海王星辰 NEPSTAR DRUGSTORE 健康药房

NPD LISTED NYSE

海王星辰健康药房
奉献健康便利的品质生活

Nepstar Chain Drugstore
Dedicated to providing high-quality, professional
and convenient pharmacy services to the Chinese market

2007 Annual Report

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LETTER FROM CHAIRMAN

Dear Shareholders,

We are excited to report that 2007 was a benchmark year for China Nepstar characterized by a strong financial performance and great momentum in executing our strategic goals. We have expanded market share, increased new store openings, developed greater financial strength through a successful IPO and continued our legacy as one of the most prominent retail pharmacy chains in China delivering high standards of service and convenience.

Market dynamics in China continue to support our growth. China's population is over 1.3 billion. With the rapidly rising standard of living, China is demonstrating strong growth in expenditures on pharmaceutical products per capita. Meanwhile, China's retail pharmacy market is still highly fragmented. By the end of 2007, there were roughly 300,000 drugstores in mainland China, with the majority of them being independently owned. During 2007, we added 556 new stores organically, growing our store network to 2,002 stores in 62 cities throughout China. This ranks China Nepstar as the number one chain in terms of the number of corporate outlets for three consecutive years.

Turning to China Nepstar's financial performance in 2007, our strong bottom-line results illustrate the success of our strategy to deliver sustained margin growth by streamlining product offerings to focus on higher margin private label and centrally-procured merchandise. During the year, we increased our portfolio of private label products to 1,356 from 1,020 at the end of 2006. Sales of private label products represented approximately 18.7% of revenue and 30.7% of gross profit for fiscal 2007. On a revenue base of RMB524.1 million (US$71.8 million) for 2007, gross profits rose 41.8% to RMB862.7 million, or US$118.3 million. Gross margin was 44.1% for the year compared with 35.1% for 2006. Including share-based compensation expenses, operating income grew 532% to RMB180.8 million, or US$24.8 million, primarily due to a substantial improvement in gross margins and store network development. Net income for 2007 increased 989.3% to RMB148.2 million, or US$20.3 million. Diluted earnings-per-share were RMB0.80 or US$0.11, or RMB1.6 or US$0.22 in diluted earnings-per-ADS compared with diluted net loss of RMB0.03 per share in fiscal year 2006.

Apart from opening new stores, we are focused on improving operating efficiencies, driving same-store sales, and making complementary acquisitions. This is evidenced by a few recently implemented programs. We are deploying an SAP-based ERP system aiming to enhance our operating efficiencies. The system will improve individual store inventory management and will enable us to better analyze and use store-level business data. We have also established a store-level promotional support program across the company. Dedicated regional branch teams are charged with promoting regional stores and developing creative in-store promotions to increase sales.

On the merger and acquisition front, in 2008, we announced two definitive acquisition agreements for 68 drugstores owned by Ningbo New Century Medical in satellite districts of Ningbo in Zhejiang Province, as well as 18 drugstores owned by DongGuan Hui Ren Tang Pharmaceutical Company in DongGuan City, Guangdong Province. Both acquisitions are in high-growth markets and are in line with our overall business development strategies. The demographics of our industry continue to support our dynamic expansion strategy, and we are working hard to ensure that China Nepstar is well positioned to take advantage of every opportunity to ensure profitable growth in the coming years.

We thank our shareholders for their continued support and look forward to another strong year in 2008. We remain committed to further strengthening our leading market position in China, accelerating market share expansion, and building shareholder value.

Sincerely,

Simin Zhang 
Chairman
China Nepstar Chain Drugstore Ltd.

PREFACE:

CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT

Unless otherwise indicated, references in this annual report 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.;
- "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 11 PRC incorporated companies that operate Nepstar drugstores in their respective regions under the trade name Nepstar;
- "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; and
- "Yunnan Nepstar" are to Yunnan Jianzhijia Chain Drugstore Ltd., our 40.0% owned consolidated subsidiary that operates our directly operated stores in Yunnan province. Yunnan Nepstar operates under the trade name Jianzhijia.

INTRODUCTION

This annual report includes our audited consolidated financial statements for the years ended December 31, 2005, 2006 and 2007 and as of December 31, 2006 and 2007.

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 operations data for the years ended December 31, 2005, 2006 and 2007 and consolidated balance sheet data as of December 31, 2006 and 2007 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The following selected consolidated statement of operations data for the year ended December 31, 2004 and consolidated balance sheet data as of December 31, 2005 have been derived from our audited consolidated financial statements, which are not included in this annual report. The following selected consolidated statement of operations data for the year ended December 31, 2003 and consolidated balance sheet data as of December 31, 2003 and 2004 have been derived from our unaudited consolidated financial statements, which are not included in this annual report. You should read the selected consolidated financial data in conjunction with our financial statements included in this annual report and "Item 5. 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,					
	2003 RMB	2004 RMB	2005 RMB	2006 RMB	2007 RMB	2007 US$
	(in thousands, except share and per share data)					
Consolidated Statement of Operations Data						
Revenue	543,125	842,862	1,313,153	1,732,433	1,954,683	267,963
Gross profit	144,870	222,984	381,180	608,212	862,672	118,262
Sales, marketing and other operating expenses(1)	(136,968)	(214,258)	(348,297)	(517,047)	(606,340)	(83,122)
General and administrative expenses(1)	(23,778)	(29,388)	(45,480)	(62,556)	(75,514)	(10,351)
(Loss)/Income from operations	(15,876)	(20,662)	(12,597)	28,609	180,818	24,789
Net (loss)/income	(14,179)	(20,822)	(17,953)	13,602	148,165	20,312
Accretion to Series A redeemable convertible preferred shares redemption value	—	(2,367)	(10,551)	(16,592)	(15,135)	(2,075)
Net (loss)/income attributable to ordinary shareholders	(14,179)	(23,189)	(28,504)	(2,990)	133,030	18,237
Net (loss)/income per share						
Basic	(0.12)	(0.20)	(0.25)	(0.03)	0.80	0.11
Diluted	(0.12)	(0.20)	(0.25)	(0.03)	0.80	0.11
Shares used in computation(2)						
Basic	115,000,000	115,000,000	115,000,000	115,000,000	128,976,023	128,976,023
Diluted	115,000,000	115,000,000	115,000,000	115,000,000	130,091,840	130,091,840

(1) The sales, marketing and other operating expenses and the general and administrative expenses in 2007 include share-based compensation expenses of RMB1.8 million (US$0.3 million) and RMB6.9 million (US$0.9 million), respectively, that were realized upon completion of our initial public offering in 2007.

(2) We issued 115,000,000 ordinary shares in August 2004 in connection with our restructuring in 2004. For the purposes of calculating basic and diluted (loss)/income per share, the number of ordinary shares used in the calculation reflects the issuance of ordinary shares as if the restructuring took place as of the beginning of the earliest period presented.

	As of December 31,					
	2003	2004	2005	2006	2007	2007
	RMB	RMB	RMB	RMB	RMB	US$
			(in thousands)			
Consolidated Balance Sheet Data						
Cash	17,606	106,899	110,851	82,996	2,168,911	297,331
Held-to-maturity investment security	—	—	—	—	600,000	82,253
Inventories	106,952	150,865	228,452	271,362	285,307	39,112
Accounts receivable, net of allowance for doubtful accounts	8,994	22,172	28,534	40,155	54,753	7,506
Total current assets	161,609	316,450	425,615	465,267	3,225,051	442,115
Property and equipment, net	55,364	81,807	121,820	146,978	172,171	23,603
Total assets	241,800	426,138	577,305	642,227	3,438,541	471,382
Accounts payable	133,829	200,242	223,292	244,034	233,425	32,000
Amounts due to related parties	6,398	10,919	52,505	55,628	50,544	6,929
Total current liabilities	178,336	257,947	352,448	399,051	464,432	63,668
Series A redeemable convertible preferred shares	—	126,388	217,940	234,532	—	—
Total shareholders' equity/(deficit)	55,906	37,590	698	(2,392)	2,955,145	405,114

Exchange Rate Information

This 2007 Annual Report contains translations of certain RMB amounts into U.S. dollar amounts at specified rates. All translations from RMB to U.S. dollar were made at the noon buying rate in The City of New York for cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York, or the noon buying rate. Unless otherwise stated, the translations of RMB into U.S. dollar have been made at the noon buying rate in effect on December 31, 2007, which was RMB7.2946 to US$1.00. 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. dollar or RMB, as the case may be, at any particular rate or at all. See "20F form 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 May 27, 2008, the noon buying rate was RMB 6.9450 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. These rates are provided solely for your convenience and are not necessarily the exchange rates that we used in this annual report or will use in the preparation of our periodic reports or any other information to be provided to you. The source of these rates is the Federal Reserve Bank of New York.

	Noon Buying Rate			
Period	**Period End**	**Average(1)**	**Low**	**High**
		(RMB per US$1.00)		
2003	8.2767	8.2772	8.2800	8.2765
2004	8.2765	8.2768	8.2771	8.2765
2005	8.0702	8.1826	8.2765	8.0702
2006	7.8041	7.9579	8.0702	7.8041
2007	7.2946	7.6072	7.8127	7.2946
November	7.3850	7.4212	7.4582	7.3800
December	7.2946	7.3682	7.4120	7.2946
2008				
January	7.1818	7.2405	7.2946	7.1818
February	7.1115	7.1644	7.1973	7.1100
March	7.0120	7.0722	7.1110	7.0105
April	6.9870	6.9997	7.0185	6.9840
May (through May 27)	6.9450	6.9780	7.0000	6.9412

(1) 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 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, 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. Each of Liping Zhou and Feng Tu is an employee of our company and a PRC citizen. 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.

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 cash of RMB2.5 million. The carrying value of our share of Medicine Shoppe's net assets was RMB2.3 million as of March 31, 2008, and the transaction is expected to be completed by end of June 2008.

BUSINESS OVERVIEW

Overview

We are the largest retail drugstore chain in China based on the number of directly operated stores. As of December 31, 2007, our store network was comprised of 2,002 directly operated drugstores located in 64 cities in China. 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, Suzhou and Kunming, in terms of store count. According to the China Drugstore Magazine, we had the highest revenue among all directly operated retail drugstore chains in China in 2005, 2006 and 2007. 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 0.5% of the total transaction value in each of these three years.

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 1,356 private label products as of December 31, 2007. Sales of our private label products accounted for 18.7% of our revenue and 30.7% of our gross profit in 2007.

Since our inception in 1995, we have rapidly expanded our operations, primarily through organic growth. The numbers of our directly operated drugstores increased from 1,115 as of December 31, 2005 to 1,446 as of December 31, 2006 and to 2,002 as of December 31, 2007. Our stores are generally located in well established residential communities and prime retail locations in major cities in China's coastal and adjoining provinces. Our revenue increased from RMB1,313.2 million in 2005 to RMB1,732.4 million in 2006 and to RMB1,954.7 million (US$268.0 million) in 2007.

Our Competitive Strengths

We believe the following competitive strengths will enable us to take advantage of the rapid growth of the drugstore industry in China:

Leading Market Position with Strong Brand Name Recognition

We are the largest retail drugstore chain in China, with a network of 2,002 directly operated stores located in 12 provinces and municipalities across China as of December 31, 2007. 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, Suzhou and Kunming, in terms of store count. We have also developed, in the course of our nationwide expansion, extensive operational expertise ranging from procurement chain, supply chain and distribution management, to merchandising and marketing and the sale of products. Furthermore, we have become familiar with consumer demand patterns and distinctive regional regulatory regimes in various regions in China. This leading market position has allowed us to achieve economies of scale from our extensive store network, thereby obtaining better pricing terms from suppliers and gaining access to a broader customer base, which in turn allow us to offer quality products and services at competitive prices. Our leading market position is further evidenced by the wide consumer recognition of our brand name, Nepstar, which we believe is one of the most recognized brand names in the PRC drugstore industry. Our strong brand name has enabled us to maintain and increase our loyal customer base, grow our high margin private label business, attract and retain good quality managers, and enhance our bargaining leverage with suppliers.

Directly Operated Business to Provide a Consistent Customer Experience

We operate all of our stores directly, which we believe is critical in building a strong brand name and offering a consistent customer experience across our store network. Moreover, we believe direct operation of our drugstores is critically important to our success in the retail drugstore chain business in China, given the highly fragmented market, the relatively small size of other retail drugstores chains and their short operating histories. Through a decade of direct operating experience, we have developed uniform standards among various aspects of drugstore operations and are able to provide a consistently high quality of services in all of our stores. Direct operation also enables us to 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.

Optimized, Diverse and High Quality Product Offerings including Private Label Products

As the largest retail drugstore chain in China, we have developed an optimized and diverse merchandise portfolio. In particular, we have rigorously analyzed a large quantity of prescription and OTC drugs available for sale in China, as well as sales data accumulated through our decade-long direct operation of drugstores, and have concluded that a much smaller quantity of active ingredients are present in a significant majority of the drugs purchased by our consumers. Moreover, we continuously review and refine our product selection and monitor product quality. In September 2005, we began introducing private label products as part of our initiative to take advantage of our brand name and to improve our profitability. We have selected a core set of 225 such manufacturers as suppliers of our private label products after reviewing product selection and quality and manufacturing, packaging, transportation and storage capabilities as well as cost competitiveness. As a result, our private label products not only provide quality, choice and convenience to our customers, but also deliver high gross margins to us. As of December 31, 2007, we have successfully developed a portfolio of 1,356 private label products. Sales of our private label products accounted for 18.7% of our revenue and 30.7% of our gross profit in 2007. We believe our private labels are particularly attractive to customers because counterfeit drugs and other counterfeit healthcare products have proliferated in China over recent years, and our brand name and reputation instill customer confidence. We believe the quality of our private label products has won trust from our customers, and we continuously monitor the quality of our products to retain that trust.

Proven Ability to Expand Rapidly While Increasing Profitability

We have expanded our store network at a rapid pace in recent years, while maintaining and increasing our gross margin. In particular, the number of our directly operated drugstores increased from 1,115 as of December 31, 2005 to 2,002 as of December 31, 2007, and our gross margin has increased from 29.0% in 2005 to 44.1% in 2007. Our rapid expansion is supported by our national distribution center located near to our headquarters in Shenzhen and 11 regional distribution centers serving our stores located in 64 cities across China. We believe our distribution centers enable us to provide effective support to our stores, cope with distinctive regional factors such as local regulatory requirements and demographics, and reduce the incremental cost of opening additional stores in cities close to our existing distribution centers. These attributes have allowed us to effectively shorten the amount of time required for us to open new stores and for new stores to become profitable. Our ability to grow nationwide is further supported by the unique attributes of our headquarters in Shenzhen, a city which is noted for a large proportion of emigrants from different regions across China. We are able to hire and train management personnel who have an intimate knowledge of local regions that we plan to enter and who are willing to relocate. All of our management personnel are trained in our headquarters in Shenzhen. We believe our ability to manage rapid expansion will further strengthen our leading market position in the drugstore industry in China.

Experienced Management Team with Proven Track Record

Over the past decade, Simin Zhang, chairman of our board of directors, and other members of our senior management team have successfully led our operations and increased our revenue and profit. Many members of our senior management team have worked with us since our inception or otherwise have broad experience in the retail industry, and have developed extensive expertise in operating a national chain of drugstores, which is important to our future success. Our Chief Executive Officer, Jiannong Qian, has extensive experience in chain store retailing, gained from his four years service with Metro AG, a leading multinational retail company headquartered in Germany, and China Resources and Wumart Corporation, both of which operate major retail chains in China. In addition, a significant portion of our mid-level managers and managers of our regional operations and stores have worked with us for many years. These managers have been trained by us through our Nepstar School of Drugstore Management and have gained significant experience in managing retail stores and distribution centers.

Our Strategies

We intend to further strengthen our position as the leading retail drugstore chain in China by implementing the following strategies:

Expand in Large and Fast-Growing Metropolitan Markets

We believe that achieving a critical mass in terms of store count, and locating stores in desirable geographic markets, are essential to competing effectively as well as maintaining and increasing our profitability. We strive to significantly expand our market presence in fast growing metropolitan markets in China by effectively leverage our existing operating infrastructure. In 2008, we plan to open approximately 1,050 new stores mainly in our existing metropolitan markets, including Shenzhen, Tianjin, Ningbo, Guangzhou and Dalian. We believe there is potential for significant additional growth in these cities as there are many under-penetrated local neighborhoods available for us to further expand our leading market share in these cities. From 2009 to 2011, we plan to focus our store development program on expanding in new metropolitan markets where we have not had a presence and where we can leverage our existing regional distribution centers and other infrastructure. Within our targeted cities, we plan to open stores in clusters in or near large residential communities to become the preferred community drugstore.

Strengthen Customer Trust and Loyalty with Effective Marketing and Promotional Programs

We believe that a strong brand name is critical to winning customers' trust in us and our products, as well as building customer loyalty and increasing customer visits to our stores. As a result, we intend to continue promoting aggressively and effectively both our brand name and our private label products. Specifically, we will continue to deploy the following marketing and promotional initiatives:

- adopting western-style category management by focusing on seasonal and cross-merchandising, and offering a wider selection of products;

- offering services that are carefully tailored to meet our customers' healthcare needs, including integrated health programs focused on health supplements, weight management, diabetes, infant care and birth control;

- enhancing our customer loyalty by organizing community-based activities and targeted promotion programs;

- using data mining techniques to tailor relevant promotional offers to our target customers, especially our loyalty members;

- enlarging the number of our promotional partners and developing additional promotional campaigns with these partners; and

- increasing advertising of our brand and private label products in selected newspapers that service our targeted cities.

Increase Private Label Product Offerings

We intend to continue expanding our private label product offerings to further improve our profitability. In particular, we plan to:

- gradually increase our assortment of private label products, especially high margin nutritional supplements and herbal products;

- continue to develop and invest in multiple private label products targeted at various product categories, geographic regions and customer groups; and

- continue offering a selection of high, medium and low price private label products within each product category in order to appeal to a broad range of customers.

We believe recent regulatory changes present us with additional opportunities to extend our range of private label products. In particular, increased restrictions have been imposed on the advertisement of drugs in recent years, which we expect to increase drug manufacturers' reliance on retail drugstores to build brand awareness among the general public. This in turn creates significant growth opportunities for us.

Upgrade our Information Management Systems and Distribution Centers

We plan to upgrade our information management systems and processes by implementing new technologies, including the installation of a retail ERP system, which will fully integrate product selection, procurement, pricing, distribution and retail management processes in line with global retailing best practices. The ERP system is expected to improve our data aggregation capabilities and facilitate our category management decisions, enabling us to fine-tune product selection, pricing, shelf space allocation and store replenishment and distribution center replenishment triggers. These improvements will yield significant benefits to us in the form of lower costs and expenses related to procurement and distribution, improved merchandise replenishment and increased real-time visibility of our inventory position, merchandise mix and product movements, leading to increases in our gross profit.

Furthermore, in order to increase operating efficiency and to accommodate future growth, we plan to build two new regional distribution centers, one in Shenzhen and one in Hangzhou, to serve our stores located in the Pearl River Delta and the Yangtze River Delta regions, where we currently have a strong market presence and plan to open a significant number of new stores. These two new distribution centers will have a total of approximately 40,000 square meters of storage space and are expected to be completed in 2009 and 2010, respectively. Upon completion, the new Shenzhen distribution center will replace our existing distribution center located in Shenzhen.

Selectively Pursue Complementary Acquisitions

We plan to selectively acquire drugstore chains or independently operated drugstores that complement our existing store network or help us to establish a presence in new markets. In particular, we plan to grow through acquisition in cities such as Beijing and Shanghai, where local regulations prohibit the opening of new drugstores within certain distances of an existing drugstore, and in cities that are close to our distribution centers in order to gain economies of scale in distribution and leverage our information technology infrastructure over a broader store base. We intend to screen acquisition opportunities by focusing on retail chains or individual stores in prime locations and with good brand names, well-developed facilities and customer bases that are complementary to ours, and which are commercially attractive. In February 2008, we entered into definitive agreement to acquire all of the 68 drugstores (including inventory and store equipment) owned by Ningbo New Century Medical Ltd. for cash consideration of RMB30.0 million (US$4.1 million). In addition, we entered into an agreement with Dongguan Hui Ren Tang Pharmaceutical Co. Ltd. to purchase all of its 18 directly operated chain drugstores in Dongguan City, Guangdong Province for a cash consideration of RMB2.3 million (US$0.3 million) in February 2008. We believe that our relationship with many industry participants and our knowledge of, and operational expertise in, the drugstore market in China will assist us in making acquisitions. We also believe that we can rapidly and successfully integrate newly acquired stores into our current distribution network and quickly realize operating and financial benefits.

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 2,002 directly operated stores as of December 31, 2007. According to the China Drugstore Magazine, we had the highest revenue among all directly operated retail drugstore chains in China in 2005, 2006 and 2007. 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 0.5% 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 throughout 12 provinces and municipalities and 64 cities. 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, Suzhou and Kunming, in terms of store count.

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 and prime retail locations in 64 cities in China where living standards and consumer purchasing power are relatively high. The following table sets forth the number of stores we owned and operated in the top ten cities that we operated as of the dates indicated:

	As of December 31,		
City	**2005**	**2006**	**2007**
Shenzhen	179	202	311
Kunming	125	152	191
Dalian	100	127	174
Guangzhou	111	123	161
Hangzhou	77	102	144
Dongguan	60	75	94
Weifang	58	74	84
Ningbo	60	73	96
Chengdu	50	60	65
Suzhou	50	54	70
Others	245	404	612
Total	1,115	1,446	2,002

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

	As of December 31,		
	2005	**2006**	**2007**
Number of stores at the beginning of the period	668	1,115	1,446
Acquired stores during the period(1)	47	9	-
Stores closed or relocated during the period	23	48	38
New stores opened during the period	423	370	594
Number of stores at the end of the period	1,115	1,446	2,002

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(1) Acquisition of stores in 2005 primarily related to our acquisition of Shandong Nepstar from an entity under the common control of the Neptunus Group. We accounted for such acquisition in a manner similar to a pooling of interest.

Our stores are typically between 80 to 120 square meters in floor area, and conduct business from 8:30 AM to 10:30 PM, seven days a week. Our stores are generally staffed with three employees per shift, including an in-store pharmacist, which 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 medicine 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 relaxed, 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 quantity 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 1,199 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 ask all prescription drug customers to 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 23.4% of our revenue in 2007.

OTC Drugs. We offer approximately 1,182 OTC drugs, including western medicines and traditional Chinese medicines, for the treatment of common diseases. Sales of OTC drugs accounted for 35.6% of our revenue in 2007.

Nutritional Supplements. We offer approximately 636 nutritional supplements, including a variety of healthcare supplements, vitamin, mineral and dietary products. According to a survey of over 8,000 households across China conducted in 2004 by China Pharmaceutical News, a newspaper sponsored by the SFDA, a majority of Chinese consumers prefer to buy nutritional supplements from a reputable drugstore as opposed to supermarkets or convenience stores. We expect sales of nutritional supplements to increase more rapidly than those of drugs due to increasing wealth and disposable income of Chinese residents living in the larger metropolitan cities, and intend to rapidly grow the variety of nutritional supplements available in our stores. Nutritional supplements normally generate higher gross margins than drugs. Sales of nutritional supplements accounted for 18.3% of our revenue in 2007.

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 margins than prescription and OTC drugs. Sales of herbal products accounted for 2.6% of our revenue in 2007.

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 consumable, cleaning agents, stationeries. 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 20.1% of our revenue in 2007.

Private Label Products

We launched our first private label product in September 2005, and since then our private label portfolio has increased to 1,356 products marketed under 133 private labels, covering all categories of products we offer except herbal products. In 2007, private label products accounted for approximately 18.7% of our revenue and 30.7% 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 “Beautiful Life,” which we introduced in November, 2005 to market nutritional supplements related to beauty care, “Qianlong,” which we introduced in January 2006 to market a variety of OTC drugs including gastrointestinal and dermatology 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 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 openings 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 charge manufacturers promotional fees in exchange for granting them the right to promote and display their products in our stores during promotional periods. 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 ongoing marketing efforts and in order to build customer loyalty, we launched our “Loyal Customer” scheme in 1999. As of December 31, 2007, this program had more than 7.0 million members, approximately 3.6 million of whom were active customers of our stores, which is 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 RMB10.0 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, and this helps us tailor our promotional programs to meet our customers' specific needs. On average, members of our loyalty scheme spend approximately 2.3 times more per sales transaction than non-member customers, and our member customers purchase more frequently from our stores than non-member customers. Sales to our member customers accounted for 53.4% of our revenue in 2007.

Our loyalty scheme membership has grown rapidly in recent years. The following table set forth the approximate number of our loyalty scheme members as of the dates indicated:

	As of December 31,		
	2005	2006	2007
		(In thousands)	
Members	2,757	4,781	7,075
Active members	1,626	2,343	3,643

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. 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. We usually arrange to deliver these newspapers to our loyalty scheme members. In selected cities, we promote our brand and products using billboards and on the passenger compartments of subway trains. In all 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 prices of products available for sale in our stores. Such advertising is not subject to the series of measures regulating the advertising of pharmaceutical products recently adopted by the PRC government.

Customers

During 2007, our stores served an average of approximately 200,000 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 also 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 constituted less than 1% of our revenue in each of 2006 and the 2007. 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, 2007, 523, or 26.1% of our stores are designated stores under the PRC national medical insurance program.

Procurement

We currently source our merchandise from approximately 3,490 suppliers, including 1,481 manufacturers and approximately 2,009 wholesalers. Among these 3,490 suppliers, approximately 2,000 of them supplied us with between one and three products. In 2007, 75.2% 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 20.0% of our total purchases in 2007. The transaction value of purchases from our largest five suppliers accounted for 27.7% of our total purchases in 2007. 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.

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 expense 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 11 regional distribution centers serving our drugstores located in 64 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 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.

In order to increase operating efficiency and to accommodate future growth, we plan to build two new distribution centers, one in Shenzhen and one in Hangzhou, to serve our stores located in the Pearl River Delta and the Yangtze River Delta regions, where we currently have a strong market presence and plan to open a significant number of new stores. Each new distribution center is expected to have approximately 20,000 square meters of storage space. The new distribution center in Shenzhen is expected to be completed in 2009 and upon completion, will replace our existing distribution center located in Shenzhen. The new distribution center in Hangzhou is expected to be completed by the end of 2010.

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

Our information management system, STARIII, was initially developed by us with the technology support provided by a software company in Taiwan in 1998. We have since continually maintained and upgraded the system, including two significant upgrades in 2001 and 2004, respectively.

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.

We have recently started to upgrade our information management and inventory control system by implementing a retail ERP system to fully integrate our merchandise selection, procurement, pricing, distribution and retail management processes in line with global retailing best practices. The project will be implemented in three phases. The first phase will cost approximately RMB35.0 million and is expected be completed by the end of 2008. We plan to spend approximately RMB50.0 million in total and expect the complete implementation of the ERP system will take approximately two years. Upon the completion of the planned upgrades, our information management system will have a national platform with regional hubs (in our major distribution centers), with an increased aggregate capacity sufficient to support the planned expansion of our store network. The information management system is also expected be able to collect and analyze more data, and provide more complete and accurate data for our management decision making.

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 financial department also carries out a daily 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 place strong emphasis on quality control for both merchandise sourcing and in-store services. Our quality control starts with procurement. As of December 31, 2007, we had 225 suppliers for our private label products. 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 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 drugstores, but also increasingly face competition from discount stores, convenience stores and supermarkets as we increase our offering of non-drug convenience products and services. We compete for customers primarily on the basis of store location, merchandise selection, our private label offerings, prices, services that we offer and our brand name. 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 individual drugstores as our major competitors, although we compete with them on an aggregate basis. Our main competitors in Shenzhen include Shenzhen Accord Pharmacy Co., Ltd. and Shenzhen Associate Pharmacy Co., Ltd.; our main competitors in Guangzhou are Guangzhou Dashenlin Chain Drugstore; and our main competitors in Dalian, Hangzhou and Ningbo are Liaoning Chengda Co., Ltd., Hangzhou Wulin Drugstore Co., Ltd. and Ningbo Siming Dayaofang Co., Ltd., respectively. 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.

The requirements for capital, brand strength and management expertise to operate a retail drugstore chain make it difficult for new entrants to enter into the drugstore industry. In addition, current PRC laws, rules and regulations effectively limit a foreign investor's ownership in retail drugstores to 49.0% if the investor owns interests in more than 30 drugstores that sell a variety of branded drugs sourced from different suppliers. This limitation, together with the complex market conditions and distinctive PRC regulations and consumer habits, has made it difficult for foreign retail drugstore chain operators to enter into the PRC market. If the PRC government removes the barriers for the foreign companies to control more than 30 drugstores in China, we could face increased competition from foreign companies. Some of our existing and potential competitors, especially foreign competitors, may enjoy competitive advantages over us, such as better information management systems, greater financial resources, operating experience and management expertise.

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 RMB706.8 million for 2008 and we have paid approximately RMB0.6 million in insurance premiums for the coverage. Furthermore, 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 SFDA. 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 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 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 national or provincial medical insurance catalogs 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. See “Item 4. Information on the Company — C. Organizational Structure.”

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 medicine products, including standards regarding staff qualifications, distribution premises, warehouses, inspection equipment and facilities, management and quality control. The GSP certificate is usually valid for five years.

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 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, there are prohibitions on the advertising of certain pharmaceutical products, and advertisement of prescription pharmaceutical products may only be made in authorized medical magazines. In addition, an approval must be obtained from the provincial level of 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' rights 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 national and provincial medical insurance catalogs 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. 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 retail prices of medicines that are subject to price controls are administered by the Price Control Office of 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 medicine that are subject to price controls. Fixed prices and price ceilings on medicine 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. Currently, approximately 2,014 pharmaceutical products are subject to price control. The price controls of all of those pharmaceutical products are administered by the NDRC.

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 NDRC regulated. 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 PRC government has been ordering reductions in the retail prices of various pharmaceutical products. The latest price reduction occurred in December 2007 and affected 47 different pharmaceutical products, none of which is sold in our stores. As of December 31, 2005, 2006 and 2007, 2.0%, 7.5% and 12.7% of the pharmaceutical products we offered were subject to price controls, respectively.

The NDRC may grant premium pricing status to certain pharmaceutical products that are under price control. The NDRC may set the retail prices of pharmaceutical products that have obtained premium pricing status at a level that is significantly higher than comparable products.

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 national or provincial medical insurance catalogs. 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 national and provincial medical insurance catalogs 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 are used for specifically stated purposes in the medical insurance catalogs. 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 medical insurance catalogs 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 medicine 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 provincial medical insurance catalogs. 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 the provincial medical insurance catalogs. 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 caps of reimbursements in excess of the amounts in the individual accounts.

Sales of Nutritional Supplements and other Food Products

According to the PRC Food Hygiene Law and Rules on Food Hygiene Certification, a distributor of nutritional supplements and other food products must obtain a food hygiene certificate from relevant provincial or local health regulatory authorities. The grant of such certificate is subject to an inspection of the distributor’s facilities, warehouses, hygienic environment, quality control systems, personnel and equipment. The food hygiene certificate is valid for four years, and the holder must apply for renewal of the certificate within six months prior to its expiration.

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 2006, 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 accumulative amount of such reserve reaches 50% of its respective registered capital. These reserves are not distributable as cash dividends. As of December 31, 2007, the accumulated balance of our statutory reserve funds reserves amounted to RMB8.1 million (US$1.1 million) and the accumulated profits of our consolidated PRC entities that were available for dividend distribution amounted to RMB70.0 million (US$9.6 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. We currently operate one national distribution center located near our headquarters and 11 regional distribution centers with a combined total of approximately 43,463 square meters of space. We lease all of our distribution centers for various terms ranging from one year to 10 years. To support our continued expansion, we plan to establish two new distribution centers, one in Shenzhen and one in Hangzhou, to serve the Peal river and Yangtze river delta regions, where a significant portion of our stores are located and where we plan to open a significant number of new stores in the next few years. We plan to spend approximately US$27.4 million to construct the two new distribution centers. Each of the two new distribution centers will have approximately 20,000 square meters of storage space and is expected to be completed in 2009 and 2010, respectively. Upon completion, the new Shenzhen distribution center will replace our existing distribution center located in Shenzhen. We believe that there will be no significant difficulties for us to locate suitable distribution centers and enter into new leases on acceptable terms. We also do not expect any significant difficulties in renewal of existing leases upon their expiration, where desired.

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, 2007, 328 leases (covering an aggregate gross floor area of approximately 38,269 square meters, equivalent to approximately 18.2% 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, 2007, we had 2,029 leased properties with an aggregate gross floor area of approximately 272,543 square meters. Approximately [1.0]% of these leased properties had defects in their legal titles. Out of the total floor area of properties with defects in their legal titles, approximately 3,426 square meters were used as drugstores, equivalent to approximately 2.0% of the total gross floor area of our drugstores.

OPERATING RESULTS

Overview

Since our inception in 1995, we have rapidly expanded our operations, primarily through organic growth. Our directly operated drugstores increased from 1,115 as of December 31, 2005, to 1,446 as of December 31, 2006 and 2,002 as of December 31, 2007. According to the China Drugstore Magazine, we had the highest revenues in 2005 and 2006 and 2007 among all directly operated retail drugstore chains in China, and 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, Suzhou and Kunming, in terms of store count. Our revenue increased from RMB1,313.2 million in 2005, to RMB1,732.4 million in 2006 and to RMB1,954.7 million (US$268.0 million) in 2007, representing an increase of 12.8% from 2006 to 2007.

The increase in private label product sales was a significant factor attributing to the increases in our gross margin since late 2005. Other factors attributable to the increases in our gross margin included our centralization of procurement and increased economies of scale realized by our large network of retail stores. Our gross margin, which was calculated as the difference between our revenue and cost of goods sold as a percentage of our revenue, increased from 29.0% in 2005, to 35.1% in 2006 and to 44.1% in 2007.

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 continued growth of the drugstore industry in China;
- our ability to expand our drugstore network;
- our ability to optimize product offerings and increase 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 Continued Growth of the Drugstore Industry in China

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, and this trend is expected to continue. 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 from 2005 to 2007. We believe there is a significant potential for our future growth.

Moreover, recent regulatory changes in China are expected to drive the growth of drug sales at retail drugstores. 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. We expect these and other regulatory changes to foster the growth of retail pharmacies, and thus 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 Expand Our Drugstore Network

We earn our revenue primarily from the sale of products, including our own private label products, carried by our drugstores. 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. The following table sets forth certain information with respect to our stores for the periods indicated:

	Year Ended December 31,		
	2005	2006	2007
Number of stores at the beginning of the year	668	1,115	1,446
Number of stores at the end of the year	1,115	1,446	2,002

We believe that store location is an important factor driving our average store sales. We establish stores in clusters in well-developed cities in China's coastal and adjoining provinces. Within each major city, we locate our stores in well-established residential communities and prime retail locations. 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.

For our drugstores that had been opened for at least 12 months at the beginning of each year, the average daily revenue per store decreased from RMB5,075 in 2005, to RMB4,586 in 2006 and to RMB3,947 (US$541.1) in 2007. The decrease in the average daily revenue per store was primarily due to our continued opening of stores at new locations, which resulted in an increasingly larger proportion of stores that had been opened for less than 24 months. As a general matter, it takes about three years for sales growth of a new store to approach maturity, and the high proportion of stores that were still in the growing stage lowered the average daily revenue per store in 2005, 2006 and 2007.

The following table sets forth the number of drugstores and our daily average revenue per store with respect to our stores that have opened more than 12 months at the beginning of each period:

	2005		2006		2007	
	Number of Drugstores	Daily Average Revenue per Store	Number of Drugstores	Daily Average Revenue per Store	Number of Drugstores	Daily Average Revenue per Store
Opened prior to December 31, 2003	406(1)	5,075	406	4,990	406	4,819
Opened prior to December 31, 2004			668(2)	4,586	668	4,553
Opened prior to December 31, 2005					1,115(3)	3,958

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(1) Include the 218 drugstores opened prior to December 31, 2002.

(2) Include the 406 drugstores opened prior to December 31, 2003.

(3) Include the 668 drugstores opened prior to December 31, 2004.

Our Ability to Optimize Product Offerings and Increase 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,					
	2005		2006		2007	
	RMB	% of Revenue	RMB	% of Revenue	RMB	% of Revenue
	(in thousands, except percentages)					
Prescription drugs	286,811	21.8%	410,953	23.7%	456,986	23.4%
OTC drugs	491,740	37.5	623,276	36.0	696,651	35.6
Nutritional supplements	248,541	18.9	311,599	18.0	357,790	18.3
Herbal products	28,999	2.2	35,366	2.0	51,248	2.6

Other products(1)	257,062	19.6	351,239	20.3	392,008	20.1
Total	1,313,153	100.0%	1,732,433	100.0%	1,954,683	100.0%

(1) Include 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 achieve high gross margins from our product sales. As a result, we continuously review and refine our product offerings to respond to changing demographics, lifestyles, habits and preferences of customers. We also seek to focus our product offerings on drugs that contain the ingredients that we believe, based upon our analysis of a large quantity of drugs available for sale in China, drive consumer demand.

We generate a substantial portion of our revenue from sales of prescription drugs and OTC drugs. Sales of prescription drugs accounted for 23.4% of our revenue in 2007, while sales of OTC drugs accounted for 35.6% of our revenue in 2007. Going forward, we plan 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 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 1,356 products marketed using 133 private labels as of December 31, 2007, covering all categories of products we offer except herbal products. To develop our private label products, we have obtained rights to use an aggregate of 545 trademarks from the Neptunus Group and its affiliates, including 17 registered trademarks that we have obtained exclusive rights to use, 23 registered trademarks that we have obtained non-exclusive rights to use, and 505 trademarks that are in the process of being registered by subsidiaries of the Neptunus Group, of which we have been granted the exclusive rights to use 239 and the non-exclusive rights to use 266, upon completion of the registration of the respective trademarks. In 2007, private label products accounted for approximately 18.7% of our revenue and 30.7% of our gross profit. 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, 2007	
	Revenue from Private Label Products (In thousands of RMB)	**Private Label Revenue as % of Our Revenue**
Prescription drugs	54,379	2.8%
OTC drugs	136,386	7.0%
Nutritional supplements	97,335	5.0%
Herbal products	-	-
Others(1)	77,250	3.9%
Total(2)	365,350	18.7%

(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 plan to continue 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. In 2007, we sourced our merchandise from approximately 3,490 suppliers, including

2,000 suppliers who supplied us with between one and three products. The transaction value of purchases from our largest supplier accounted for 20.0% of our total purchases in 2007. The transaction value of purchases from our largest five suppliers accounted for 27.7% of our total purchases in 2007.

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 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 including the prices of competitive drugs and the expected marketing expenditures.

A portion of the medicines sold in our stores, primarily those included in the national or provincial medical insurance catalogs, 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 24 times. The latest price reduction occurred in December 2007 and affected 47 different pharmaceutical products, none of which is sold in our stores. As of December 31, 2005, 2006 and 2007, 2.0%, 7.5% and 12.7% of the pharmaceutical products we offered were subject to price controls, respectively. In 2005, 2006 and 2007, approximately 2.1%, 3.1% and 4.9% of our revenue was derived from sales of pharmaceutical products that are subject to price controls, respectively. 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 scheme. 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,		
	2005	2006	2007
Sales, marketing and other operating expenses	26.5%	29.9%	31.0%
General and administrative expenses	3.5	3.6	3.9
Total operating expenses	30.0%	33.5%	34.9%

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, 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. 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 store network. However, we plan to maintain our sales, marketing and other operating expenses in line with our growth in revenue.

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.

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, decreased from an average of 39 days in 2006 to 35 days in 2007. As part of our efforts to continue to reduce the amount of time required to open new stores as well as for new stores to become profitable, we have developed uniform standards and streamlined our store operations through centralized management.

- *Sufficient Inventory Levels.* We must maintain sufficient inventory levels to meet our customers' needs on one hand, and to guard against the risk of accumulating excess inventory on the other hand. 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 2005, 2006 and the 2007, 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 74 days, 81 days and 93 days, respectively. The increases in inventory turnover days over the period were caused by higher inventory levels for some of our newly introduced private label products, as their initial sales volumes were relatively small and we had to purchase enough quantity of such products to comply with the minimum quantity requirements by our suppliers when we place a purchase order. We expect our inventory turnover days to decrease as we continue to increase centralized procurement, increase our sales volume and upgrade our information management systems and logistic processes.

- *Warehousing Costs.* We depend on our distribution centers to provide effective support to our stores, cope with distinctive regional factors such as local regulatory requirements and demographics, and reduce the incremental cost of opening additional stores in cities close to our existing distribution centers. We currently have one national distribution center located close to our headquarters in Shenzhen and 11 regional distribution centers serving our stores located in 64 cities across China. We plan to spend approximately RMB200.0 million (US$27.4 million) to build two new distribution centers, one in Shenzhen and one in Hangzhou to serve our stores located in the Pearl River Delta and the Yangtze River Delta regions, respectively, where we currently have a strong market presence and plan to open a significant number of new stores. We expect depreciation, which is included in our sales, marketing and other operating expenses, to increase significantly upon completion of the new distribution centers in Shenzhen and Hangzhou in 2009 and 2010, respectively.

Recent Acquisitions

In February 2008, we entered into definitive agreement to acquire all of the 68 drugstores (including inventory and store equipment) owned by Ningbo New Century Medical Ltd. for cash consideration of RMB30.0 million (US$4.1 million). In addition, we entered into an agreement with Dongguan Hui Ren Tang Pharmaceutical Co. Ltd. to purchase all of its 18 directly operated chain drugstores in Dongguan City, Guangdong Province for a cash consideration of RMB2.3 million (US$0.3 million) in February 2008. We have taken over the operations of the acquired stores in March 2008. The cost of acquisitions is less than 1.0% of our total assets as of December 31, 2007 and is immaterial to our company.

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 Chinese New Year falls in the first quarter of each year and our customers generally pay fewer visits to drugstores during this period. In addition, sales of some health and beauty products are driven, to some extent, by seasonal purchasing patterns and seasonal product changes. We may be unable to manage the increased sales effectively in the high sales season, and increases in inventory in anticipation of sales increase could negatively affect our cash flow.

Taxation

The recently enacted PRC Enterprise Income Tax Law, or the EIT Law, and the implementation regulations for the EIT Law issued by the PRC State Council, became effective as of January 1, 2008. The EIT 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 EIT 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, it is unclear whether PRC tax authorities would treat us as a PRC resident enterprise.

Under the EIT Law and implementation regulations, PRC income tax at the rate of 10% 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. We derive substantially all of our revenue and income from our operations in China; therefore, if we are treated as a “non-resident enterprise” for PRC tax purposes, dividends paid by our PRC subsidiaries to us will be subject to the 10% PRC income tax.

Our operating subsidiaries including the regional Nepstar companies, all being incorporated in the PRC, were subject to the PRC enterprise income tax rate of 33% for periods prior to January 1, 2008, except for certain subsidiaries and tax paying retail store entities located and conducting operations in the Shenzhen and Zhuhai Special Economic Zones and the Yunnan Province in the PRC, which were subject to a preferential tax rate of 15%. Under the implementation rules of the EIT law, companies that enjoyed preferential income tax rates prior to January 1, 2008 have a 5-year period to transition to the 25% uniform tax rate. In particular, companies that were subject to a tax rate of 15% will be subject to tax rates of 18%, 20%, 22%, 24% and 25% in 2008, 2009, 2010, 2011 and 2012, respectively. Accordingly, our operating subsidiaries and retail store entities in Shenzhen that were subject to 15% income tax rate in 2007 will be subject to 18% income tax rate in 2008. Yunnan Nepstar may enjoy an income tax rate of 15%, subject to annual review and approval of tax authority, until 2010 under the PRC policy to encourage development in Western China. Our subsidiaries outside of Shenzhen and Yunnan 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 statement of operations 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; (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.

Share-Based Compensation

We account for share-based compensation in accordance with SFAS No. 123R, under which we are required to measure the fair value of employees share options on the date of the option grant, and recognize shared-based compensation expense in our consolidated statements of operations over the period during which an employee is required to provide service in exchange for the award, which is generally the vesting period. In connection with the Pre-IPO Option Scheme, we granted 1,000,000 options, 6,680,000 options, 1,000,000 options and 200,000 options on August 30, 2005, March 20, 2006, September 1, 2006, and November 9, 2007, respectively. The exercise price was US$0.075 per share for options granted on August 30, 2005, US$0.75 per share for options granted on March 20, 2006 and September 1, 2006 and US$8.10 for the options granted on November 9, 2007. With respect to the options granted on August 30, 2005, 25.0% of which 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 which vested immediately on the respective dates of grant and the remaining 75.0% of the options shall vest over a four year period in eight equal six-monthly installments. With respect to the options granted on November 9, 2007, the options will vest and become exercisable in three equal annual installments on the first, second and third anniversaries of the date of grant.

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 is, at least partly, outside of our control, no share-based compensation expenses were recorded in 2005 and 2006 in accordance with

SFAS No. 123R. We recorded share-based compensation expense for these options of RMB8.3 million in the year ended December 31, 2007 as the qualified initial public offering performance condition was met. The recognized share-based compensation expenses was allocated to sales, marketing and other expenses and general and administrative expenses in the amounts in the amounts of RMB1.8 million and RMB6.9 million, respectively. As of December 31, 2007, we had unrecognized share-based compensation expense of RMB2.1 million related to unvested options issued under the Pre-IPO Scheme which is expected to be recognized over a weighted average period of 1.5 years.

We determined the fair value of employee share options granted under the Pre-IPO 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

In connection with the share options granted in November, 2007, the exercise price of which is the same as our IPO price, we recorded share-based compensation expense of RMB0.4 million in general and administrative expenses in the year ended December 31, 2007. As of December 31, 2007, we had unrecognized compensation expense of RMB3.9 million related to such unvested share options which is expected to be recognized over a weighted average period of 1.9 years.

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

Expected dividend yield	1.67%
Expected volatility	40.74%
Risk-free interest rate	4.23%
Expected life (in years)	3.8-5.8

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 2005, 2006 and 2007.

Impairment of Long-Lived Assets

We evaluate long-lived assets, including property and equipment and intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We assess recoverability by comparing the carrying amount of an asset to the estimated undiscounted future cash flow expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, we recognize an impairment charge based on the amount by which the carrying amount of the asset exceeds the fair value of the asset. We estimate the fair value of the asset based on the best information available, including prices for similar assets and in the absence of an observable market price, the results of using a present value technique to estimate the fair value of the asset. We recognized no impairment charges on our long-lived assets in 2005, 2006 and 2007.

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, can be returned to the suppliers in exchange for new batches of products. Our inventory write-downs due to shrinkage losses and damaged merchandise in 2005, 2006 and 2007 were RMB1.5 million, RMB2.8 million and RMB4.1 million (US$0.6 million), respectively.

Results of Operations

The following table sets forth a summary of our statements of operations 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,					
	2005		2006		2007	
	RMB	% of Revenue	RMB	% of Revenue	RMB	% of Revenue
	(In thousands, except percentages and per share data)					
Revenue	1,313,153	100.0%	1,732,433	100.0%	1,954,683	100.0%
Cost of goods sold	(931,973)	(71.0)	(1,124,221)	(64.9)	(1,092,011)	(55.8)
Gross profit	381,180	29.0	608,212	35.1	862,672	44.1
Operating expenses:						
Sales, marketing and other operating expenses (1)	(348,297)	(26.5)	(517,047)	(29.9)	(606,340)	(31.0)
General and administrative expenses (1)	(45,480)	(3.5)	(62,556)	(3.6)	(75,514)	(3.9)
(Loss)/Income from operations	(12,597)	(1.0)	28,609	1.6	180,818	9.3
Net interest income(2)	1,145	0.1	1,020	0.1	10,552	0.5
Investment income/(loss)(3)	(428)	—	1,006	0.1	1,077	0.1
Income taxes	(4,881)	(0.4)	(12,705)	(0.7)	(36,354)	(1.9)
Minority interests	(1,192)	(0.1)	(4,328)	(0.3)	(7,928)	(0.4)
Net (loss)/income	(17,953)	(1.4)	13,602	0.8	148,165	7.6
Accretion to Series A redeemable convertible preferred shares redemption value	(10,551)	(0.8)	(16,592)	(1.0)	(15,135)	(0.8)
Net (loss)/income attributable to ordinary shareholders	(28,504)	(2.2)%	(2,990)	(0.2)%	133,030	6.8%
Net (loss)/income per share						
Basic	(0.25)		(0.03)		0.80	
Diluted	(0.25)		(0.03)		0.80	

(1) The sales, marketing and other operating expenses and the general and administrative expenses in 2007 include share-based compensation expenses of RMB1.8 million (US$0.3 million) and RMB6.9 million (US$0.9 million), respectively, that were realized upon completion of our initial public offering in 2007.

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

(3) Investment income/(loss) includes "dividend income from cost method investments" and "gain/(loss) on disposal of cost method investments" set forth in our consolidated financial statements included elsewhere in this annual report.

Comparison Of Years Ended December 31, 2006 And December 31, 2007

Revenue. Our revenue increased by 12.8% to RMB1,954.7 million (US$268.0 million) in 2007 from RMB1,732.4 million in 2006. This increase was primarily due to higher sales of products we carry as a result of the continued increase in the number of our drugstores. The number of our directly operated drugstores increased to 2,002 as of December 31, 2007 from 1,446 as of December 31, 2006. Our average daily revenue per store for drugstores opened for at least 12 months at the beginning of each year decreased to 3,947 (US$541.1) in 2007 from RMB4,586 in 2006. The decrease was primarily due to changes in product portfolio and our continued opening of stores at new locations in 2007, which resulted in an increasing proportion of stores that had been opened for less than 24 months. Generally, it takes about three years for sales growth of a new store to approach maturity, and the high proportion of stores that were still in the growing stage lowered the average daily revenue per store.

We generated a substantial portion of our revenue from sales of prescription drugs and OTC drugs in both 2006 and 2007. Sales of OTC drugs accounted for 36.0% and 35.6% of our revenue in 2006 and 2007, respectively, and sales of prescription drugs accounted for 23.7% and 23.4% of our revenue in 2006 and 2007, respectively. Going forward, we plan 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. Sales of private label products as a percentage of our revenue increased to 18.7% in 2007 from 17.5% in 2006.

Gross Profit. Our gross profit increased by 41.8% to RMB862.7 million (US$118.3 million) in 2007 from RMB608.2 million in 2006. Our gross margin increased to 44.1% in 2007 from 35.1% in 2006. 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. In 2007, private label products accounted for 18.7% of our revenue and 30.7% of our gross profit. Private label products generally command higher margins than their third party branded equivalents. This is because 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. The increase of our gross margin was also a result of our refined product selection, which included a higher percentage of high gross margin 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 retail stores.

Operating Expenses. Our operating expenses increased by 17.6% to RMB681.9 million (US$93.5 million) in 2007 from RMB579.6 million in 2006. Operating expenses as a percentage of our revenue increased to 34.9% in 2007 from 33.5% in 2006.

- ***Sales, Marketing and Other Operating Expenses.*** Our sales, marketing and other operating expenses increased by 17.3% to RMB606.3 million (US$83.1 million) in 2007 from RMB517.0 million in 2006. This increase was primarily due to increased salaries and bonus payments in connection with increased headcount as a result of the continued expansion of our drugstores. Salaries and bonuses paid to our in-store pharmacists and other store and distribution center staff increased by 25.8% to RMB263.2 million (US$36.1 million) in 2007 from RMB209.3 million in 2006. The increase in sales, marketing and other operating expenses was also due largely to 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. Rental and utility expenses for our stores and distribution centers increased by 17.2% to RMB239.4 million (US$32.8 million) in 2007 from RMB204.2 million in 2006. Depreciation for store and distribution center leasehold improvements and store equipment increased by 5.6% to RMB41.8 million (US$5.7 million) in 2007 from RMB39.6 million in 2006. Sales, marketing and other operating expenses as a percentage of our revenue increased to 31.0% in 2007 from 29.8% in 2006. This increase was primarily due to our continued opening of stores at new locations, which typically require a period of time to develop customer base and generate sufficient revenue to become profitable, and increased sales of private label products, which generally have lower sales prices than the equivalent third party branded products. We expect that our sales, marketing and other operating expenses will increase as we continue to expand our store network, set up new distribution centers and upgrade our information management and inventory control system. However, we expect that revenue generated from our new stores will be sufficient to cover these additional costs.

- ***General and Administrative Expenses.*** Our general and administrative expenses increased by 20.7% to RMB75.5 million (US$10.4 million) in 2007 from RMB62.6 million in 2006. This increase was primarily due to the recognition of RMB6.9 million share based compensation expenses upon completion of our initial public offering and an increase of RMB6.6 million on audit and audit related fees. General and administrative expenses as a percentage of our revenue increased to 3.9% in 2007 from 3.6% in 2006.

Income from Operations. As a result of the foregoing, our income from operations increased significantly to RMB180.8 million (US$24.8 million) in 2007 from RMB28.6 million in 2006. Our operating margin increased to 9.3% in 2007 compared to 1.6% in 2006.

Net Interest/Income. Our net interest income increased significantly to RMB10.6 million (US$1.4 million) in 2007 from RMB1.0 million in 2006. This increase was principally a result of the interest income on the cash raised in our initial public offering. The average balance of our cash in interest-bearing savings accounts increased to RMB2,758.5 million (US$378.2 million) in 2007 from RMB76.6 million in 2006.

Net Investment Income. Our investment income which represents dividends received from our investments in companies that we do not exercise significant influence over their operations and financial policies increased to RMB1.1 million (US$0.1 million) in 2007 from RMB1.0 million in 2006.

Income Taxes. Our income tax expense increased to RMB36.4 million (US$5.0 million) in 2007 from RMB12.7 million in 2006. Our effective tax rate decreased from 41.5% in 2006 to 18.9% in 2007. The decrease of our effective tax rate in 2007 was primarily due to a decrease in the effect of non-tax deductible staff costs and rental expenses. The decrease of our effective tax rate was also due to the magnitude of increase in valuation allowance in 2006 against certain deferred tax assets that we did not expect the benefits to be realizable. We did not experience such increase in valuation allowance in 2007. The above effects were partially offset by lower proportion of our PRC subsidiaries' profits being subject to favorable tax rates in 2007.

Minority Interests. Our minority interests increased to RMB7.9 million (US$1.1 million) in 2007 from RMB4.3 million in 2006. This increase was mainly due to an increase of Yunnan Nepstar's after-tax profit attributable to minority shareholders.

Net Income. As a result of the foregoing, our net income increased to RMB148.2 million (US$20.3 million) in 2007 from RMB13.6 million in 2006.

Accretion to Series A Redeemable Convertible Preferred Shares Redemption Value. Accretion to Series A redeemable convertible preferred shares redemption value was RMB15.1 million (US$2.1 million) in 2007 compared to RMB16.6 million in 2006. The decrease was largely due to the conversion of Series A redeemable convertible preferred shares into ordinary shares upon our initial public offering in November 2007.

Net (Loss)/Income Attributable to Ordinary Shareholders. As a result of the foregoing, we had a net income attributable to ordinary shareholders of RMB133.0 million (US$18.2 million) in 2007 compared to a net loss of RMB3.0 million in 2006.

Comparison of Years Ended December 31, 2005 and December 31, 2006

Revenue. Our revenue increased by 31.9% to RMB1,732.4 million in 2006 from RMB1,313.2 million in 2005. This increase was primarily due to higher sales of products we carry as a result of the continued increase in the number of our drugstores. The number of our directly operated drugstores increased to 1,446 as of December 31, 2006 from 1,115 as of December 31, 2005. Our average daily revenue per store for drugstores opened for at least 12 months at the beginning of each year decreased to RMB4,586 in 2006 from RMB5,075 in 2005. The decrease was primarily due to our continued opening of stores at new locations in 2006, which resulted in an increasing proportion of stores that had been opened for less than 24 months.

We generated a substantial portion of our revenue from sales of prescription drugs and OTC drugs in both 2005 and 2006. Sales of OTC drugs accounted for 37.5% and 36.0% of our revenue in 2005 and 2006, respectively, and sales of prescription drugs accounted for 21.8% and 23.7% of our revenue in 2005 and 2006, respectively. Sales of private label products as a percentage of our revenue increased to 17.5% in 2006 from 1.5% in 2005.

Gross Profit. Our gross profit increased by 59.5% to RMB608.2 million in 2006 from RMB381.2 million in 2005. Our gross margin increased to 35.1% in 2006 from 29.0% in 2005. The increase in our gross margin was primarily due to an increase in private label product sales as a percentage of our revenue. We launched our first private label product in September 2005. In 2006, private label products accounted for 17.5% of our revenue and 34.6% of our gross profit. Private label products generally command higher margins than their third party branded equivalents. This is because 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. The increase of our gross margin was also a result of our refined product selection, which included a higher percentage of high gross margin 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 retail stores.

Operating Expenses. Our operating expenses increased by 47.2% to RMB579.6 million in 2006 from RMB393.8 million in 2005. Operating expenses as a percentage of our revenue increased to 33.5% in 2006 from 30.0% in 2005.

- ***Sales, Marketing and Other Operating Expenses.*** Our sales, marketing and other operating expenses increased by 48.4% to RMB517.0 million in 2006 from RMB348.3 million in 2005. This increase was primarily due to increased salaries and bonus payments in connection with increased headcount as a result of the continued expansion of our drugstores. Salaries and bonuses paid to our in-store pharmacists and other store and distribution center staff increased by 53.7% to RMB209.3 million in 2006 from RMB136.1 million in 2005. The increase in sales, marketing and other operating expenses was also due largely to 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. Rental and utility expenses for our stores and distribution centers increased by 46.1% to RMB204.2 million in 2006 from RMB139.8 million in 2005. Depreciation for store and distribution center leasehold improvements and store equipment increased by 46.2% to RMB39.6 million in 2006 from RMB27.1 million in 2005. Sales, marketing and other operating expenses as a percentage of our revenue increased to 29.9% in 2006 from 26.5% in 2005. This increase was primarily due to our continued opening of stores at new locations, which typically require a period of time to develop customer base and generate sufficient revenue to become profitable, and increased sales of private label products, which generally have lower sales prices than the equivalent third party branded products.

- ***General and Administrative Expenses.*** Our general and administrative expenses increased by 37.5% to RMB62.6 million in 2006 from RMB45.5 million in 2005. This increase was primarily due to increases in salaries and bonus payments resulting from an increase in management and administrative personnel. Salaries and bonuses paid to management and administrative personnel increased by 49.2% to RMB39.4 million in 2006 from RMB26.4 million in 2005. General and administrative expenses as a percentage of our revenue increased to 3.6% in 2006 from 3.5% in 2005.

(Loss)/Income from Operations. As a result of the foregoing, we had income from operations of RMB28.6 million in 2006 compared to loss from operations of RMB12.6 million in 2005. Our operating margin was 1.6% in 2006 compared to negative 1.0% in 2005.

Net Interest/Income. Our net interest income decreased by 10.9% to RMB1.0 million in 2006 from RMB1.1 million in 2005. This decrease was principally a result of decreased average balance of our cash in interest-bearing savings accounts as we spent additional net proceeds we received from the issuance of Series A redeemable convertible preferred shares in opening new stores in 2006. The average balance of our cash in interest-bearing savings accounts decreased to RMB76.6 million in 2006 from RMB87.7 million in 2005.

Investment (Loss)/Income. We had dividend income of RMB1.0 million in 2006 from our investments in companies that we do not exercise significant influence over their operations and financial policies. We incurred an investment disposal loss of RMB0.4 million in 2005.

Income Taxes. Our income tax expense increased to RMB12.7 million in 2006 from RMB4.9 million in 2005. Our effective tax rate changed from negative 41.1% in 2005 to 41.5% in 2006 primarily due to an increase in the deferred tax asset valuation allowance for tax loss carry forwards that we do not expect the benefits will be realized.

Minority Interests. Our minority interests increased to RMB4.3 million in 2006 from RMB1.2 million in 2005. This increase was mainly due to an increase of Yunnan Nepstar's after-tax profit attributable to minority shareholders.

Net (Loss)/Income. As a result of the foregoing, we had a net income in 2006 of RMB13.6 million compared to a net loss of RMB18.0 million in 2005.

Accretion to Series A Redeemable Convertible Preferred Shares Redemption Value. Accretion to Series A redeemable convertible preferred shares redemption value was RMB16.6 million in 2006 compared to RMB10.6 million in 2005. This was largely due to the full year effect of accretion with respect to the 20.0 million Series A redeemable convertible preferred shares we issued in December 2005.

Net Loss Attributable to Ordinary Shareholders. As a result of the foregoing, we incurred a net loss attributable to ordinary shareholders of RMB3.0 million in 2006 compared to RMB28.5 million in 2005.

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,			
	2005	2006	2007	2007
	RMB	RMB	RMB	US$
	(In thousands)			
Net cash provided by/(used in) operating activities	(1,024)	43,109	171,057	23,449
Net cash used in investing activities	(68,925)	(74,355)	(666,284)	(91,339)
Net cash provided by financing activities	73,980	3,490	2,618,831	359,010
Net increase/(decrease) in cash	3,952	(27,855)	2,085,915	285,953
Cash at end of the year	110,851	82,996	2,168,911	297,331

In 2005, we financed our operations and capital investments primarily through proceeds from issuance of the Series A redeemable convertible preferred shares. In 2006 and 2007, we were able to finance a significant portion of our operations and capital investments from our cash flows from operations. We did not rely on bank debt or other form of borrowings to finance our operations and drugstore network expansion. As of December 31, 2007, we had RMB2,168.9 million (US$297.3 million) in cash. Our cash consists of cash on hand and cash deposited in banks and interest-bearing savings accounts.

We expect to continue to generate positive operating cash flow in 2008. 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 increased to RMB171.1 million (US$23.4 million) in 2007 from RMB43.1 million in 2006, primarily due to a significant increase in the amount of cash provided by the sale of merchandise.

In 2006, our operating activities provided net cash of RMB43.1 million as opposed to net operating cash outflow of RMB1.0 million in 2005 primarily because of our increased sale of merchandise, which was partially offset by our increased payments for merchandise purchases and operating expenses, in 2006.

Investing Activities

Net cash used in investing activities increased to RMB666.3 million (US$91.3 million) in 2007 from RMB74.4 million in 2006. The increase was due to the investment in the 594 new stores opened in 2007 and the acquisition of RMB600 million (US82.3 million) held-to-maturity investment security using the proceeds from our initial public offering.

Net cash used in investing activities increased to RMB74.4 million in 2006 from RMB68.9 million in 2005 primarily due to increased purchase of property and equipment for the expansion of our store network. Although we opened 370 new stores in 2006 as compared to 423 new stores in 2005, we used more cash in 2006 because some capital expenditure incurred in 2005 was paid in 2006. In addition, we also received RMB 2.9 million in net proceeds from disposal of property and equipment in 2005.

Financing Activities

Net cash provided by financing activities increase to RMB2,618.8 million (US$359.0 million) in 2007 from RMB3.5 million in 2006, as we received net proceeds of US$355.8 million from our initial public offering in 2007. Net cash provided by financing activities was RMB3.5 million in 2006, which mainly consisted of proceeds from short-term bank borrowing. Net cash provided by financing activities in 2005 was RMB74.0 million, primarily consisted of proceeds from issuance of Series A redeemable convertible preferred shares.

Capital Expenditures

In 2005, 2006 and 2007, our capital expenditures totaled RMB71.5 million, RMB75.2 million and RMB68.4 million (US$9.4 million), respectively. In the past, our capital expenditures were used primarily to open stores, set up distribution centers and install and upgrade our information management systems. We estimate that our capital expenditures in 2008 will be approximately RMB447.5 million, of which we plan to use approximately RMB157.5 million to open new stores, approximately RMB150.0 million to acquire other drugstores, approximately RMB100.0 million to construct two new distribution centers, and approximately RMB35.0 million to upgrade our information management and inventory control system.

Inflation

In recent years, China has not experienced significant inflation, and thus inflation has not had a material impact on our results of operations. According to the PRC National Bureau of Statistics, the change in Consumer Price Index in China was 1.8%, 1.5% and 4.8% in 2005, 2006 and 2007 respectively.

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, or SFAS No. 157, which defines fair value, provides a framework for measuring fair value, and expands the disclosures required for fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require fair value measurements and does not require any new fair value measurements. SFAS No. 157 is effective for fiscal year beginning after November 15, 2007. We are required to adopt SFAS No. 157 beginning on January 1, 2008. SFAS No. 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening retained earnings in the year of adoption. In November 2007, the FASB proposed a one-year deferral of SFAS No. 157's fair value measurement requirements for non-financial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. We do not expect the initial adoption of SFAS No. 157 will have a material impact on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS No. 159. SFAS No. 159 permits companies to measure certain financial instruments and certain other items at fair value and requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for us on January 1, 2008, although earlier adoption is permitted. We have decided not to elect the fair value option.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (Revised) "*Business Combinations*" and Statement of Financial Accounting Standards No. 160, *"Noncontrolling Interests in Consolidated Financial Statements – an amendment to ARB No. 51"*. SFAS No. 141(R) and SFAS No. 160 require most identifiable assets, liabilities, noncontrolling interests and goodwill acquired in a business combination to be recorded at "full fair value" and require noncontrolling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with noncontrolling interest holders. Both statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. SFAS No. 141(R) will be applied to business combinations occurring after the effective date. SFAS No. 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date. We are currently evaluating the impact of adopting SFAS No. 141(R) and SFAS No. 160 on our consolidated financial statements.

Research and Development

We do not make, and do not expect to make significant expenditures on research and development.

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 through a license agreement, we have obtained the non-exclusive right to use "Neptunus" for free so long as the trademark is valid. Haiwang was recognized as a "China Well-Known Trademark" by the SAIC in 2004. If the Neptunus Group believes such well-known trademark is registered by a third party as its company name, and that such registration might result in confusion to the general public, it may apply to the relevant administrative authority for an injunction prohibiting such use and to compel the third party to cancel its registration. 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 obtained licenses to use 545 trademarks, including 17 registered trademarks that we have obtained exclusive right to use, 23 registered trademarks that we have obtained non-exclusive rights to use, and 505 trademarks that are in the process of being registered by subsidiaries of the Neptunus Group, of which we have been granted the exclusive rights to use 239 and the non-exclusive rights to use 266, upon completion of the registration of the respective trademarks. Pursuant to the related license agreements, we obtained the exclusive right to use these trademarks for free during the period these trademarks are valid. We use these licensed trademarks to develop our private label products. As of December 31, 2007, we have developed 133 private labels.

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 or to resolve the infringement through negotiation with the infringer. 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. Like 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. Therefore, 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.

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, 2008 to December 31, 2008 that are reasonably likely to have a material adverse effect on our net revenues, income, profitability, liquidity or capital resources, or that 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, 2007:

	Contractual Obligations				
	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years	Total
	(In thousands of RMB)				
Operating lease commitments	157,779	324,615	140,483	45,574	668,451
Capital commitments	4,800	-	-	-	4,800
Total	162,579	324,615	140,483	45,574	673,251

DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

Name	Age	Position/Title
Simin Zhang	46	Chairman of the Board of Directors
Jiannong Qian	46	Director and Chief Executive Officer
Barry J. Buttifant	64	Independent Director (1)(2)(3)
Yongtu Long	65	Independent Director (3)
Stephanie Hui	35	Director
Alistair Eric MacCallum Laband	56	Independent Director (1)(2)(3)
Gary Siu Kwan Sik	40	Independent Director (1)(2)
Jiaxin Feng	40	Chief Investment Officer
Andrew Weiwen Chen	41	Vice President and Chief Financial Officer
Zixin Shao	39	Vice President and Financial Controller
Liangping Mou	43	Vice President
Fuxiang Zhang	36	Vice President
Wei Lin	35	Vice President

(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. Dr. 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. Dr. Zhang received a bachelor’s degree in precision instruments from Harbin Institute of Technology in 1983, an honorary doctorate from University of New Castle in Australia in 1997 and a Ph.D. degree in economics from Nan Kai University in 2001.

Jiannong Qian has served as a director and our chief executive officer since August 2006. He was the vice general manager of Wumart Stores, Inc. from 2005 to 2006. From 2003 to 2005, he was the vice president of OBI (China) Management System Co., Ltd., a subsidiary of OBI Heimwerkermaerkte AG, a German corporation. From 2002 to 2003, he was the assistant general manager of China Resources Vanguard Co., Ltd. From 1997 to 2001, he worked at Metro AG and his last position at Metro AG was the manager of food purchase department. From 1994 to 1997, he worked as a senior manager at Weixing Company Group. From 1990 to 1994, he was a member and the chairman of general council of the Chinese Economists’ Association in Germany. From 1983 to 1987, he was a lecturer of Shanghai University of Finance and Economics. Mr. Qian received a bachelor’s degree in economics from Shandong University in 1983, a master’s degree in economics from University of Essen in Germany in 1992, and studied in the doctoral program in economics in University of Duisburg-Essen from 1992 to 1994.

Barry J. Buttifant has been a director of our company since November 2007. Mr. Buttifant is a member of our audit committee, our compensation committee and corporate governance and nominating committee. Since December 2004, he has been a managing director of Hsin Chong International Holding Limited, or HCIH, a Hong Kong company. Mr. Buttifant is also an alternate director of Hsin Chong Construction Group Ltd. and Synergies Holdings Limited, both of which are Hong Kong publicly listed companies affiliated with HCIH. Prior to joining HCIH, Mr. Buttifant was the managing director and corporate advisor to the board of director of Wo Kee Hong (Holdings) Limited and was previously the managing director of IDT International Limited for over eight years. He had worked for Sime Darby Hong Kong Limited and Polly Peck Far East Limited for more than 11 years in the capacity of finance director and managing director, respectively, during the period. He has over 30 years of experience in corporate and financial management and has lived continuously in Hong Kong for over 28 years. Mr. Buttifant currently serves as non-executive director of Alltronics Holdings Limited, Giordano International Limited, and Daiwa Associate Holdings Limited, each of which is a publicly listed company in Hong Kong. Mr. Buttifant also serves as a non-executive director of Global-Tech Appliances Inc., a New York Stock Exchange-listed company. 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.

Yongtu Long has been a director of our company since November 2007. Mr. Long is a member of our corporate governance and nominating committee. Mr. Long is the General Secretary of Boao Asian Forum and an independent director of China Life

Insurance Company Limited, a PRC life insurance company listed on the Hong Kong Stock Exchange and the New York Stock Exchange. From 1997 to 2003, Mr. Long served as the vice minister and the chief negotiation representative of the PRC MOFTEC, now the PRC Ministry of Commerce, in charge of negotiation relating to China's accession to the WTO and APEC affairs. From 1992 to 1997, Mr. Long served as the assistant minister, a director of International Trade and Economic Affairs and a director of International Communication in the PRC MOFTEC. Between 1980 and 1991, Mr. Long served as a senior officer at the regional project department of the United Nations Development Program, or the UNDP, the Deputy Representative of the UNDP Korean Delegate Office and the Deputy Director of China International Center for Economic and Technical Exchanges. Mr. Long is also the dean of School of International Relations and Public Affairs of Fudan University and a visiting professor of many renowned Chinese academic institutions, including Peking University and Tsinghua University. Mr. Long received a bachelor's degree in British and American literature from Guizhou University in 1965 and studied at London School of Economics between 1973 and 1974. He was awarded an honorary doctorate of science (economics) by London School Economics in 2006. Mr. Long received a special award from the United Nations Secretary General for his outstanding contribution to the United Nations in October 2004.

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. From 2003 to June 2007, he was a partner of PricewaterhouseCoopers, or PwC, Hong Kong/China and until March 2007, secretary of 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 Pricewaterhouse, 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 is a managing director of DBS Asia Capital Limited and an independent director of Simcere Pharmaceutical Group, a company listed on the New York Stock Exchange that manufactures and supplies branded generic pharmaceutical products for the China market. He is also a director of Dawnrays Pharmaceutical (Holdings) Limited and China Glass Holdings Limited, both of which are companies listed on the Hong Kong Stock Exchange. Mr. Sik was the managing director and head of corporate finance for Mitsubishi UFJ Securities (HK) Limited from September 2005 to March 2007. Prior to joining Mitsubishi UFJ Securities (HK) Limited in 2005, he served in various senior positions in ICEA Capital Limited (formally NatWest Markets Corporate Finance Asia Limited) from 1995 to 1998 and from 2001 to 2005. His last position in ICEA Capital Limited was managing director and head of the investment banking department. Mr. Sik received a bachelor's degree in engineering science from the University of Oxford, in the United Kingdom in 1989. He has been qualified as an associate member of the Institute of Chartered Accountants in England and Wales since 1992.

Jiaxin Feng has been our chief investment officer since November 2007. Mr. Feng served as the executive director and investment director of our company from August 2004 to November 2007. From 2002 to 2004, he was the vice general manager of Shenzhen Neptunus Investment Co., Ltd. From 1995 to 2002, he was the financial controller of Neptunus Bioengineering Holding Ltd., and from 1998 to 2002, he also worked as the secretary of the board of directors in Neptunus Bioengineering Holding Ltd., a subsidiary of the Neptunus Group. Mr. Feng received a bachelor's degree in economics from Sichuan University in China in 1991.

Andrew Weiwen Chen has served as our vice president and chief financial officer since August 2007. Prior to joining our company in August 2007, he was the chief financial officer of YRC Worldwide's China International Transportation Operations from 2006 to 2007. From 2003 to 2005, he was the finance controller of Honeywell Aerospace Engines China Operations. From 2000 to 2003, he was a senior auditor with Honeywell Corporate Audit at Honeywell's headquarters. He was an international financial analyst of Coca-Cola Company from 1999 to 2000. From 1996 to 1999, he was a senior auditor with PricewaterhouseCoopers LLP in its New York and Atlanta offices. Mr. Chen received a bachelor's degree in journalism from Xiamen University in 1991, a mater's degree in business administration from University of Alabama in 1995 and a master's degree in accounting from University of Alabama in 1996. Mr. Chen is a U.S. certified public accountant.

Zixin Shao is a vice president of our company and our financial controller. Prior to joining our company in 2003, he worked as a director, vice general manager and chief financial officer in China Resources Supermarket (Suzhou) Co., Ltd. from 1999 to 2001.

From 1992 to 2002, he was also a financial officer in China Resources Supermarket (HK) Co., Ltd. Mr. Shao received a bachelor's degree in accounting from the University of International Business and Economics in China in 1992. Mr. Shao is a PRC certified accountant.

Liangpin Mou is a vice president of our company. From January 2005 to November 2005, he was the general manager of our northern region and Dalian branch. From 2002 to 2003, he was a general manager of our Shenzhen branch. From January 2001 to November 2001, he was a vice general manager of our Kunming branch. From 1998 to 2000, he was the manager of our store department. From 1997-1998, he was a store manager in our company. He was also a medical doctor in Jilin Province Siping City Chinese-Western Medicine Integration Hospital from 1987-1997. He received a bachelor's degree in traditional Chinese medicine from Changchun College of Chinese Medicine (now Changchun University of Chinese Medicine) in 1987 and is now pursuing a master's degree in industrial engineering at Harbin Institute of Technology in China.

Fuxiang Zhang is a vice president of our company and the general manager of Shenzhen Nepstar Group Co., Ltd., or Nepstar Shenzhen, one of our regional Nepstar companies. From 2001 to 2003, he was the general manager of Nepstar Dalian. From 1999 to 2001, he served as the vice general manager of Nepstar Dalian. He was a manager in our company from 1998 to 1999 and was a director from 1997 to 1998. From August to December 1997, he was an assistant in the Human Resources Department of Nepstar Shenzhen. He received a bachelor's degree in international economics from Harbin Institute of Technology in 1997 and is currently pursuing a master's degree in industrial engineering at the Harbin Institute of Technology in China.

Wei Lin is a vice president of our company. Mr. Lin joined our company in 2004 and was a purchasing director of our company from January 2005 to November 2005. From 2003 to 2004, he was a director and the marketing director of Sunway Education Group. From 2000 to 2003, he was a senior purchasing manager at Auckland Basic English School in Shenzhen. From 1996 to 1999, he was a vice manager of the trading department in Shenzhen Trade Material Company. From 1994 to 1996, he was an assistant to the general manager of Shenzhen Jinqiao Telecom Company. Mr. Lin received a bachelor's degree in economics from Shenzhen University in 1994 and master of business administration degree from the University of Auckland in New Zealand in 2002.

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.

Board Practices

Our board of directors has established an audit committee, a compensation committee and a corporate governance and nominating committee upon completion of our initial public offering in November 2007. The Company believes that its corporate governance practices comply with those required by domestic companies under New York Stock Exchange standards and do not differ in any significant ways.

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, each of whom satisfies the requirements of New York Stock Exchange Listed Company Manual, or NYSE Manual, Section 303A. 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 U.S. 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, as defined in Item 404 of Regulation S-K under the

Securities Act;

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

- identifying and recommending to the board nominees for election or re-election to the board, or for appointment to fill any vacancy of the board;
- reviewing annually with the board the current composition of the board in light of the characteristics of independence, age, skills, experience and availability of service to us;
- advising the board 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 the board 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.

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 redeem or purchase 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 the 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.

Employees

We had 8,039, 9,096 and 14,282 employees as of December 31, 2005, 2006 and 2007, 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, 2007:

	As of December 31, 2007	
	Employees	Percentage
Non-pharmacist store staff	10,502	73.6%
Pharmacists	2,057	14.4%
Management	1,104	7.7%
Logistics	619	4.3%
Total	14,282	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 2005, 2006 and 2007, was RMB8.7 million, RMB15.5 million and RMB15.7 million (US2.1 million), respectively.

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

MISCELLANEOUS

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 the company's ordinary share of US$0.06 per share, based on the net income for the full year 2007. The cash dividend is payable on or around May 10, 2008, to shareholders of record as of the close of business on April 10, 2008. The form, frequency and amount of future dividend will depend upon our future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions, shareholders' interests and other factors that our board of directors may deem relevant.

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 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 entry's registered capital. As of December 31, 2007, the accumulated balance of our statutory reserve funds amounted to RMB8.1 million (US$1.1 million) and the accumulated profits of our consolidated PRC entities that were available for dividend distribution amounted to RMB70.0 million (US$9.6 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. dollar.

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:

- 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

The recently enacted PRC Enterprise Income Tax Law, or the EIT Law, and the implementation regulations for the EIT Law issued by the PRC State Council, became effective as of January 1, 2008. The EIT 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 EIT 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, it is unclear whether PRC tax authorities would treat us as a PRC resident enterprise.

Under the EIT Law and implementation regulations, PRC income tax at the rate of 10% 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. Similarly, any gain realized on the transfer of

ADSs or shares by such investors is also subject to 10% PRC income tax if such gain is regarded as income derived from sources within the PRC. If we are considered a PRC “resident enterprise,” it is unclear whether dividends we pay with respect to our ordinary shares or ADSs, or the gain you may realize from the transfer of our ordinary shares or ADSs, would be treated as income derived from sources within the PRC and be subject to PRC income tax. It is also unclear whether, if we are considered a PRC “resident enterprise,” holders of our ordinary shares or ADSs might be able to claim the benefit of income tax treaties entered into between China and other countries.

United States Federal Income Tax Consequences

The following summary describes certain United States 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 that are beneficial owners of ADSs or ordinary shares, that hold the ADSs or ordinary shares as capital assets and that have the U.S. dollar 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 an ADS or ordinary share 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 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 with respect to the ADSs or ordinary shares generally will be included in your gross income as foreign source dividend income on the date of actual or constructive receipt by the depositary, in the case of ADSs, or by you, in the case of ordinary shares, but only to the extent that the distribution is paid out of our current or accumulated earnings and profits (as determined under U.S. federal income tax principles). The dividends will not be eligible for the dividends-received deduction allowed to corporations under the Code in respect of dividends received from other U.S. corporations.

With respect to non-corporate U.S. Holders, certain dividends received 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 backed 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 we have applied to list 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 backed by ADSs, but not on our ordinary shares that are not backed 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 shares, regardless of whether such 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.

In the event that we are deemed to be a PRC "resident enterprise" under PRC tax law, you may be subject to PRC withholding taxes on dividends paid to you with respect to the ADSs or ordinary shares. 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 may be treated as foreign taxes eligible for credit against your U.S. federal income tax liability. 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.

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 an 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 shares, including the availability of the foreign tax credit under your particular circumstances.

Passive Foreign Investment Company

Based on the composition of our income and valuation of our assets, we believe we were not a passive foreign investment company, or a PFIC, for 2007, and we do not expect to become one in the future, although there can be no assurance in this regard. Because PFIC status is a factual determination, our special United States counsel expresses no opinion with respect to our PFIC status and also expresses no opinion with respect to our expectations contained in this paragraph.

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

- at least 75% of our gross income is passive income, or
- at least 50% of the value (determined based on a quarterly average) of our assets 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.

The determination of whether we are a PFIC is made annually. Accordingly, it is possible that we may become a PFIC in the current or any future taxable year due to changes in our asset or income composition. Because we have valued our goodwill based on the market value of our equity, a decrease in the price of our ADSs may also result in our becoming a PFIC. In addition, the composition of our income and assets will be affected by how, and how quickly, we spend the cash we raise in our initial public offering. 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.

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 and any of our foreign 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 will be 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. 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.

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 United States 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.

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This annual report contains forward-looking statements 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 our products, 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 the registration statement, of which this annual report is a part, 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.

谨感谢一直以来支持海王星辰发展的社会各界！

We attribute our success to all walks of society supporting us on the way!

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Dedicated to providing high-quality, professional and convenient pharmacy services to the Chinese market

中国海王星辰连锁药店有限公司
地址：深圳市南山区南海大道新能源大厦B座6楼
(518054)
电话：0755-26433366
传真：0755-26430889
网址：www.nepstar.cn

China Nepstar Chain Drugstore Ltd.
Address: 6th Floor, Tower B, Xinnengyuan Building, Nanhai Road, Nanshan District, Shenzhen, P.R. China (518054)
Tel: 0755-26433366
Fax: 0755-26430889
http: www.nepstar.cn