the guidance should be applied on a retrospective basis to the first period in which we adopted ASC Subtopic 810-10. The adoption of the provision of this standard update did not have any impact on our financial condition, results of operations or cash flows.

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, and the Chinese characters "Jianzhijia."

In addition to "Neptunus," we have also obtained rights to use an aggregate of 518 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 19 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, 2009, we have developed 1,524 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. 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, 2009 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 caused 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 and commercial commitments as of December 31, 2009:

Contractual Obligations	Payment due by period				
	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years	Total
(In thousands of RMB)					
Short-term debt obligations	470,000	-	-	-	470,000
Operating lease commitments	221,990	398,089	130,559	25,392	776,030
Capital commitments.....	3,350	-	-	-	3,350
Total	695,340	398,089	130,559	25,392	1,249,380

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. 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 expansion of 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 the 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	48	Chairman of the Board of Directors
Ian F. Wade	68	Chief Executive Officer
Barry J. Buttifant	65	Independent Director ⁽¹⁾⁽²⁾⁽³⁾
Stephanie Hui	37	Director
Alistair Eric MacCallum Laband.....	58	Independent Director ⁽¹⁾⁽²⁾⁽³⁾
Gary Siu Kwan Sik.....	42	Independent Director ⁽¹⁾⁽²⁾⁽³⁾
William Weili Dai	47	Chief Financial Officer
Jason (Xinghua) Wu.....	35	Chief Operating 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.

Ian F. Wade has served as our chief executive officer since January 2009. He was the group managing director for 25 years at the A.S. Watson Group, or Watson, a Hong Kong based entity that has one of the largest and fastest growing global retail operations, with over 7,700 stores in 37 countries. Under his leadership, Watson opened 270 stores in China and 400 stores in Taiwan, and launched hypermarkets in China. In addition, Mr. Wade also managed Watson's retail operations and private label businesses in many countries in Europe.

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, and a non-executive director of Hsin Chong Construction Group Ltd., or HCCG, and Synergis Holdings Limited, or Synergis, all of which are publicly listed companies in Hong Kong. Mr. Buttifant also serves as a non-executive director of Global-Tech Advanced Innovations Inc., a NASDAQ listed company. In October 2009, Mr. Buttifant rejoined Mission Hills Group, or MHG, as a Director – Corporate Finance, and prior to this appointment, he had been a consultant to the MHG since December 2008. Prior to joining MHG, he served as a Principal to KLC Kennic Lui & Company, a professional accounting firm and Managing Director of KLC Transactions Limited. Prior joining KLC, Mr. Buttifant was the Executive Director — Finance of the MHG from February 2008 till November 2008. Since 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). Mr. Buttifant was also an alternate director to both HCCG and Synergis. Mr. Buttifant was an operating partner of Barings Private Equity Asia Limited. He was also the managing director of Wo Kee Hong (Holdings) Limited, or Wo Kee Hong from 2001 to 2002 and was the advisor to the board of directors of Wo Kee Hong from November 2002 to April 2004. Prior to joining Wo Kee Hong, he was the managing director of IDT International Limited for over eight years and had worked for Polly Peck Group and Sime Darby Hong Kong Limited for more than 11 years in the capacity of finance director and managing director. Mr. Buttifant is a fellow member of the Association of Chartered Certified Accountants, the Hong Kong Institute of Certified Public Accountants, the Chartered Management Institute, the Hong Kong Management Association and the Hong Kong Institute of Directors.

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.

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 late November 2008, Mr. Laband has been 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.

Gary Siu Kwan Sik has been a director of our company since November 2007. Mr. Sik is a member of our audit committee and our compensation committee. Mr. Sik has more than fifteen years of experience in investment banking and finance. He has held senior positions with a number of major international investment banks, as well as the Hong Kong operations of the securities and investment banking division of a state-owned PRC bank, responsible for business development and regional business operations. Mr. Sik achieved his Bachelor's degree in engineering science and Master's degree in Arts from Oxford University in 1989 and 2006 respectively. Mr. Sik is a member of The Institute of Chartered Accountants in England and Wales and a fellow member of Hong Kong Institute of Certified Public Accountants. He is an independent non-executive director of China Glass Holdings Limited and Dawnrays Pharmaceutical (Holdings) Limited respectively, both companies are listed on the Stock Exchange of Hong Kong Limited. Mr. Sik is also an independent non-executive director of Sincere Pharmaceutical Group, a company listed on the New York Stock Exchange that manufactures and supplies branded generic pharmaceutical products for the China market.

William Weili Dai was appointed as the Chief Financial Officer of our company on January 5, 2009. Prior to joining our company, Mr. Dai was the chief financial officer of MicroPort Medical, a leading medical device company in China. From 1996 to 2006, Mr. Dai served as finance director in charge of China operations for three leading global companies, Mundipharma Pharmaceuticals, Boston Scientific and Case Corporation. During his tenure at Mundipharma and Boston Scientific, he was involved in multiple strategic mergers and acquisitions and business development projects in China. Mr. Dai began his financial management career with Ford Motor Company in Michigan in 1993 as financial analyst and later became the component department controller and then the assistant to the CFO of Ford's joint venture in China. Mr. Dai received his MBA degree in 1993 from Michigan State University and his bachelor's degree in 1988 from Shanghai University.

Jason (Xinghua) Wu was appointed as the Chief Operating Officer of our company on June 2, 2009. Mr. Wu joined our company in July 2008. He has served in various positions within our company, as the vice general manager of our Guangzhou branch, the regional general manager in charge of our North China Region and was promoted to vice president of operations in March 2009. Before joining our company, Mr. Wu held senior management positions at various consumer goods companies. From 2002 to early 2008, he was the CEO of Yiming Group, a private company specializing in food distribution, nutrient manufacturing, and convenience store operations. Prior to joining Beijing Yiming, Mr. Wu served as the divisional marketing director of Four Seas Group, a food manufacturing, trading and distribution company. Jason received his master's degree in management from the Northeastern University of China in 1999.

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 2009, the aggregate cash compensation to our executive officers, including all the directors, was RMB5.4 million (US\$0.8 million). For options granted to officers and directors, see “— Pre-IPO Share Option Scheme” and “— 2007 Share Incentive Plan.”

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, 2009, 2,708,412 ordinary share options granted under the pre-IPO Share Option Scheme were exercised, options to purchase 63,200 ordinary shares were forfeited and options to purchase 2,731,566 ordinary shares were outstanding.

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 options with a grant date fair value of approximately US\$2.86 per option or RMB4.3 million in aggregate, to our four independent directors at that time. The exercise price of such options is US\$8.10 per share, which is equal to the initial public offering price of our ordinary shares. The options vest and become exercisable in three equal annual installments on the first, second and third of the anniversaries of the date of grant. The share options shall expire on the fifth anniversary of the date of grant.

On January 5, 2009, we granted 600,000 options with a grant date fair value of approximately US\$0.8 per option or RMB3.2 million in aggregate, to an executive officer. The exercise price of such options is US\$2.40 per share. The options vest and become exercisable in three equal annual installments on the first, second and third of the anniversaries of the date of grant. The share options shall expire on the 10th anniversary of the date of grant.

On January 5, 2010, we granted an aggregate of 1,000,000 options with a grant day fair value of approximately US\$0.86 per option to two of our executive officers. The exercise price of such options is US\$3.725 per share. The options vest and become exercisable in four equal annual installments on the first, second, third and fourth of the anniversaries of the date of grant. The share options shall expire on the 10th anniversary of the date of grant.

On March 2, 2010, we granted an aggregate of 150,000 shares to our three current independent directors and 50,000 restricted shares to an executive officer. The grant of the shares to our independent directors was made in exchange for their forfeiture of 150,000 options granted in November 2007 and their waiver of certain cash compensations they were entitled to under their director agreements. The restricted shares granted to the executive officer vest and become exercisable in five equal annual installments on the first, second, third, fourth and fifth of the anniversaries of the date of grant.

Board Practices

Committees of the Board of Directors

Audit Committee

Our audit committee consists of Alistair Eric MacCallum Laband, Barry J. Buttifant and Gary Siu Kwan Sik. 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 Gary Siu Kwan Sik. 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, Alistair Eric MacCallum Laband and Gary Siu Kwan Sik. 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 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 14,282, 17,188 and 16,015 employees as of December 31, 2007, 2008 and 2009, 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, 2009:

	As of December 31, 2009	
	Employees	Percentage of Total
Non-pharmacist store staff	9,690	60.5%
Pharmacists.....	4,262	26.6
Management.....	1,388	8.7
Logistics	675	4.2
Total	16,015	100.0%

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, work-related injury benefits, maternity insurance, medical and unemployment benefit plans. Our contributions are made based on specified percentages of the salaries, bonuses, housing funds and certain allowances of our employees, up to a maximum amount 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 2007, 2008 and 2009, was RMB18.3 million, RMB30.1 million and RMB28.7 million (US\$4.2 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, 2010 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	51.0
Barry J. Buttifant	*	*
Alistair Eric MacCallum Laband	*	*
Gary Siu Kwan Sik	*	*
Jason (Xinghua) Wu	*	*
Stephanie Hui ⁽³⁾	50,000,000	23.8
William Weili Dai	*	*
All directors and executive officers as a group	159,142,305	75.8
Principal Shareholders		
China Neptunus Drugstore Holding Ltd.	107,000,000	51.0
GS Funds ⁽⁴⁾	50,000,000	23.8

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

- (1) Beneficial ownership is determined in accordance with Rule 13d-3 of the General Rules and Regulations under the Exchange Act, and includes voting or investment power with respect to the securities. The number of ordinary shares outstanding in calculating the percentages for each listed person includes the ordinary shares underlying options held by such person. Percentage of beneficial ownership of each listed person is based on 209,873,148 ordinary shares outstanding as of December 31, 2009 and additional shares issuable upon the exercise of the outstanding options held by such person within 60 days of this annual report.
- (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.

- 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 24, 2010, of the 209,873,148 issued and outstanding ordinary shares, 53,771,984 ordinary shares were registered in the name of a nominee of JPMorgan Chase Bank, N.A., the depositary of our ADSs. Approximately 25.62% of our ordinary shares, representing our ordinary shares held by the depositary, were held in the United States.

MISCELLANEOUS

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 March 18, 2008, our board of directors approved a cash dividend on our ordinary share of US\$0.06 per share, based on our net income for 2007. The cash dividend was paid on or around May 10, 2008, to shareholders of record as of the close of business on April 10, 2008. On March 13, 2009, our board of directors approved a cash dividend of US\$0.35 per ADS. The cash dividend was paid in May 2009 to shareholders of record as of the close of business on April 16, 2009. On August 24, 2009, our board of directors declared a special cash dividend of US\$1.50 per ADS. In November and December 2009, approximately RMB1,038 million (US\$152 million) was paid out to shareholders of record as of the close of business on September 25, 2009. On March 3, 2010, our Board of Directors declared a cash dividend of US\$0.28 per ADS. The cash dividend is payable on or around May 3, 2010 to shareholders of record as of the close of business on April 2, 2010.

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, 2009, the accumulated balance of our statutory reserve funds totaled RMB42.8 million (US\$6.3 million) and the accumulated profits of our consolidated PRC entities that were available for dividend distribution totaled RMB158.0 million (US\$23.1 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.

Taxation

Cayman Islands Taxation

The Cayman Islands currently levy 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 are not parties 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 may continue to enjoy the lower rate and gradually transition to the new tax rate within five years 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 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 20% is applicable to dividends payable to non-PRC investors that are “non-resident enterprises”, to the extent such dividends are derived from sources within the PRC, and the State Council has reduced such rate to 10% through the implementation regulations. 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 a withholding tax at a rate of 10%, or at a 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 will be determined by treaty between the PRC and the tax residence of the holder of the PRC subsidiary. Although we are a Cayman Islands incorporated Company, we are considered as a Hong Kong tax resident as we are primarily managed and controlled in Hong Kong and subject to Hong Kong Profits Tax on income arising in or derived from Hong Kong and may qualify under the Double Taxation Arrangement (Hong Kong). We have determined that we have qualified for the 5% withholding tax rate pursuant to the Double Taxation Arrangement (Hong Kong).

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” refer to any holder 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.

The U.S. Treasury has expressed concerns that intermediaries in the chain of ownership between the holder of an ADR and the issuer of the security underlying the ADR may be taking actions that are inconsistent with the claiming, by U.S. Holders of ADSs, of foreign tax credits for U.S. federal income tax purposes. Such actions would also be inconsistent with the claiming of the reduced rate of tax applicable to dividends received by certain non-corporate U.S. Holders, as described below. Accordingly, the analysis of the creditability of PRC taxes, if any, and the availability of the reduced tax rate for dividends received by certain non-corporate U.S. Holders could be affected by future actions that may be taken by the U.S. Treasury or intermediaries in the chain of ownership between the holder of an ADR and our company.

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 depository, 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, certain dividends received in taxable years beginning before January 1, 2011 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 such conditions required 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. 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 this legislation 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 in taxable years beginning prior to January 1, 2011, if we are a passive foreign investment company, or PFIC, in the taxable year in which such dividends are paid or in the preceding taxable year.

Under PRC tax law, if the dividends paid by us are deemed to be derived from sources within the PRC, you may be subject to PRC withholding taxes on dividends paid to you with respect to the ADSs or ordinary shares. In that case, you may be able to obtain a reduced rate of PRC withholding taxes under the treaty between the United States and the PRC if certain requirements are met, although no assurances can be given in this regard. In addition, 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. 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 past composition of our income and valuation of our assets, including goodwill, we believe that we were not a PFIC for our taxable year ending on December 31, 2009, although there can be no assurance in this regard. However, due to the volatility of the market price of our ADSs and ordinary shares in recent market conditions, we believe that we may be a PFIC for our current taxable year or that we may become one in the future. Under the Code, the determination of whether we are a PFIC is made annually. Accordingly, our PFIC status for the current taxable year cannot be determined with certainty until after the close of the current 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 (and may fluctuate considerably given that the global capital markets have been experiencing extreme volatility). Accordingly, 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, if it is determined that we own directly or indirectly 49.0%, but not the remaining 51.0%, of the equity interests in the regional Nepstar companies for U.S. federal income tax purposes, we may be treated as a PFIC for our taxable year ending on December 31, 2009, the current taxable year or in the future. 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 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, 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 will not be eligible for reduced rates of taxation on any dividends received from us prior to January 1, 2011, if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year. You will be required to file Internal Revenue Service Form 8621 if you hold our ADSs or ordinary shares in any year in which we are classified as a PFIC.

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, 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. 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, you can sometimes avoid the rules described above with respect to the stock you own in 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.

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 such as a corporation. 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.

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2008 AND 2009

(Amounts in thousands, except share data)

		December 31,		
	Note	2008 RMB	2009 RMB	2009 USD
ASSETS				
Current assets:				
Cash, cash equivalents and bank deposits	2(d),3	1,197,884	666,012	97,571
Restricted cash	2(e)	-	765,000	112,074
Held-to-maturity investment securities	4	641,000	400,000	58,600
Accounts receivable, net of allowance for doubtful accounts	5	88,136	72,561	10,630
Prepayments for purchase of merchandise paid to related parties	23	70,306	38,102	5,582
Amounts due from related parties	23	7,244	7,306	1,070
Prepaid expenses, deposits and other current assets	6	178,354	144,154	21,119
Inventories	7	373,689	369,775	54,172
Deferred tax assets	12	15,863	6,907	1,012
Total current assets		2,572,476	2,469,817	361,830
Long-term bank deposits	3	200,000	-	-
Held-to-maturity investment securities	4	400,000	-	-
Property and equipment, net	8	240,396	204,710	29,990
Deposits for purchases of properties paid to related parties	23	2,100	-	-
Rental deposits		28,873	38,557	5,649
Cost method investments		12,638	12,638	1,851
Equity method investment	12	-	29,343	4,299
Land use right	2(k)	-	8,622	1,263
Intangible assets, net	9	2,390	725	106
Goodwill	10	35,177	40,462	5,928
Deferred tax assets	12	4,723	2,914	427
Deposits for acquisitions	10	-	12,788	1,874
TOTAL ASSETS		3,498,773	2,820,576	413,217
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities:				
Short-term bank loans	13	-	470,000	68,855
Accounts payable		267,250	313,794	45,972
Amounts due to related parties	23	64,200	12,533	1,836
Accrued expenses and other payables	14	123,905	121,645	17,821
Income tax payable		35,344	38,599	5,655
Dividend payable	18	-	38,631	5,659
Total current liabilities		490,699	995,202	145,798
Deferred income		14,992	27,002	3,956
Deferred tax liabilities	12	10,443	20,640	3,024
Total liabilities		516,134	1,042,844	152,778
Shareholders' equity:				
Share capital – ordinary shares USD0.0001 par value:				
360,000,000 shares authorized; 208,293,136 shares issued and outstanding as of December 31, 2008;				
360,000,000 shares authorized; 209,873,148 shares issued and outstanding as of December 31, 2009				
	15	165	166	24
Additional paid-in capital		2,823,668	1,605,762	235,245
Accumulated other comprehensive loss		(38,009)	(38,485)	(5,638)
Retained earnings	16	173,650	210,289	30,808
Total China Nepstar Chain Drugstore Ltd. shareholders' equity		2,959,474	1,777,732	260,439
Noncontrolling interest		23,165	-	-
Total shareholders' equity		2,982,639	1,777,732	260,439
Commitments and contingencies	24			
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		3,498,773	2,820,576	413,217

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009

(Amounts in thousands, except per share data)

	Note	Year ended December 31,			
		2007 RMB	2008 RMB	2009 RMB	2009 USD
Revenue	19,23	1,954,683	2,396,642	2,217,613	324,882
Cost of goods sold		(1,092,011)	(1,257,752)	(1,143,398)	(167,509)
Gross profit		862,672	1,138,890	1,074,215	157,373
Sales, marketing and other operating expenses		(606,340)	(898,019)	(858,072)	(125,708)
General and administrative expenses		(75,514)	(99,495)	(105,652)	(15,478)
Income from operations		180,818	141,376	110,491	16,187
Interest income		10,703	121,557	75,335	11,037
Interest expense		(151)	-	(2,507)	(367)
Dividend income from cost method investments		1,077	1,116	3,776	553
Equity in income of an equity method investee	11	-	-	5,128	751
Other income	11	-	113	8,927	1,308
Income before income tax expense		192,447	264,162	201,150	29,469
Income tax expense	12	(36,354)	(64,922)	(61,174)	(8,962)
Net income		156,093	199,240	139,976	20,507
Less: net income attributable to noncontrolling interest		(7,928)	(6,494)	-	-
Net income attributable to China Nepstar Chain Drugstore Ltd.		148,165	192,746	139,976	20,507
Accretion to Series A redeemable convertible preferred shares redemption value	17	(15,135)	-	-	-
Net income attributable to China Nepstar Chain Drugstore Ltd. ordinary shareholders		133,030	192,746	139,976	20,507
Earnings per ordinary share:					
Basic	22	0.80	0.90	0.67	0.10
Diluted	22	0.80	0.88	0.66	0.10

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009

(Amounts in thousands, except share data)

	Ordinary shares		Additional		Accumulated		China Nepstar		Total	
			Paid-in		Comprehensive		Chain Drugstore Ltd.		Total	
	Number of	Par Value	Capital		Loss	Retained	Shareholders'	Noncontrolling	Shareholders'	
	Shares	Amount	Capital		Loss	Earnings	Equity	Interest	Equity	
		RMB	RMB		RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2007	115,000,000		59,617		((61,617	(2	11,0	8,6	
Net income			-			148,165	148,165	7,	156,0	
Foreign currency translation adjustment										
net of tax effect of nil			-		(37,4		(37		(37,47	
Comprehensive income							110	7,	118,6	
Accretion to Series A redeemable convertible										
preferred shares redemption value (Note 17)			-			(15,135	(15,		(15,13	
Issuance of ordinary shares upon initial public offering										
("IPO"), net of share offering costs of RMB 51,806	47,437,500		2,601,302				2,601		2,601,337	

Conversion of Series A convertible redeemable								
Preferred shares to ordinary shares (Note 17)	50,000,000		249,630			24	-	249,667
Issuance of ordinary shares upon exercise of								
employee share options (Note 15)	640,44		2,265					2,2
Share-based compensation expense (Note 20)			8,707					8,7
Balance as of December 31, 2007	213,077,944	16	2,921,521	(37,9	71,41	2,955,	18,5	2,974,10

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009

(Amounts in thousands, except share data)

	Ordinary shares		Accumulated			Total				
	Number of Shares	Par Value	Additional Paid-in Capital	Comprehensive Loss	Retained Earnings	China Nepstar				
		Amount				Chain Drugstore Ltd.	Shareholders’ Equity	Noncontrolling Interest	Shareholders’ Equity	Total
RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB			
Balance as of January 1, 2008	213,077,944	1	2,921,521	(37,957)	71,413	2,955,145	18,964	2,974,109		
Net income					192,746	192,746	6,	199,24		
Foreign currency translation adjustment										
net of tax effect of nil								(
Comprehensive income						19	6,	199,18		
Disposal of a subsidiary							(2,2	(2,29		
Repurchase and retirement of ordinary shares (Note 15)	(8,081,000)		(116,390)			(116		(116,395		
Issuance of ordinary shares upon exercise of										
employee share options (Note 15)	3,296,192		14,395			14,397		14,39		
Share-based compensation expense (Note 20)			4,142			4,142		4,14		

Dividend (Note 18)					(90,509	(90,509	(90,509	
Balance as of December 31, 2008	208,293,136	16	2,823,668	(38,000	173,650	2,959	23,100	2,982,639

See accompanying notes to consolidated financial statements.

CHINA NEPSTAR CHAIN DRUGSTORE LTD AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009

(Amounts in thousands, except share data)

	Ordinary shares		Additional		Other	Retained	China Nepstar		Total
	Number of	Par Value	Paid-in	Comprehensive	Loss	Earnings	Chain Drugstore Ltd.	Noncontrolling	Total
	Shares	Amount	Capital				Shareholders' Equity	Interest	Shareholders' Equity
		RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Balance as of January 1, 2009	208,293,136		2,823,661	(38,011)	173,650		2,955,300	23,111	2,982,639
Net income					139,976		139,976	-	139,976
Foreign currency translation adjustment									
net of tax effect of nil					(4,000)				(4,000)
Comprehensive income							13		13,500
Repurchase and retirement of ordinary shares (Note 15)	(1,128,400)		(16,081)				(16,081)		(16,081)
Issuance of ordinary shares upon exercise of									
employee share options (Note 15)	2,708,412		13,300				13,300		13,300
Share-based compensation expense (Note 20)			3,000						3,000
Dividend (Note 18)			(1,218,128)		(103,337)		(1,321,465)		(1,321,465)

Deconsolidation of Yunnan Nepstar							(23,16	(23,16
Balance as of December 31, 2009	209,873,148	16	1,605,762	(38,48	210,289	1,777,		1,777,73
	=====	=====	=====	=====	=====	=====	=====	=====
Balance as of December 31, 2009 (USD)		:	235,24	(5,62	30,808	260,		260,48
		=====	=====	=====	=====	=====	=====	=====

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, 2007, 2008 AND 2009
(Amounts in thousands)

	Year ended December 31,			
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2009</u>
	RMB	RMB	RMB	USD
Cash flows from operating activities:				
Net income	156,093	199,240	139,976	20,507
Adjustments to reconcile net income to net cash provided by operating activities:				
Share-based compensation expense	8,707	4,142	3,003	440
Depreciation and amortization	47,841	62,400	63,144	9,251
Loss on disposal of property and equipment	893	1,445	3,728	546
Gain on disposal of intangible assets	-	(113)	-	-
Gain on deconsolidation of a subsidiary	-	-	(8,927)	(1,308)
Equity in income of equity method investees	-	-	(5,128)	(751)
Deferred income taxes	(1,006)	(6,820)	19,519	2,860
Provision for inventory write-downs	4,097	13,510	8,702	1,275
Changes in operating assets and liabilities (net of effect of acquisitions, a disposal and the deconsolidation of Yunnan Nepstar):				
Accounts receivable	(14,598)	(33,837)	(12,793)	(1,874)
Prepayment for purchase of merchandise paid to related parties	(4,452)	(65,854)	32,204	4,717
Amounts due from related parties	4,410	(5,836)	(2,198)	(322)
Prepaid expenses, deposits and other current assets	(54,175)	(76,698)	8,604	1,260
Inventories	(18,042)	(92,550)	(52,727)	(7,725)
Deferred income	-	14,992	12,009	1,759
Accounts payable	(10,609)	35,347	46,759	6,850
Amounts due to related parties	(5,084)	13,656	8,476	1,242
Accrued expenses and other payables	31,209	5,859	25,490	3,734
Income tax payable	25,773	(2,614)	5,439	797
Net cash provided by operating activities	171,057	66,269	295,280	43,258
Cash flows from investing activities:				
Increase in restricted cash	-	-	(15,000)	(2,198)
Purchase of property and equipment	(68,430)	(129,933)	(53,982)	(7,907)
Proceeds from disposal of property and equipment	2,146	1,476	413	60
Purchase of held-to-maturity investment securities	(600,000)	(1,691,380)	-	-
Proceeds from maturity of held-to-maturity investment securities	-	1,250,380	641,000	93,907
Proceeds from disposal of intangible assets	-	1,335	-	-
Payment for acquisitions	-	(57,887)	(19,078)	(2,795)
Payment for land use right	-	-	(8,622)	(1,263)
Investment in time deposits with original maturity over three months	-	(2,156,000)	(690,000)	(101,086)
Proceeds from maturity of time deposits with original maturity over three months	-	1,111,000	805,000	117,933
Effect of deconsolidation of Yunnan Nepstar	-	-	(7,011)	(1,027)
Net cash (used in)/ provided by investing activities	(666,284)	(1,671,009)	652,720	95,624
Cash flows from financing activities:				
Proceeds from issuance of ordinary shares upon IPO, net of share offering costs of RMB33,578 paid	2,619,565	-	-	-
Proceeds from issuance of ordinary shares upon exercise of employee share options	2,266	14,397	13,302	1,949
Payment for repurchase of ordinary shares	-	(116,395)	(16,082)	(2,356)
Proceeds from short-term bank loans	3,000	-	610,000	89,366
Repayment of short-term bank loans	(6,000)	-	(140,000)	(20,510)
Dividends paid	-	(86,669)	(1,282,111)	(187,830)
Payment of IPO offering costs	-	(18,288)	-	-
Net cash provided by/(used in) financing activities	2,618,831	(206,955)	(814,891)	(119,381)

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, 2007, 2008 AND 2009

(Amounts in thousands)

	Year ended December 31,			
	<u>2007</u> RMB	<u>2008</u> RMB	<u>2009</u> RMB	<u>2009</u> USD
Effect of foreign currency exchange rates on cash	(37,689)	(4,332)	19	2
Net (decrease) / increase in cash	2,085,915	(1,816,027)	133,128	19,503
Cash and cash equivalents at beginning of the year	82,996	2,168,911	352,884	51,698
Cash and cash equivalents at end of the year	<u>2,168,911</u>	<u>352,884</u>	<u>486,012</u>	<u>71,201</u>
Supplemental disclosure of cash flow information:				
Interest paid	<u>(151)</u>	<u>-</u>	<u>(2,068)</u>	<u>(303)</u>
Income taxes paid	<u>(25,361)</u>	<u>(73,943)</u>	<u>(31,960)</u>	<u>(4,682)</u>
Payable for purchase of property and equipment	<u>10,821</u>	<u>6,067</u>	<u>8,112</u>	<u>1,188</u>
Share offering costs payable	<u>18,228</u>	<u>-</u>	<u>-</u>	<u>-</u>

See accompanying notes to consolidated financial statements.

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 (“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, 2009, the Company, through its subsidiaries, was the owner operator of 2,479 retail drugstores in approximately 70 cities in Guangdong, Jiangsu, Zhejiang, Liaoning, Shandong, Hunan, Fujian, Sichuan, and Hubei 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 investee which principally affect the consolidated results of operations and financial condition of the Company.

<u>Name of subsidiary</u>	<u>Principal activities</u>	<u>Percentage of equity interest as of December 31,</u>		
		<u>2007</u>	<u>2008</u>	<u>2009</u>
Shenzhen Nepstar Pharmaceutical Co., Ltd. (“Nepstar Pharmaceutical”)	Procurement of merchandise for the Group	100%	100%	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%

1 PRINCIPAL ACTIVITIES, ORGANIZATION AND BASIS OF PRESENTATION - CONTINUED

(a) *Principal activities - continued*

<u>Name of subsidiary</u>	<u>Principal activities</u>	<u>Percentage of equity interest as of December 31,</u>		
		<u>2007</u>	<u>2008</u>	<u>2009</u>
Shandong 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%
Weifang Nepstar Pharmaceutical Co., Ltd ("Weifang Nepstar")	Procurement of merchandise for the Group	100%	100%	100%
Yunnan Jian Zhijia Chain Drugstore Ltd. ("Yunnan Nepstar")	Operation of retail drugstores (Note 1(a)(i))	40%	40%	40%
Fuzhou Nepstar Chain Co., Ltd. ("Fuzhou Nepstar")	Operation of retail drugstores	-	-	100%
Hubei Nepstar Chain Co., Ltd. ("Hubei Nepstar")	Operation of retail drugstores	-	-	100%
Beijing Nepstar Chain Co., Ltd. ("Beijing Nepstar")	Operation of retail drugstores	-	-	100%
Shenyang Nepstar Chain Co., Ltd. ("Shenyang Nepstar")	Operation of retail drugstores	-	-	100%

Note (i)

Yunnan Nepstar is 40% owned by Nepstar Pharmaceutical, 30% owned by Yunnan Qunxiang Industrial Trading Co., Ltd. ("Qunxiang"), a company 100% beneficially owned by a director of Yunnan Nepstar, who is also an employee of the Group, and 30% owned by Yunnan Hengyu Industrial Trading Co., Ltd. ("Yunnan Hengyu"), a third party investor. In 1999, Qunxiang assigned Nepstar Pharmaceutical its 30% voting interest right with respect to the corporate, financial and operating actions of Yunnan Nepstar, including the approvals for the appointment of directors, business operating and capital investment plans, financial budgets, and dividends or profit distributions. Under the Articles of Association of Yunnan Nepstar, the approval and resolution of these corporate, financial and operating actions require a majority vote by the shareholders. The assignment of the voting interest right to Nepstar Pharmaceutical was legally binding and irrevocable as long as Nepstar Pharmaceutical remained a 40% shareholder of Yunnan Nepstar. Also, Qunxiang agreed not to dispose its 30% equity interest in Yunnan Nepstar to any parties other than Nepstar Pharmaceutical without receiving Nepstar Pharmaceutical's prior consent. Since Nepstar Pharmaceutical had legal and unilateral control of the operations of Yunnan Nepstar by virtue of ownership of a majority voting interest held directly (40%) and indirectly through the voting interest right assignment (30%), Yunnan Nepstar was accounted for as a 40%-owned consolidated subsidiary of the Group with 60% noncontrolling interest during the years ended December 31, 2007 and 2008. On January 5, 2009, the Company announced that its Board of Directors approved the termination of the voting interest right assignment agreement between Qunxiang and Nepstar Pharmaceutical. The termination of the voting interest right assignment was considered by the Board of Directors to be in the long term interest of the Company's shareholders. Upon the termination of the voting interest right assignment in January 2009, Yunnan Nepstar is no longer a consolidated subsidiary of the Company and instead accounted for under the equity method of

accounting. Upon deconsolidation, management remeasured the retained noncontrolling interest in Yunnan Nepstar to its fair value. See Note 11.

(b) Significant concentrations and risks

For the years ended December 31, 2007, 2008 and 2009, none of the Group's suppliers contributed more than 10% of the Group's total purchase of merchandise except for a related party supplier, Yunnan Jian Zhijia Medical Ltd., as disclosed in Note 23(a).

As of December 31, 2008 and 2009, the Group held US dollar denominated bank deposits of USD11,172 and USD35,328 (equivalent to RMB76,223 and RMB241,149). The deposits were primarily placed with Citibank N.A. Hong Kong Branch and Merrill Lynch International Bank Limited in the Hong Kong Special Administrative Region of the PRC ("HKSAR"). Apart from the bank deposits in HKSAR, all of the Group's bank deposits are with financial institutions of 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").

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 RMB36,000 to the Company for the 51% equity interest in the Pre-2009 Regional Companies, which was financed by loans of the same amount provided by the Company. 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 funds advanced by 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 and Fuzhou Nepstar, (these 12 entities 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 agreement among Nepstar Pharmaceutical and the Transferee Companies, the Transferee Companies are not allowed to transfer its equity interests in the Regional Companies to a third party, nor are they 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 the voting rights of the directors representing it on the Board of Directors of the Regional Companies to the directors representing Nepstar Pharmaceutical.

(c) **Organization - continued**

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 brand names 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 other suppliers of products sold by these companies' retail drugstores need to be authorized and approved by Nepstar Pharmaceutical. The purchase price to be paid by the Regional Companies to Nepstar Pharmaceutical is determined by Nepstar Pharmaceutical monthly based on latest market conditions. However, Nepstar Pharmaceutical has the right to adjust the purchase price at its sole discretion. These agreements allow a substantial portion of 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. 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.

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".

(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 of and advance to the Transferee Companies are fully eliminated upon 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 collectibility of accounts receivable, the fair values of employee share-based payment arrangements and financial instruments; and the assessment of contingent obligations. 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 these 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. The resulting exchange differences are recorded in general and administrative expenses in the consolidated statements of income. Gains and loss 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.

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.

For the convenience of the readers, the December 31, 2009 RMB amounts included in the accompanying consolidated financial statements have been translated into U.S. dollars at the rate of US\$1.00=RMB6.8259, being the noon buying rate for U.S. dollars in effect on December 31, 2009 for cable transfers in RMB per U.S. 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 U.S. dollars at that rate or at any other rate on December 31, 2009 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.

As of December 31, 2008, none of the cash or cash equivalents was restricted. Restricted cash of RMB765,000 (USD112,073) as of December 31, 2009 primarily related to short-term pledged bank deposits held by certain financial institutions, which were designated as security for the short-term bank loans and other credit facilities granted by these financial institutions (Note 13). Upon repayment of bank loans covered and the expiry of these credit facilities, the restriction will be released by the respective financial institutions.

(f) *Held-to-maturity investment securities*

Investments in debt securities in which the Group has the intent and ability to hold the securities, until maturity are classified as held-to-maturity investment securities. Held-to-maturity investment securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Interest income from the held-to-maturity investment securities is recognized when earned. Premiums and discounts, if any, are amortized or accreted over the life of the related security as an adjustment to interest income using the effective-interest method.

(g) *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 government 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 collectibility 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.

(h) *Inventories*

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average cost method. Market is the lower of replacement cost or net realizable value. 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. The provisions for inventory write-downs due to shrinkage losses and damaged merchandise for the years ended December 31, 2007, 2008 and 2009 were RMB4,097, RMB13,510 and RMB8,702, respectively, and are included in cost of goods sold.

(i) ***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 residual value. Leasehold improvements are amortized over the shorter of 5 years or the lease term of the underlying assets. The estimated useful lives of the Group's property and equipment are as follows:

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

Goodwill

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

Intangible assets

The Group's intangible assets represent favorable lease contracts acquired in business combinations (see Note 9). The favorable lease contracts are amortized over the remaining lease term.

Impairment of long-lived assets

Long-lived assets including property and equipment and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. No impairment of long-lived assets was recognized for the years ended December 31, 2007, 2008 and 2009.

Goodwill is reviewed for impairment at least annually in accordance with the provisions of FASB ASC Topic 350 "Intangibles-Goodwill and Other". The goodwill impairment test is a two-step test. Under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). If the fair value of the reporting unit is less than its carrying value, 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. Fair value of the reporting unit is determined using a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed. No impairment of goodwill was recognized for the years ended December 31, 2007, 2008 and 2009.

(j) Cost and equity method investments

Investments in the stock of an investee where 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 that are distributed from net accumulated earnings of the investee since the date of acquisition.

Investments in the stock of an investee, where the Company 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 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 Company 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.

(k) Land use right

Land use right represents the cost of right to use land in the PRC. 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.

(l) 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 carryforwards. 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.

In accordance with FASB ASC Section 740-10-25, the Group recognizes in the consolidated financial statements the impact of a tax position, if that position is more likely than not of being sustained upon examination, based on the technical merits of the position. 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, if and when required, as interest expense and a component of general and administrative expenses, respectively, in the consolidated statements of income.

(m) 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; 3) the sales price is fixed or determinable; and 4) collectibility is probable. Historically, sales return was immaterial.

The Group's revenue is 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.

(n) Government grants

Government grants are recognized in balance sheet initially when there is reasonable assurance that they will be received and the Group will comply with the relevant conditions attaching to them. Grants that compensate the Group for expenses to be incurred are recognized in other income on a systematic basis in the same periods in which the expenses are incurred.

For the years ended December 31, 2007, 2008 and 2009, government grant of nil, nil and RMB1,078, respectively, have been recognized in the consolidated statements of income to offset related costs.

(o) Advertising and promotion costs

Advertising and promotion costs are expensed as incurred. Advertising and promotion costs amounted to RMB15,962, RMB8,945 and RMB7,941, for the years ended December 31, 2007, 2008 and 2009, respectively.

(p) Store opening costs

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

(q) Vendor allowances

The Group accounts for vendor allowances according to FASB ASC Subtopic 605-50, Customer Payments and Incentives. 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 they are recognized as a reduction of the related advertising and promotion costs.

For the years ended December 31, 2007, 2008 and 2009, the Company recognized vendor allowances of RMB57,978, RMB50,439 and RMB41,072 in cost of goods sold, and nil, RMB7,088 and RMB9,753 as a reduction of advertising and promotion costs, respectively.

(r) 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. These costs are expensed as incurred and are included in sales, marketing and other operating expenses. Warehouse and buying costs amounted to RMB20,567, RMB25,228 and RMB28,175 and distribution costs amounted to RMB8,842, RMB10,912 and RMB8,224 for the years ended December 31, 2007, 2008 and 2009, respectively.

(s) 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.

(t) Retirement and other postretirement benefits

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

(u) Share-based payments

The Group accounts for share-based payments in accordance with FASB ASC Topic 718 "Compensation-Stock Compensation". Under FASB ASC Topic 718, 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. Details of the Group's share option plan are set out in Note 20.

(v) Earnings per share

Basic earnings per ordinary share is computed by dividing net income attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year using the two-class method. Under the two-class method, net income is allocated between ordinary shares and other participating securities based on dividends declared (or accumulated) and participating rights in undistributed earnings. The Company's redeemable convertible preferred shares (Note 17) were participating securities since the holders of these securities may participate in dividends with ordinary shareholders based on a pre-determined formula.

Diluted earnings per share is calculated by dividing net income attributable to ordinary shareholders as adjusted for the effect of dilutive ordinary equivalent shares, if any, by the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the year. Ordinary equivalent shares consist of the ordinary shares issuable upon the conversion of the redeemable convertible preferred shares (using the if-converted method) and ordinary shares issuable upon the exercise of outstanding share options (using the treasury stock method). Potential dilutive securities are not included in the calculation of dilutive earnings per share if the impact is anti-dilutive.

(w) 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 of the assessment can be reasonably estimated. Historically, the Group has experienced no product liability claims.

(x) ***Segment reporting***

The Group's chief operating decision maker has been identified as its Chief Executive Officer. The Group has no operating segment, as defined by FASB ASC Topic 280 "Segment Reporting". Because all of the Group's operations and customers are located in the PRC, no geographic information is presented.

(y) ***Fair value measurements***

On January 1, 2008, the Group adopted the provisions of FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("Statement 157"), included in ASC Topic 820, Fair Value Measurements and Disclosures, for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. Statement 157 defines fair value 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. ASC Topic 820 (Statement 157) also establishes a framework for measuring fair value and expands disclosures about fair value measurements.

ASC Topic 820 (Statement 157) establishes 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. ASC Topic 820 (Statement 157) 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 Company 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.

On January 1, 2009, the Group adopted the provisions of ASC Topic 820 (Statement 157) to fair value measurements of nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The initial adoption of the provisions of this standard related to nonfinancial assets and nonfinancial liabilities did not have any impact on the Company's consolidated financial statements.

The Company did not have any financial assets and liabilities or nonfinancial assets and liabilities that are measured at fair value on a recurring or nonrecurring basis as of December 31, 2008 and 2009.

(z) ***Recently issued accounting pronouncements***

On January 1, 2009, the Company adopted SFAS 141(R), *Business Combinations*, included in FASB ASC Topic 805, *Business Combination* (“ASC Topic 805”). ASC Topic 805 modifies the accounting for business combinations and requires, with limited exceptions, the acquirer in a business combination to recognize 100 percent of the assets acquired, liabilities assumed, and noncontrolling interest in the acquiree at the acquisition-date fair value. In addition, ASC Topic 805 requires the expensing of acquisition-related transaction and restructuring costs, and certain contingent acquired assets and liabilities, as well as contingent consideration, to be recognized at fair value. The initial adoption of the provisions of this standard did not have any impact on the Company’s consolidated financial statements.

On January 1, 2009, the Company adopted Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, included in FASB ASC Subtopic 810-10, *Consolidations – Overall* (“ASC Subtopic 810-10”), which requires certain changes to the presentation of the financial statements. This amendment requires noncontrolling interests (previously referred to as “minority interest”) to be classified in the consolidated statements of income as part of consolidated net earnings (RMB7,928, RMB6,494 and nil for the years ended December 31, 2007 and 2008 and 2009, respectively) and to include the accumulated amount of noncontrolling interests in the consolidated balance sheets as part of shareholders' equity (RMB23,165 and nil as of December 31, 2008 and 2009, respectively). The amount previously reported as net income is now presented as net income attributable to China Nepstar Chain Drugstore, Ltd. If a change in ownership of a consolidated subsidiary results in loss of control and deconsolidation, any retained ownership interests are remeasured with the gain or loss reported in net earnings. The Company accounted for the deconsolidation of Yunnan Nepstar in January 2009 under ASC Subtopic 810-10. See Note 11.

In May 2009, the FASB updated its guidance in FASB Statement No. 165, *Subsequent Events*, which was primarily codified into FASB ASC Topic 855, *Subsequent Events* (“ASC Topic 855”), establishing principles and requirements for subsequent events. In particular, ASC Topic 855 sets forth the period after the balance sheet date during which management shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity shall recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity shall make about events or transactions that occurred after the balance sheet date. This updated guidance is effective for interim periods ended after June 15, 2009. The adoption of ASC Topic 855 did not have a significant impact on the Company’s financial condition, results of operations or cash flows.

In June 2009, the FASB issued FASB ASC Topic 105, *Generally Accepted Accounting Principles* (“ASC Topic 105”) and established the FASB ASC, as the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related accounting literature. The FASB ASC is updated through the FASB’s issuance of Accounting Standards Updates, or ASUs. ASC Topic 105 was effective for financial statements issued for interim and annual periods ending after September 15, 2009. Its adoption did not have any impact on the Company’s consolidated financial statements.

In January 2010, the FASB released Accounting Standards Update 2010-02 (“ASU 2010-02”), *Accounting and Reporting for Decreases in Ownership of a Subsidiary - A Scope Clarification*. The ASU 2010-02 specified that the guidance in ASC Subtopic 810-10 on accounting for decreases in ownership of a subsidiary applied to a subsidiary or group of assets that constitutes a business or nonprofit activity. ASU 2010-02 is effective for the first interim or annual reporting period ending on or after December 15, 2009 for the Company and the guidance should be applied on a retrospective basis to the first period in which the Company adopted ASC Subtopic 810-10. The adoption of the provision of this standard update did not have any impact on the Company’s financial condition, results of operations or cash flows.

3 CASH, CASH EQUIVALENTS AND BANK DEPOSITS

As of December 31, 2008 and 2009, the amount of cash and cash equivalents and bank deposits by original maturity was as follows:

	December 31,	
	2008	2009
	RMB	RMB
Cash and cash equivalents	352,884	486,012
Short-term time deposits with original maturity over three months but within two years	845,000	180,000
Total current cash and bank deposits	1,197,884	666,012
Long-term time deposits with original maturity between one and two years	200,000	-

As of December 31, 2008 and 2009, the Company held US Dollar denominated bank deposits of USD11,172 and USD35,328 (equivalent to RMB76,223 and RMB241,149), respectively.

As of December 31, 2009, the interest rates of time deposits range from 2.25% to 4.41% per annum with a weighted average original maturity of 18.9 months. The Group places its cash in financial institutions with sound credit rating.

4 HELD-TO-MATURITY INVESTMENT SECURITIES

Held-to-maturity investment securities represent unquoted debt securities issued by PRC financial institutions. The principals of these debt securities are guaranteed by respective PRC financial institutions.

As of December 31, 2009, the debt securities bear fixed interest rate at 6.68% per annum, mature on January 17, 2010, and are not redeemable prior to maturity.

The fair value, carrying amount, gross unrecognized gains/(losses) and maturities of the held-to-maturity investment securities at December 31, 2008 and 2009 were as follows:

	December 31,	
	2008	2009
	RMB	RMB
Due within one year:		
Fair value	641,000	400,318
Unrecognized gain	-	318
Carrying amount	641,000	400,000
Due after one year but less than two years		
Fair value	400,750	-
Unrecognized gain	750	-
Carrying amount	400,000	-

The fair value is estimated as the present value of future cash flows, discounted at current market interest rates for similar investment securities.

5 ACCOUNTS RECEIVABLE, NET OF ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable consist of the following:

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Accounts receivable due from:		
Banks	2,931	1,181
Social security bureaus	66,232	53,985
Non-retail customers	<u>19,939</u>	<u>17,991</u>
	89,102	73,157
Less: allowance for doubtful accounts	<u>(966)</u>	<u>(596)</u>
Accounts receivable, net	<u>88,136</u>	<u>72,561</u>

The following table presents the movement of allowance for doubtful accounts for the years ended December 31, 2007, 2008 and 2009.

	December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Balance at the beginning of the year	-	897	966
Additions charged to bad debt expense for the year	897	69	-
Write-off of accounts receivable against the allowance	<u>-</u>	<u>-</u>	<u>(370)</u>
Balance at the end of the year	<u>897</u>	<u>966</u>	<u>596</u>

Historically, the amount of bad debt write-off has been immaterial and the Group has been able to collect substantially all amounts due from these parties.

6 PREPAID EXPENSES, DEPOSITS AND OTHER CURRENT ASSETS

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

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Prepaid rental	73,459	79,407
Rental deposits	7,796	872
Prepayments for purchases of merchandise	3,298	8,010
Advances to employees	8,321	3,884
Deferred tax charge on unrealized profits on inter-company sales	14,971	8,532
Store consumables and supplies	7,617	7,891
Accrued interest income	52,117	29,683
Other prepaid expenses and deposits	<u>10,775</u>	<u>5,875</u>
	<u>178,354</u>	<u>144,154</u>

7 INVENTORIES

Inventories consist of the following:

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Merchandise in stores	245,645	226,102
Merchandise in warehouses	<u>128,044</u>	<u>143,673</u>
	<u>373,689</u>	<u>369,775</u>

8 PROPERTY AND EQUIPMENT, NET

Property and equipment consist of the following:

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Store properties	10,552	10,271
Leasehold improvements	264,993	239,148
Store fixture and equipment	142,799	138,490
Software	23,983	30,676
Motor vehicles	12,722	14,293
	<u>455,049</u>	<u>432,878</u>
Less: Accumulated depreciation and amortization	<u>(214,653)</u>	<u>(228,168)</u>
	<u>240,396</u>	<u>204,710</u>

Total depreciation and amortization expense for property and equipment for the years ended December 31, 2007, 2008 and 2009 was RMB47,158, RMB60,870 and RMB61,480, respectively, of which RMB41,836, RMB55,392 and RMB55,802 was recorded in sales, marketing and other operating expenses and RMB5,322, RMB5,478 and RMB5,678 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.

9 INTANGIBLE ASSETS, NET

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Cost	3,692	3,692
Less: Accumulated amortization	<u>(1,302)</u>	<u>(2,967)</u>
	<u>2,390</u>	<u>725</u>

As of December 31, 2008 and 2009, the Group's intangible assets represented favorable lease contracts acquired in business combinations in 2008 (see Note 10). The Group amortizes these favorable lease contracts over the remaining lease term ranging from 2 to 6 years from the date of acquisition.

Amortization expense for intangible assets was RMB683, RMB1,530 and RMB1,664 for the years ended December 31, 2007, 2008 and 2009, respectively and was all included in general and administrative

expenses. Estimated amortization expenses for the years ending December 31, 2010 and 2011, 2012, 2013 and 2014 thereafter are RMB423, RMB122, RMB98, RMB75 and RMB7, respectively.

10 ACQUISITIONS

During the year ended December 31, 2008, the Group completed several business combinations in which it acquired 144 drugstores in the PRC. Upon completing each individual acquisition, the Group expects to achieve regional operational synergy and market share growth in drugstore operations. The Group accounted for these business combinations using the purchase method of accounting. The total aggregate purchase price of RMB57,987 was allocated to the identifiable assets acquired and liabilities assumed based on their fair values as of the respective acquisition dates with the excess of RMB35,177 recognized as goodwill.

During the year ended December 31, 2009, the Group completed two business combinations in which it acquired 5 stores from Beijing Zeruntong Medical Ltd. and 2 stores from Shanghai Riye Chain Co.,Ltd. in order to expand its retail store network. The Group accounted for these business combinations using the acquisition method of accounting. The total aggregate purchase price of RMB6,289 was allocated to the identifiable assets acquired and liabilities assumed based on their fair value as of the respective acquisition dates with the excess of RMB5,285 recognized as goodwill. Acquisition related costs were expensed as incurred and included in general and administrative expenses in the consolidated statements of income.

Upon completing each individual acquisition, the Group expects to achieve regional operational synergy and market share growth in drugstore operations.

A summary of the identifiable assets acquired and liabilities assumed in connection with these acquisitions are as follows:

	Year ended December 31,		A
	<u>2008</u>	<u>2009</u>	
	RMB	RMB	<i>Amortization period</i> RMB
Total aggregate purchase price	57,987	6,289	
Property, plant and equipment	7,215	159	
Inventories	10,865	159	
Prepaid rent and other current assets	1,961	686	
Intangible assets - favorable lease contracts	3,692	-	2 to 6 years
Deferred tax liability	(923)	-	
Net assets acquired and liabilities assumed	22,810	1,004	
Goodwill	35,177	5,285	

Goodwill arising from these business combinations is not deductible for income tax purpose. No pro forma financial information as if the acquisitions had occurred on January 1, 2008 and 2009 has been provided since the effect would not be material to the Group's consolidated financial condition or results of operations.

During the year ended December 31, 2009, the Group entered into definite agreements with Shanghai Riye Chain Co.,Ltd., Beijing Xiang Yun Kang Drugstore and Wenzhou Ren Ren Hao Chain Drugstore Co.,Ltd, to acquire eight, six and eight stores, respectively. These acquisitions have been approved by the investment committee of the Company. As of December 31, 2009, the acquisitions of twenty stores have not been completed. A total deposit of RMB 12,788 has been paid to the respective parties and was recorded as deposits for acquisitions in the consolidated balance sheets. As of April 15, 2010, the acquisitions of seventeen stores have been completed. The acquisitions of the remaining three stores from Shanghai Riye Chain Co., Ltd. are expected to be completed by the end of 2010.

11 EQUITY METHOD INVESTMENT

The equity method investment represents the 40% equity interest in Yunnan Nepstar, a non-public retail drugstore operating company. Upon the approval by the Company's Board of Directors on the termination of the voting interest right assignment in January 2009 (see Note 1(a)), the investment in Yunnan Nepstar was accounted for under the equity method of accounting. Upon deconsolidation, a gain of RMB 8,927 was recognized in other income in 2009. The gain was measured as the difference between a) the aggregate of the fair value of the Company's retained 40% equity interest and the carrying amount of the former 60% noncontrolling interest in Yunnan Nepstar, and b) the carrying amount of Yunnan Nepstar's assets and liabilities. The fair value of the Company's retained 40% equity interest in Yunnan Nepstar was determined using a market approach by reference to the market observable earning multiples of other comparable companies in the same industry and applying an appropriate marketability discount for illiquidity.

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. In addition, upon any payment of dividend by the Company, no withholding tax is imposed.

Hong Kong Tax

Although not incorporated in Hong Kong, the Company is considered as a Hong Kong tax resident since it is a company primarily managed and controlled in Hong Kong. The Company is subject to Hong Kong profits tax on income arising in or derived from Hong Kong. No provision for Hong Kong profits tax was made in the consolidated financial statements as the Company derived no taxable income from Hong Kong for the years ended December 31, 2007, 2008 and 2009.

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.

Prior to January 1, 2008, the Company's operating subsidiaries, all being incorporated in the PRC, are governed by the PRC income tax law and were subject to the PRC enterprise income tax rate of 33%, except for certain subsidiaries and tax paying retail store entities that are located and conduct operations in the Shenzhen Special Economic Zones and Yunnan Province, which were subject to a preferential tax rate of 15%.

On March 16, 2007, the Fifth Plenary Session of the Tenth National People's Congress passed the Corporate Income Tax Law of the PRC ("new tax law") which became effective on January 1, 2008. According to the new tax law, the statutory income tax rate is 25%. Further, from January 1, 2008, certain enterprises that were previously taxed at preferential rates are subject to a five-year transition period during which the income tax rate will gradually be increased to the unified rate of 25%. According to a notice issued by the State Council on December 26, 2007, for entities operating in the Shenzhen and Zhuhai Special Economic Zones, their applicable tax rates are 18%, 20%, 22%, 24%, and 25%, for 2008, 2009, 2010, 2011 and 2012 onwards, respectively ("the transitional rates"). Based on the above, the income tax

rate applicable to the Company's PRC subsidiaries, other than those operating in the Shenzhen and Zhuhai Special Economic Zones which are subject to the transitional rates, is reduced from 33% to 25% from January 1, 2008.

Under the new tax law and its implementation rules beginning on January 1, 2008, a withholding tax 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 exempted from withholding tax. The implementation rules provide that the withholding tax rate is 10% unless reduced by a tax treaty/arrangement. Under the Arrangement between the Mainland of China and Hong Kong Special Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, or China-HK Tax Treaty 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 qualifies for the 5% withholding tax rate pursuant to the China-HK Tax Treaty and its related regulations.

The Group's earnings before income tax expense consist of:

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
PRC	190,369	271,965	209,105
Non-PRC	<u>2,078</u>	<u>(7,803)</u>	<u>(7,955)</u>
Earnings before income tax expense	<u>192,447</u>	<u>264,162</u>	<u>201,150</u>

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

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Current tax expense	37,360	71,742	41,655
Deferred tax (benefit)/expense	<u>(1,006)</u>	<u>(6,820)</u>	<u>19,519</u>
Income tax expense	<u>36,354</u>	<u>64,922</u>	<u>61,174</u>

The reconciliation between actual income tax expense and the amount that results by applying the PRC statutory tax rate of 33% for the year ended December 31, 2007, and 25% for the years ended December 31, 2008 and 2009, to earnings before income taxes is as follows:

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Computed "expected" tax expense	63,508	66,041	50,288
Effect of tax rate differential	(33,543)	(27,145)	(7,108)
Dividend withholding taxes on undistributed earnings of PRC subsidiaries	-	9,846	7,696
Effect of deferred income tax recognized upon deconsolidation of Yunnan Nepstar	-	-	3,722
Effect of change in enacted tax rate	(680)	-	-
Non-deductible expenses:			
- Staff costs exceeding allowable limit	5,080	-	-

- Disallowed rental expenses	1,470	4,820	7,215
- Others	2,462	2,459	2,255
Non-taxable income	(941)	(1,307)	(751)
Change in valuation allowance	<u>(1,002)</u>	<u>10,208</u>	<u>(2,143)</u>
Actual income tax expense	<u><u>36,354</u></u>	<u><u>64,922</u></u>	<u><u>61,174</u></u>

12 INCOME TAXES - CONTINUED

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, 2008 and 2009 are presented below.

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Deferred tax assets:		
- Property and equipment	1,333	-
- Tax loss carryforwards	39,691	26,226
- Inventories	2,492	2,143
- Accrued expenses	1,653	1,640
- Deferred income	-	1,886
	<hr/>	<hr/>
Total gross deferred tax assets	45,169	31,895
Valuation allowance	(24,583)	(22,074)
	<hr/>	<hr/>
Total deferred tax assets, less valuation allowance	20,586	9,821
	<hr/>	<hr/>
Deferred tax liabilities:		
- Dividend withholding taxes on undistributed earnings of subsidiaries	(9,846)	(13,224)
- Equity method investment	-	(7,236)
- Intangible assets	(597)	(180)
	<hr/>	<hr/>
Total gross deferred tax liabilities	(10,443)	(20,640)
	<hr/>	<hr/>
Net deferred tax assets/(liabilities)	10,143	(10,819)
	<hr/>	<hr/>
Classification on consolidated balance sheets:		
Deferred tax assets:		
- Current	15,863	6,907
- Non-current	4,723	2,914
	<hr/>	<hr/>
Deferred tax liabilities:		
- Current	-	-
- Non-current	(10,443)	(20,640)
	<hr/>	<hr/>

For the years ended December 31, 2007, 2008 and 2009, the change in valuation allowance was a decrease of RMB7,763, an increase of RMB8,750 and a decrease of RMB2,509, respectively. The change in valuation allowance for the year ended December 31, 2009 was primarily due to the utilization of tax loss carryforwards by certain subsidiaries that generated taxable income in the year and that had previously been loss making.

12 INCOME TAXES - CONTINUED

The realization of the future tax benefits of deferred tax assets is dependent on future taxable income against which such tax benefits can be applied or utilized and the consideration of the scheduled reversal of deferred tax liabilities and any available tax planning strategies. 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. All available evidence must be considered in the determination of whether sufficient future taxable income will exist since the ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible and tax loss carryforwards are utilized. Such evidence includes, but is not limited to, the financial performance of the subsidiaries, the market environment in which these subsidiaries operate and the length of relevant carryforward periods. Sufficient negative evidence, such as cumulative net losses during a three-year period that includes the current year and the prior two years, may require that valuation allowances be established with respect to existing and future deferred tax assets. 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, 2008 and 2009. The amount 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, 2009, the tax loss carryforwards of the Group amounted to RMB106,229. The tax loss carryforwards as of December 31, 2009 expires as follows:

By year ending December 31, 2010	4,128
By year ending December 31, 2011	16,600
By year ending December 31, 2012	11,311
By year ending December 31, 2013	60,538
By year ending December 31, 2014	13,652

As of January 1, 2007 and for the years ended December 31, 2007, 2008 and 2009, the Group did not have unrecognized tax benefits, and it does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months. Accordingly, no interest and penalties related to unrecognized tax benefits were accrued.

The Company and its PRC subsidiaries file income tax returns in Hong Kong and the PRC, respectively. The tax returns of the Company are open to audit by the Hong Kong tax authority for the year beginning in 2006. 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 limitation is ten years. There is no statute of limitation in the case of tax evasion. The tax returns of the Company's PRC subsidiaries for the tax years beginning in 2004 are subject to examination by the relevant tax authorities.

13 SHORT-TERM BANK LOANS

During November 2009, certain financial institutions in the PRC granted short-term bank loans totalling RMB410,000 and credit facilities totalling RMB250,000 to the Group. As security for the loans and credit facilities, the Group is required to place time deposits amounting to RMB750,000 with these financial institutions.

As of December 31, 2009, outstanding short-term bank loans were RMB470,000. These loans were primarily obtained for general working capital purposes and bore a weighted average fixed interest rate of 4.359%. These loans mature in 2010.

14 ACCRUED EXPENSES AND OTHER PAYABLES

Accrued expenses and other payables consist of the following:

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Accrued payroll and employee benefits	45,267	47,849
Other accrued expenses (Note (a))	36,318	40,784
Payable for purchases of property and equipment	6,067	8,112
Interest payable	-	460
Deposits received (Note (b))	2,899	2,256
VAT and other taxes payable	<u>33,354</u>	<u>22,184</u>
	<u>123,905</u>	<u>121,645</u>
	=====	=====

Notes:

- (a) Amounts represent primarily accrued rental, utilities, advertising and other sundry expenses.
- (b) Amounts represent primarily deposits from non-retail customers for purchase of merchandise.

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.

On November 9, 2007, upon completion of the IPO, the Company issued 20,625,000 ADSs representing 41,250,000 ordinary shares. On November 20, 2007, the Company issued additional 3,093,750 ADSs, representing 6,187,500 ordinary shares upon exercise of over-allotment option by the underwriters.

In November 2007, all Series A redeemable convertible preferred shares were converted into 50,000,000 ordinary shares upon completion of the IPO.

For the years ended December 31, 2007, 2008 and 2009, the Company issued 640,444, 3,296,192 and 2,708,412, ordinary shares, respectively, to employees upon the exercise of vested share options.

On August 26, 2008, the Board of Directors of the Company authorized a share repurchase program ("The Program"). The Program allows the Company, from time to time and before December 27, 2009, to purchase up to USD40,000 of its outstanding ordinary shares in the form of ADS from the open market. During the years ended December 31, 2008 and 2009, the Company purchased 8,081,000 and 1,128,400 of its ordinary shares for a total purchase price of USD16,913 (equivalent to RMB116,395) and USD2,356 (equivalent to RMB16,082), respectively. As of December 31, 2008 and 2009, all of the purchased 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 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.

For the years ended December 31, 2007, 2008 and 2009, the Company's PRC subsidiaries made appropriations to these statutory reserve funds of nil, RMB29,778 and RMB9,257 respectively. The accumulated balance of the statutory reserve funds maintained at the PRC subsidiaries as of December 31, 2008 and 2009 was RMB37,848 and RMB42,754, respectively. No equivalent amounts were appropriated by the Company or at the Company's level.

17 REDEEMABLE CONVERTIBLE PREFERRED SHARES

Pursuant to a securities purchase agreement dated October 6, 2004 ("Securities Purchase Agreement"), the Company issued 30,000,000 and 20,000,000 Series A redeemable convertible preferred shares ("Series A Preferred Shares") on October 6, 2004 and December 1, 2005 to a group of third party investors at USD0.50 per share for cash of USD15,000 and USD10,000, respectively. Under the terms of the Securities Purchase Agreement, holders of the Series A Preferred Shares have the right to require the Company to redeem the shares to the extent a Qualified IPO has not occurred within 48 months after the date of issuance of the shares. A Qualified IPO is defined as a firm commitment underwritten initial public offering of the Company's ordinary shares on a stock exchange internationally recognized and duly approved by the Company's Board of Directors, that values the Company at no less than USD250,000 immediately prior to the IPO and that results in aggregate proceeds to the Company of USD50,000, net of offering costs. In the event of a redemption under this right, the Company shall redeem all of the outstanding Series A Preferred Shares at a redemption price equal to the original issue price of the shares, plus an amount which would have accrued on the original issue price at a compound annual rate of 8% from the date of issuance up to and including the date on which such redemption price is paid, plus any declared, accrued but unpaid dividends and interest thereon, proportionally adjusted for share subdivisions, share dividends, reorganizations, reclassifications, consolidations or mergers. The accretion to the redemption value is reflected as a charge against retained earnings, or in the absence of retained earnings, by a charge against additional paid-in capital and amounted to RMB15,135 for the year ended December 31, 2007.

In November 2007, all Series A Preferred Shares were converted into ordinary shares upon completion of the Company's IPO.

18 DIVIDEND

On March 18, 2008, the Board of Directors of the Company approved the payment of a cash dividend of USD0.06 per ordinary share, totaling approximately USD12,785 (equivalent to RMB90,509 at the exchange rate on March 18, 2008), to the ordinary shareholders on record as of close of business on April 10, 2008. The cash dividends, were fully paid during the year ended December 31, 2008.

On March 16, 2009, the Board of Directors of the Company approved the payment of a cash dividend of USD0.175 per ordinary share, totaling USD36,254 (equivalent to RMB247,908 at the exchange rate on March 16, 2009), to the ordinary shareholders on record as of close of business on April 16, 2009. As approved by the Board of Directors of the Company, RMB 144,571 of the dividends was paid out of additional paid-in capital. The cash dividends were fully paid during the year ended December 31, 2009.

On August 24, 2009, the Board of Directors of the Company declared a special cash dividend of USD0.75 per ordinary share, totaling USD157,164 (equivalent to RMB1,073,557 at the exchange rate on August 24, 2009), to

the ordinary shareholders on record as of close of business on September 25, 2009. 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. USD 152,027 (equivalent to RMB1,037,721 at the exchange rate on December 31, 2009) has been paid up to December 31, 2009.

19 REVENUE

Revenue by each major product categories is analyzed as follows:

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Prescription drugs	456,986	516,042	515,472
Over-the-counter drugs	696,651	863,624	818,919
Nutritional supplements	357,790	484,516	455,343
Herbal products	51,248	75,438	80,549
Other product sales	392,008	457,022	347,330
	<u>1,954,683</u>	<u>2,396,642</u>	<u>2,217,613</u>

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 subject, in certain cases, 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, 2007, 2008 and 2009, approximately 5% and 4% and 8% 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, 2007, 2008 and 2009.

20 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").

Under the Pre-IPO Option Scheme, the Grantee shall not in any way sell, transfer, charge, mortgage, encumber or create any interest (whether legal or beneficial) in favor of any third party over or in relation

to the options or enter into any agreement to do so, except for transfer solely for tax planning purpose. Any breach of the foregoing by a Grantee shall render all outstanding options of such Grantee be automatically cancelled. In the event that on or before the Listing Date, a Grantee ceases to be employed by a member of the Group for any reason, the options granted to such Grantee shall be forfeited on the date of cessation and will not be exercisable, unless the Board otherwise determines that the options will remain exercisable for an additional period which shall not extend beyond the expiration of the original option period.

Pursuant to the Pre-IPO Option Scheme, in addition to meeting the service or vesting criterion as discussed below, the exercise of the options is conditional upon meeting a performance criterion, which is the initial public offering of the Company's ordinary shares on a stock exchange internationally recognized and duly approved by the Company's Board of Directors and such offering meets a Qualified IPO (as defined in Note 17). The exercise period and life of the options expires five years after a Qualified IPO.

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 shall vest 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 allows 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 shall vest over a four year period in eight equal six-monthly installments.

The fair value of the share options granted under the Pre-IPO Option Scheme was estimated using the Black-Scholes option pricing model based on following assumptions at the date of grant:

	<i>Awards granted on August 30, 2005</i>	<i>Awards granted on March 20, 2006</i>	<i>Awards granted on September 1, 2006</i>
Expected dividend yield	0%	0%	0%
Expected volatility	39.17%	36.80%	35.19%
Risk-free interest rate	4.69%	5.26%	5.27%
Expected life (in years)	4.85	4.59	4.30
Estimated fair value of underlying ordinary shares (USD per share)	0.46	0.49	0.57

The expected volatility of the Company's ordinary shares was based on the average volatility of seven comparable companies in the drugstore industry. At the time these options were issued, the Company's ordinary shares were not listed in any exchange and therefore did not have a trading history. The Company estimated the volatility of its ordinary share price by referring to the average volatility of these comparable companies as management believed that the average volatility of such companies was a reasonable benchmark to use in estimating the expected volatility of the Company's ordinary shares.

The share-based compensation expense of pre-IPO option scheme is allocated as follows:

	December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Sales, marketing and other operating expenses	1,828	487	73
General and administrative expenses	<u>6,515</u>	<u>1,326</u>	<u>13</u>
Total share-based compensation expense	<u>8,343</u>	<u>1,813</u>	<u>86</u>

As of December 31, 2009, the Company had unrecognized share-based compensation expense of RMB102 related to unvested options issued under the Pre-IPO Scheme which is expected to be recognized over a weighted average period of six months.

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 of the 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 anniversary of the date of grant. The share options shall expire on the tenth anniversary of the date of grant.

For share options granted prior to November 9, 2007, the fair value for options was estimated at the date of the grant using the Black-Scholes option pricing model. For share options granted under the 2007 Share Incentive Plan, the fair value of each award was estimated on the date of the grant using the Binomial option pricing model. The Binomial model considers characteristics of fair value option pricing that are not available under the Black-Scholes model. Both models take into account variables such as volatility, dividend yield rate, and risk free interest rate. However, 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 which are not accounted for under the Black-Scholes model. For these reasons, the Company believes that the Binomial model provides a fair value that is more representative of actual experience and future expected experience after the Company's listing in November 2007.

The fair value of the above share options was estimated using the Binomial option pricing model based on following assumptions at the date of grant:

	<i>Awards granted on November 9, 2007</i>	<i>Awards granted on January 5, 2009</i>
Expected dividend yield	1.67%	2.54%
Expected volatility	40.74%	41.76%
Risk-free interest rate	4.23%	2.54%
Option life (in years)	10	10
Forfeiture rate	0	0
Suboptimal exercise factor	1.5	1.5

As the Company's ordinary shares have a limited trading history, the Company estimates 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 award granted on November 9, 2007 and the historical volatility of five comparable companies in the drugstore industry for a period equal to the option life for the award granted on January 5, 2009. 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 of respective grants under the 2007 Plan. The suboptimal exercise factors applied in the valuations of share options granted on November 9, 2007 and January 5, 2009 were estimated based on the early exercise behavior of employees with share options.

In connection with the share options granted under the 2007 Plan, the Company recorded share-based compensation expense of RMB364, RMB2,329 and RMB2,917 in general and administrative expenses for years ended December 31, 2007, 2008 and 2009, respectively. As of December 31, 2009, the Company had unrecognized compensation expense of RMB1,708 related to such unvested share options under the 2007 Share Incentive Plan, which is expected to be recognized over a weighted average period of one year.

A summary of the Company's option activities for the years ended December 31, 2007, 2008 and 2009 is presented below:

	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Weighted average remaining contractual term</i>	<i>Aggregate intrinsic value (USD millions)</i>
Outstanding as of January 1, 2007	8,675,000	USD0.67		
Granted	200,000	USD8.10		
Exercised	(640,444)	USD0.48		
Forfeited	(1,000)	USD0.075		
Outstanding as of December 31, 2007	8,233,556	USD0.87		
Exercised	(3,296,192)	USD0.63		
Forfeited	(34,186)	USD0.75		
Outstanding as of December 31, 2008	4,903,178	USD1.03		
Granted	600,000	USD2.40		
Exercised	(2,708,412)	USD0.72		
Forfeited	(63,200)	USD0.74		
Outstanding as of December 31, 2009	2,731,566	USD1.64	4.6 years	6.4
Exercisable as of December 31, 2009	1,074,777	USD1.63	3.5 years	2.8

The total intrinsic value of share options exercised during the years ended December 31, 2007, 2008 and 2009 was USD5,411, USD15,449 and USD6,356, respectively. The intrinsic value is calculated as the difference between the market value of shares on the date of exercise for the fiscal years and the exercise price of the shares.

The intrinsic value of share options outstanding and options exercisable is calculated as the difference between the market value of the shares as of December 31, 2009 and the exercise price of the shares.

21 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 expense in the consolidated statements of income was RMB18,274, RMB30,053 and RMB28,652 for the years ended December 31, 2007, 2008 and 2009, respectively.

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

22 EARNINGS PER SHARE

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Numerator:			
Net income attributable to China Nepstar Chain Drugstore Ltd.	148,165	192,746	139,976
Accretion to Series A redeemable convertible preferred shares redemption value	(15,135)	-	-
Undistributed earnings allocated to Series A redeemable convertible Preferred shares	<u>(29,469)</u>	<u>-</u>	<u>-</u>
Net income attributable to China Nepstar Chain Drugstore Ltd. ordinary shareholders	<u>103,561</u>	<u>192,746</u>	<u>139,976</u>
Denominator:			
Basic weighted average number of ordinary shares	128,976,023	212,984,310	208,215,802
Dilutive effect of outstanding share options	<u>1,115,817</u>	<u>5,301,941</u>	<u>2,440,018</u>
Dilutive weighted average number of ordinary shares	<u>130,091,840</u>	<u>218,286,251</u>	<u>210,655,820</u>
Basic earnings per ordinary share:	<u>0.80</u>	<u>0.90</u>	<u>0.67</u>
Diluted earnings per ordinary share	<u>0.80</u>	<u>0.88</u>	<u>0.66</u>

For purposes of computing the basis earnings per ordinary share under the two-class method, net income for the year ended December 31, 2007 has been allocated to the ordinary shares and Series A Preferred Shares based on their respective rights to share in dividends for the period from January 1, 2007 through the date of conversion of the Series A Preferred Shares as if all of the earnings for the period had been distributed.

22 EARNINGS PER SHARE - CONTINUED

During the year ended December 31, 2007, the Company's dilutive potential ordinary shares outstanding consisted of Series A Preferred Shares (for period prior to the IPO) and share options. The computation of diluted net income per share for the year ended December 31, 2007 was based on net income attributable to ordinary shareholders of RMB103,561 and included the potential dilutive effect of 8,233,556 ordinary shares issuable upon exercise of employee share options by applying treasury stock method. The computation of diluted net income per share for the year ended December 31, 2007 did not assume the conversion of Series A Preferred Shares for period prior to the actual conversion of the Series A Preferred Shares because the effect of such assumed conversion would be anti-dilutive.

During the year ended December 31, 2008, the Company's dilutive potential ordinary shares outstanding consisted of share options. The computation of diluted net income per share for year ended December 31, 2008 was based on net income attributable to ordinary shareholders of RMB192,746 and included the potential dilutive effect of 4,903,178 ordinary shares issuable upon exercise of employee share options by applying treasury stock method. The Company has no potential ordinary shares that are anti-dilutive for the year ended December 31, 2008.

During the year ended December 31, 2009, the Company's dilutive potential ordinary shares outstanding consisted of share options. The computation of diluted earnings per share for the year ended December 31, 2009 was based on net income attributable to ordinary shareholders of RMB139,976 and included the potential dilutive effect of 1,931,566 ordinary shares issuable upon exercise of employee share options by applying treasury stock method. The Company excluded 800,000 potential ordinary shares issuable upon exercise of employee share option in the calculation of diluted earnings per share for the year ended December 31, 2009, as their effect would be anti-dilutive.

23 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,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Purchases from related parties (Notes 23(a) and 23(b))	295,696	410,305	89,560
Sales to related parties (Note 23(c))	9,393	1,020	3,936
Rent of property from related parties (Note 23(d))	-	180	1,082
	December 31,		
	<u>2008</u>	<u>2009</u>	
	RMB	RMB	
Prepayments for purchase of merchandise paid to related parties (Note 23(b))	70,306	38,102	
Amounts due from related parties (Note 23(c))	7,244	7,306	
Deposits for purchases of properties paid to related parties (Note 23(e))	2,100	-	
Amounts due to related parties (Note 23(f))	64,200	12,533	

Notes:

- (a) The Group purchased merchandise from the following related parties in the normal course of business:

	Year ended December 31,		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
	RMB	RMB	RMB
Yunnan Jian Zhijia Medical Ltd. (an affiliated entity of Yunnan Nepstar)	230,896	279,900	-
Neptunus Group and its affiliates	64,800	130,405	89,560
	<u>295,696</u>	<u>410,305</u>	<u>89,560</u>

Except for the prepayments made by the Group to Shandong Neptunus Galaxy Medicine Co. Ltd and Shenzhen Neptunus Changjian Pharmaceutical Co. Ltd and its affiliates for procurement of merchandise (see Note 23(b)), 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, except for Yunnan Jian Zhijia Medical Ltd., which accounted for 20.0%, 21.4% and nil of the Group's total purchases of merchandise for the years ended December 31, 2007, 2008 and 2009, respectively.

RELATED PARTY BALANCES AND TRANSACTIONS - CONTINUED

- (b) In April 2008, the Group made total prepayments of RMB132,871 to Shandong Neptunus Galaxy Medicine Co. Ltd. and Shenzhen Neptunus Changjian Pharmaceutical Co. Ltd and its affiliates for the procurement of merchandise. China Neptunus Drugstore Holding Ltd., the controlling shareholder of the Company and Mr. Simin Zhang, Chairman of the Company's Board of Directors, have provided guarantee to the Group to indemnify damages, if any, incurred by the Group due to breach of contract by the two related party suppliers. During the year ended December 31, 2008 and 2009, the Group purchased merchandise of RMB62,565 and RMB32,204 from these two suppliers. The Group expects to utilize the remaining balance of the prepayments by the end of 2010.
- (c) In the normal course of business, the Group sold merchandise to Neptunus Group and its affiliates. As of December 31, 2008 and 2009, the amounts due from Neptunus Group and its affiliates of RMB12 and RMB3,936, respectively, related to the sale of merchandise. As of December 31, 2008 and 2009, amounts related to expenses paid by the Group on behalf of Neptunus Group and its affiliates and Yunnan Jian Zhijia Medical Ltd. were RMB7,232 and RMB3,370, respectively.
- (d) The Group rented a property from Neptunus Group and its affiliates under an operating lease arrangement entered in November 2008. The monthly rental is approximately RMB90 and the operating lease expires in November 2011.
- (e) As of December 31, 2008, deposits for purchase of properties paid to related parties in the amount of RMB2,100 represented amount paid to Yunnan Jian Zhijia Medical Ltd. for the purchase of store properties.
- (f) The balances represent amounts due to the following parties in connection with the purchase of merchandise as described in Note 23(a) above:

	December 31,	
	<u>2008</u>	<u>2009</u>
	RMB	RMB
Yunnan Jian Zhijia Medical Ltd.	60,284	-
Neptunus Group and its affiliates	3,916	12,533
	<u>64,200</u>	<u>12,533</u>
	=====	=====

24 COMMITMENTS AND CONTINGENCIES

(a) Operating lease commitments

Future minimum lease payments under non-cancelable operating lease agreements as of December 31, 2009 were as follows. The Group's leases do not contain any escalating lease payments or contingent rental payments terms.

Years ending December 31,	<i>Store premises</i> RMB	<i>Warehouses and office premises</i> RMB	<i>Total</i> RMB
2010	213,339	8,651	221,990
2011	220,036	6,652	226,688
2012	166,219	5,182	171,401
2013	83,955	3,524	87,479
2014	41,556	1,524	43,080
Thereafter	25,182	210	25,392
Total	<u>750,287</u>	<u>25,743</u>	<u>776,030</u>

The Group's rental expenses under operating leases amounted to RMB208,086, RMB317,493 and RMB323,548 for the years ended December 31, 2007, 2008 and 2009, respectively.

(b) Capital commitments

As of December 31, 2009, the Group had contractual commitments of RMB3,350 in respect of the purchase of property and equipment.

(c) Contingencies

The Company converted the net proceeds from the initial public offering into Renminbi in prior years in compliance with relevant procedural requirements of the State Administration of Foreign Exchange (SAFE). However, during the year ended December 31, 2009, the Company was informed by SAFE Shenzhen branch that, as the purposes for the conversion of the net proceeds as stated at the time of the conversion was not entirely consistent with the subsequent use of such proceeds, the SAFE may impose a monetary penalty against the Company as a result. The Company had not received any subsequent notices from the SAFE relating to such penalty and do not know, as of April 30, 2010, when such penalty may be imposed, if at all, and the amount of such penalty. In addition, the Company was not aware of other similar cases in which a monetary penalty is imposed.

25 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, accounts and other receivables, short-term bank loans, amounts due from/to related parties and accounts and other payables, approximate their fair values because of the short maturity of these instruments. The fair value of held-to-maturity investment securities, is disclosed in Note 4. The fair value of cost method equity investments and equity method investments in private enterprises in the PRC cannot be reasonably estimated without incurring excessive cost. However in the opinion of management, the estimated fair values of these investments are not significantly different from their current carrying values.

26 SUBSEQUENT EVENT

On January 5, 2010, the Company granted an aggregate of 1,000,000 options to certain executive officers. The exercise price of such options is US\$3.725 per share. The options vest and become exercisable in four equal annual installments on the first, second, third and fourth of the anniversaries of the date of grant.

On March 2, 2010, the Company granted an aggregate of 150,000 fully vested 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. The Company also granted 50,000 non-vested shares of the Company 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.

On March 3, 2010, the Company's Board of Directors approved the payment of a cash dividend of USD0.14 per ordinary share to the ordinary shareholders of record as of close of business on April 2, 2010.

NEPSTAR DRUGSTORE



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顾客满意
Customer satisfaction