Heng Ren Investments

Dear Chairman Simin Zhang and Board of Directors,

Heng Ren Investments is a shareholder of China Nepstar Chain Drugstore (NYSE: NPD), China's largest national drugstore chain. This letter provides recommendations to help Nepstar reverse five-straight quarters of losses and a 91%* drop in the market value of its stock since its 2007 IPO and listing on the New York Stock Exchange. This is an urgent appeal to management and the Board of Directors to review and change strategy.

Nepstar can be proud of establishing a leading national drug store chain in China. However, Heng Ren believes now it is time for Nepstar to look forward and abandon its strategy to build a nationwide chain of stores. In a nation as large as China, capturing procurement cost benefits from national scale has proven elusive as most supply is localized. Meanwhile, managing a physical chain of stores across China is proving to be costly to shareholders.

Instead, Heng Ren recommends Nepstar instead adopt a regional strategy focused on key provinces. This would bring a sharper focus on improving cost efficiency within existing stores. Management could also identify methods to generate more sales through increased customer loyalty. Our analysis shows this would produce significantly higher returns for shareholders. This is not revolutionary; this model already is bringing success to Nepstar's peers in China and benefitting their shareholders with attractive returns.

Heng Ren's analysis of Nepstar's 2013 financials provides a simple prescription of six recommendations to start its recovery:

1) **Accelerate Store Closings** – A **10% reduction in stores** in 2013 would have increased operating margin to 5.7% (vs. 0.9% actually reported in 2013), with earnings per share (EPS) of $0.08 (vs. $0.01 reported in 2013).

2) **Reduce Staffing Levels** – A **10% reduction in pharmacists** would have increased operating margin to 4.3% (vs. 0.9%), with EPS of $0.03 (vs. $0.01).

3) **Combine Store Closings and Staff Cuts** – A **10% reduction in stores, combined with** a **10% reduction in pharmacists**, would have increased operating margin to 9.2% (vs. 0.9%), and EPS of $0.11 (vs. $0.01 actual).

4) **Revive Loyalty Program** – The average number of active loyalty members is approximately 2,400 per store vs. an average of 8,100 at major US drug store chains (2013). While Nepstar had 12.3 million total members, only 4.9 million were active (2013). Although drug stores of U.S. chains are much larger, should all of Nepstar's members become active, it would average 5,900 active loyalty

members per store, bringing it to the level of the U.S.'s Rite Aid Corp. (NYSE:RAD).

5) **Increase Private-Label Sales** – Typically drug store chains attempt to increase their sales mix of private-label brands to improve profit margins. For Nepstar private-label product gross margins in 2013 were 59% vs. its 44% total gross margin. **However, its percentage of private-label sales dropped**. This deserves deeper analysis and corrective action to reverse this negative trend.

6) **Expand Online Sales** - Nepstar has made a promising start in online sales. It immediately needs to be expanded and improved. **Back office systems to electronically coordinate the filling of online drug prescription orders need to be readied as soon as possible.** This will enable Nepstar to remain a leader in offline and online prescription drug sales if, and when, online prescription drug sales are permitted in China.

Heng Ren's appeal to change strategy is urgent. E-commerce giants Alibaba.com, YHD.com, and JD.com are reportedly preparing to sell prescription drugs online. This behooves Nepstar to become as efficient and profitable as possible to battle for this valuable market. We would ask Nepstar's management and its Board of Directors to prepare for this competition by creating a new strategic plan to deliver to shareholders.

Heng Ren conducted its analysis of Nepstar's business, complete with recommendations, based on Nepstar's 2013 financials, its most recently audited statements. It is important to note we attempted to share and discuss this analysis with Nepstar's management in a friendly and collaborative manner as fellow shareholders, but our offer was declined. (**Note all price data as of February 12, 2015.)*

Following are details of the analysis that produced Heng Ren's six recommendations:

1) **Accelerate Store Closings** - This needs to be done decisively. In 2013, while Nepstar closed 188 stores, it also opened 122 new stores. Such half measures sow confusion. Nepstar's goal of being a national drug store chain may have been relevant in a past era before e-commerce, and in a smaller country than China.

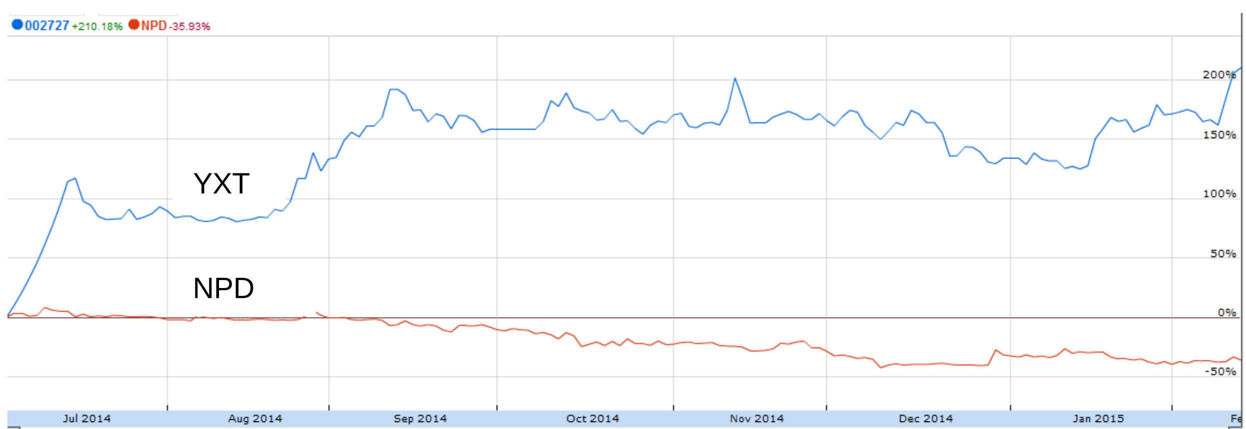
   In today's China a national footprint of physical stores seems irrelevant. There is little benefit from national scale for procurement, as supplies are predominantly localized. Also, Nepstar's Sales, General & Administrative (SG&A) expenses are relatively high. The cost burden of managing a national footprint across a huge country like China is proving to be onerous.

With approximately 2,048 stores in 13 major provincial cities (September 2014), Nepstar has leading market share in only four cities (including its headquarters, Shenzhen). While Nepstar aims to be a national chain it had just 10 stores in China’s capital city, Beijing.

Heng Ren’s analysis found that if Nepstar had closed 10% of its stores, its resulting operating margin would have been 5.7% (vs. 0.9% actual). This analysis includes impairment costs and assumes an additional 10% same store sales growth (SSS), in line with the closing of underperforming stores.

Nepstar Sensitivity to 5%-20% Store Closings (2013)					
	Actual	**5%**	**10%**	**15%**	**20%**
Operating Margin	0.9%	3.5%	***5.7%***	7.5%	8.8%

This operating margin is achievable because peers in China are already delivering it, notably regional drug store chain Yunnan Hongxiang Yixintang Pharma Co. Ltd. (Shenzhen: 002727). “YXT” achieved 7.5% operating margin in 2013 with a regional strategy focused on Yunnan Province in southwest China, home to 75% of its 2,400 stores. YXT’s performance has generously rewarded its investors. Since its IPO in July 2014, YXT’s stock has appreciated by +346% (￥12.20 – ￥54.4).



YXT’s strategy is one Nepstar should emulate to improve profitability and returns. The contrast in strategy and returns are obvious. If Nepstar were to close the gap in profitability with YXT, there could be significant benefit for shareholders. The simplest metric for this improvement would be Price/Sales (P/S), currently at 0.3x. Typically stocks trading at a depressed level below 1.0x do so because investors expect the company will remain unprofitable. If Nepstar implemented Heng Ren’s recommendations and returned to profitability, investors might have a reason to revise their expectations. If Nepstar’s streak of five-straight quarters of losses ended, Nepstar’s P/S ratio could recover toward peers like YXT (P/S of 2.6x 12-

months trailing revenue).

	YXT	Nepstar
Total stores (2013)	2480	2066
Province with highest concentration of stores (Sept.2014)	75% (Yunnan)	25% (Guangdong)
Daily average customer traffic per store (2013)	110	77
Sales (2013)	$569m	$445m
Gross profit margin (2013)	40%	44%
Operating margin (2013)	7.5%	0.9%
P/E (ttm*)	37.9x	N\A
P/B (ttm*)	6.0x	1.1x
P/S (ttm*)	2.6x	0.3x
ROE (2013)	26%	1.30%
Market capitalization (Feb.12, 2015)	$2,100m	$147.1m
Free cash flow (2013)	$13.2m	$-40m
Year end cash (2013)	$83.6m	$90.1m
** As of Sept.2014*		

Nepstar's current strategy of closing so few underperforming stores on a net basis, and allocating more capital to a sunset business model, will needlessly prolong Nepstar's unprofitability and destruction of shareholder value. Heng Ren's analysis shows by closing more underperforming stores, and instead focusing on excelling in an affluent region of relative strength (like hometown Shenzhen and the surrounding regions), Nepstar's profitability should improve.

There also would be significant tax efficiency from closing unprofitable stores. This is because under Chinese accounting rules, Chinese companies are not allowed to offset their profits with subsidiaries' losses, which makes for a higher effective tax rate. In Nepstar's case its 2013 effective tax rate was 73.1%. Nepstar commented on this in its 20-F for 2013 with the U.S. Securities and Exchange Commission (SEC) (p.51; April 22, 2014):

"Our effective tax rate increased to 73.1% in 2013 as compared to 34.6% in 2012, primarily due to non-deductible expenses and the relatively high operating losses from loss-making subsidiaries, for which full valuation allowances were made on their deferred tax assets as compared to the overall results of the Company. In the PRC, losses in companies which are part of a group are not allowed to be off-set against profits of other companies in the same group."

In 2011 and 2012, Nepstar had higher net store closings - and also lower effective tax rates - than in 2013:

	2011	2012	2013
Net store closings	153	263	66
Effective tax rate	46.3%	34.6%	73.1%

In 2013 if Nepstar had closed 10% of its stores (or 207 stores) that were unprofitable or underperforming, and we assume a simple average of its effective tax rates in 2011 and 2012 of 40.5%, plus 5.0% due to an unfavorable residency tax change in 2013, the improved profitability shows the benefits from gained efficiencies, including on the effective tax rate.

	Actual	10% store closings
Operating margin	0.9%	5.7%
Effective tax rate	73.1%	45.5%
EPS	$0.01	$0.08

In this scenario Nepstar's deferred tax asset would have been used, which would reduce its valuation allowance, and in turn be accretive to earnings.

2) **Reduce Staffing Levels** – On average there were about 1.7 pharmacists per Nepstar store. With customer traffic averaging only one customer every 10 minutes per store, each store pharmacist assists approximately 3.5 customers per hour. ***That's a lot of down time***. Heng Ren's analysis shows if in 2013 Nepstar reduced pharmacists by 10% (or by 0.2 per store), this would have lifted its operating margin to 4.3% (vs. 0.9% reported).

Pharmacist salaries comprised 82% of SG&A, and Nepstar's SG&A as a share of revenue (42.5%), far exceeded YXT (30.8%), Rite Aid (25.7%), and CVS Health Corp. (NYSE:CVS) (12.4%). There is scope for productivity gains through reductions at Nepstar.

Nepstar Sensitivity to 5%-20% Pharmacist Reduction (2013)					
	Actual	**5%**	**10%**	**15%**	**20%**
Operating Margin	0.9%	2.6%	***4.3%***	6.1%	7.8%

3) **Combine Store Closings and Staff Cuts** - If in 2013 Nepstar had combined a 10% reduction in stores with a 10% reduction in pharmacists, it would have increased the operating margin to 9.2% (vs. 0.9% actual).

		Pharmacist Reduction 5%-20%				
		Actual	**5%**	**10%**	**15%**	**20%**
Store Closings 5%-20%	**Actual**	0.9%	2.6%	4.3%	6.1%	7.8%
	5%	3.5%	5.2%	7.0%	8.7%	10.5%
	10%	5.7%	7.5%	***9.2%***	11.0%	12.7%
	15%	7.5%	9.2%	11.0%	12.8%	14.6%
	20%	8.8%	10.6%	12.4%	14.2%	16.0%

If Nepstar had implemented the combined strategy of 10% store closings and 10% pharmacist reductions in 2013, this is how Nepstar would have compared to YXT.

2013	YXT	Nepstar (new)	Nepstar (actual)
Gross profit margin	40.0%	48.8%	44.0%
Operating margin	7.5%	9.2%	0.9%
Free cash flow	$13.2m	$16.1m	$-40m
Effective tax rate	N\A	45.5%	73.1%
EPS	$0.20	$0.10	$0.01

4) **Revive Loyalty Program** - The average number of active loyalty members is approximately 2,400 per store vs. an average of 8,100 at major US drug store chains (2013). While Nepstar had 12.3 million total members, only 4.9 million were active (2013). Should all its members become active, Nepstar would average 5,900 active loyalty members per store, bringing it to a similar level as Rite Aid.

Loyalty customers generally spend more and shop more frequently than non-loyalty customers, providing a major incentive to seek ways to increase this customer base. Although an ambitious goal to activate all loyalty members, we believe it is worth pursuing. Campaigning to sign-up new members would also help hit this target. We urge Nepstar to survey active loyalty members to identify what motivates them to buy at their stores, and apply this insight to increase customer traffic and revenue.

5) **Increase Private-Label Sales** – Typically drug store chains attempt to increase their sales mix of own-brands to improve profit margins. Private label gross margins at Nepstar were 59% vs. its 44% total gross margin. A focus on increasing sales of private-label products would positively impact Nepstar's

profitability. However, in Nepstar's case, the opposite has occurred. Nepstar's sales of private label products as a share of revenue dropped to 23.5% in 2013 from 26.8% in 2012. Private label's share of gross profit dropped to 31.8% in 2013 from 46.3% in 2012. A review should involve evaluating the sales of private products across categories (e.g. nutritional supplements versus drug sales), and understanding better how to optimize sales in these categories.

6) **Expand On-Line Sales** – Cuts in marginal costs, as outlined above, need to be made. This will be necessary preparation for the potential onslaught of online sales of prescription drugs. Nepstar already has an existing on-line business with $10.7 million sales in 2013, but this business immediately needs to be expanded and improved. (*Note for all of Nepstar's unfavorable comparisons with peer YXT, Nepstar has more online sales*.) Also, the back office preparation to electronically coordinate the filling of prescriptions needs to be implemented as soon as possible to position Nepstar as one of the leaders in on- and off-line prescription drug sales.

As a shareholder, we would appreciate the management of Nepstar to review this letter, and conduct a strategic review as soon as possible. Heng Ren's recommendations should be included to change course towards sustainable profitability and positive returns. A new strategy should be presented and discussed with shareholders. This is so all shareholders can reap the benefits of growth in prescription drug sales, and thrive in the next stage of competition.

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