

## INDUSTRY OVERVIEW

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Our Group is engaged in the prescription drugs distribution industry in the PRC, whose market size and conditions are affected by (i) the PRC pharmaceutical market; (ii) the PRC pharmaceutical distribution market; and (iii) government initiatives in relation to the healthcare industry.

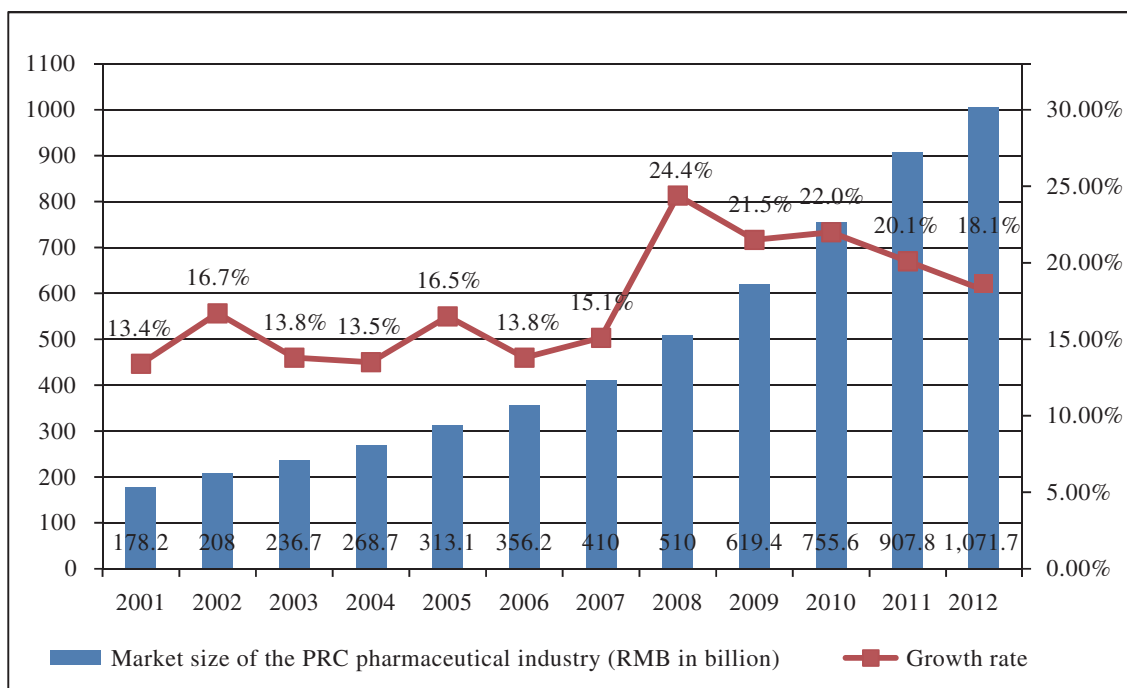
### THE PRC PHARMACEUTICAL MARKET AND THE PRC PHARMACEUTICAL DISTRIBUTION MARKET

#### Overview of the PRC pharmaceutical market

The pharmaceutical industry of the PRC is undergoing a growth. The total output value of the PRC pharmaceutical industry measured by sales at the ultimate users expanded from approximately RMB178.2 billion in 2001 to approximately RMB1,071.7 billion in 2012 with a CAGR of approximately 17.7%. The growth of the market is driven by favourable government policies as well as multiple socioeconomic factors, such as increasing disposable income and growth of GDP, aging and increased life expectancy of the PRC population, increasing urbanisation, and rising healthcare spending and health awareness. The chart below sets out the total output value and growth rate of the PRC pharmaceutical industry measured by sales from 2001 to 2012.

## INDUSTRY OVERVIEW

Chart I – Market size and growth rate of the PRC pharmaceutical industry



### Government initiatives in relation to the healthcare industry

#### *Expansion of the social medical insurance in the PRC*

According to the twelfth five-year plan for national economic and social development of the PRC, the PRC government intends to make available more healthcare resources to the rural population and the suburban communities. In particular, it intends to improve the social medical insurance program, to increase the amount of benefits under such program, to continue to implement the essential drugs program, and to increase the number of community healthcare centres and clinics.

#### *Adoption of the National List of Essential Drugs and the National Medical Insurance Drugs Catalog*

The National List of Essential Drugs was first launched in 1982. SFDA kept the list updated and NHFPC announced the latest edition in 2013 with view to focusing on “providing basic medicines to meet people’s basic need”. This edition contains 520 items, including 317 western medicines and 203 traditional Chinese medicines, or TCM.

Based on the National List of Essential Drugs, the National Medical Insurance Drugs Catalog was announced by the Ministry of Human Resources and Social Security on 27 November 2009 and took effect on the same day. Western medicines and TCM in the catalog are divided into two grades, namely Grade A and Grade B. The patients who consume Grade A drugs must be reimbursed in full by the national basic medical insurance. Patients consuming Grade B drugs will be partially reimbursed, in which the proportion would depend on the financial resources of the basic medical insurance. The amount of the deductible differs from region to region in the PRC. Drug manufacturers who produce drugs covered in the National Medical Insurance Drugs Catalog are expected to enjoy a business growth due to the reduction of cost resulting from economies of scale, but subject to price control from the government.

## INDUSTRY OVERVIEW

To be included in the National Medical Insurance Drugs Catalog, the pharmaceutical products must be, among other things, necessary in clinical use, safe, effective, reasonably priced, user friendly and available in markets. In addition, public healthcare institutions are required to purchase substantially all of the pharmaceutical products through an annual open tender organised by institutions designated by provincial governments. Pharmaceutical companies submit tenders, which are assessed by pharmaceutical experts recognised by the relevant authorities, with reference to, most importantly, drug quality, as well as other criteria including price, service and quality of the relevant drug manufacturer. Companies who fail in the collective tender processes will be disqualified to sell the agented pharmaceutical products to the hospitals in the relevant province or city.

### *Expansion of the community healthcare centers and clinics*

As of 31 March 2013, there were approximately 23,551 hospitals, 916,902 medical and healthcare institutions at the primary level and 14,820 other healthcare institutions in the PRC, according to NHFPC. As of 31 December 2012, there were approximately 782 hospitals, 28,939 medical and healthcare institutions at the primary level and 546 other healthcare institutions in Zhejiang province, according to Zhejiang Provincial Healthcare Department. In the PRC, pharmaceutical products, especially prescription drugs, are mostly sold through hospitals. Hospital purchases in the PRC represent approximately [78.8%] of the total PRC pharmaceutical market in 2012, and the size of hospital purchase had reached approximately RMB844.9 billion in 2012.

### *Control over antibiotics*

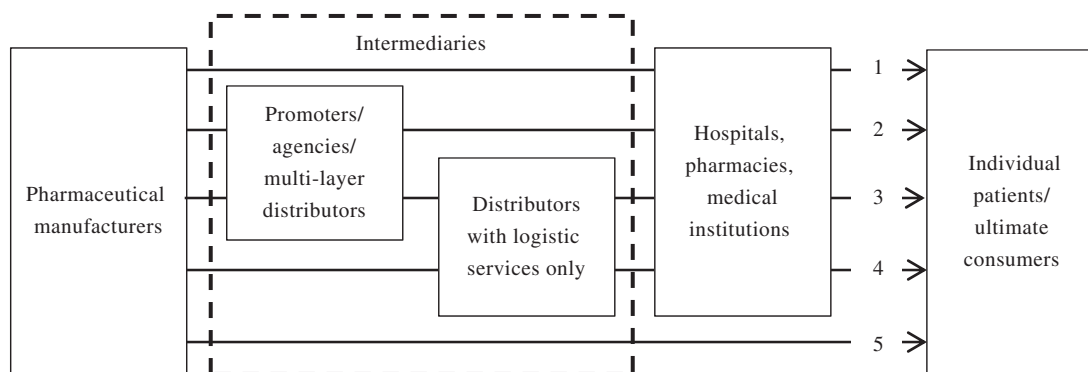
On 19 July 2012, Zhejiang Provincial Health Bureau issued the Administrative Catalogue of the Clinical Use of Antibiotics of Zhejiang Province (2012 version) (浙江省抗菌藥物臨床應用分級管理目錄(2012版)). Such policy may affect the product structure of antibiotics. However, the influence on the total market size of antibiotics would be limited, and the mainstream antibiotics products would still be predominant. According to the Administrative Catalogue of the Clinical Use of Antibiotics of Zhejiang Province (2012 version) (浙江省抗菌藥物臨床應用分級管理目錄(2012版)), certain of our products have fallen within the category of limited use, namely, Cefoxitin Sodium for Injection (注射用頭孢西丁鈉), Cefodizime Sodium for Injection (注射用頭孢地嗪鈉), Isepamicin Sulfate Injection (硫酸異帕米星注射液), Cefixime Dispersible Tablet (頭孢克肅分散片) and Ceftizoxime Sodium for Injection (注射用頭孢唑肅鈉). Our Directors are of the view that our result of operation for the year ended 31 December 2012 and the six months ended 30 June 2013 has already reflected the impact of such policy.

## INDUSTRY OVERVIEW

### Pharmaceutical industry value chain

In the PRC, like other major countries, there are normally five major stages across the pharmaceutical industry value chain: (1) research and development; (2) intermediaries and active pharmaceutical ingredients; (3) finished dosage for manufacturing and promotion; (4) distribution; and (5) retail sales. Multi-layer distributors having exclusive national, provincial or regional distribution rights may participate, engage in or organise marketing activities for promoting the products in the PRC. Distributors only providing logistic services mainly interact with the purchase department of a healthcare institution to ensure that orders are fulfilled effectively and efficiently. Distributors only providing logistic services for prescription drugs generally do not hire promotion staff and are not responsible for promoting the products. Such distributors will simply deliver pharmaceutical products to national-wide drugs dispensers in a fast and effective way. [Hospitals and healthcare institutions in the PRC usually select distributors with a diversified product portfolio, a sizable and stable supply of product in order to minimise the procurement cost and enhance the procurement and distribution efficiency.] In addition, the payment period from the drug dispensers to the distributors is generally longer than the payment period from the distributors to the manufacturers. The distributors may make deposit and/or prepayment to the manufacturers, especially for the products with market potential. Therefore, as direct and indirect customers of the manufacturers, multi-layer distributors can ease the pressure on manufacturers in the respective logistic arrangements and financial recoverabilities, and allow manufacturers to achieve higher operational efficiency level. The following chart illustrates different models of pharmaceutical distribution business:

Chart II – Different models of pharmaceutical distribution business



*Note 1:* path 1 is generally suitable for the large size and/or multinational pharmaceutical manufacturers with a strong in-house sales team and extensive financial resources.

*Note 2:* path 2 is generally suitable for the large size pharmaceutical distributors to distribute branded products with high gross profit margins.

*Note 3:* path 3 is generally suitable for the majority of pharmaceutical manufactures, which usually are small to medium size companies with an annual sales less than RMB300 million, without a strong in-house sales team and extensive financial resources to engage in small to medium size pharmaceutical distributors for the promotion and distribution of the pharmaceutical products.

*Note 4:* path 4 is generally suitable for (i) the pharmaceutical manufacturers with in-house sales team which engage the pharmaceutical distributors to provide the logistic services only; and/or (ii) the pharmaceutical products using advertisements as promotion approaches or with spontaneous demand.

*Note 5:* path 5 is only suitable for marketing, advertisement and trials of new drugs.

## INDUSTRY OVERVIEW

| <b>Path</b> | <b>Channel</b>      | <b>Control</b>    | <b>Feasibility</b> | <b>Remarks</b>  |
|-------------|---------------------|-------------------|--------------------|---|
| 1           | Narrow              | Strong            | Hard               | Manufacturers need to have their own promotion, sales and distribution team   |
| 2           | Relatively narrower | Relatively strong | Relatively easier  | The distributor with logistic service would also be responsible for product promotion. The suitable products and related distributors are very limited. |
| 3           | Wide                | Weak              | Easy               | The most commonly adopted model   |
| 4           | Relatively narrower | Relatively weaker | Relatively harder  | Manufacturers need to have their own promotion and sales team, or promote the products via advertisements.  |
| 5           | Narrow              | Strong            | Hard               | Only for marketing purpose  |

In view of the control level, the business model would have higher control level with fewer layers of intermediaries and narrower channel. It is worth noting that, considering the factors such as products, markets, manufacturers, promoters and government regulations, different business models would be suitable for different products in different region with different drug dispensers, and there is no single predominate model.

Our Group belongs to path 3 in chart II above. For path 3, the manufacturers can utilise the networks and capital resources of the distributors to increase the market share in an efficient manner, since a majority of the manufacturers cannot afford to establish their own national-wide promotion and sales team. The promoters/agencies/multi-layer distributors can focus on establishing the distribution networks, instead of making significant investments on pharmaceutical production base and logistic infrastructures for pharmaceutical distribution. The distributors with logistic services can only focus on building up logistic infrastructures for pharmaceutical distribution, instead of establishing promotion and sales team. [A comprehensive and sizable logistics infrastructure such as a significant number of transport fleet and a large area of temperature controlled warehouse is required in order to distribute a vast amount of products to a large number of hospitals and healthcare institutions in a fast and cost effective way. The investment of such logistic infrastructure and solution is capital intensified.] Each link can develop on its strength.

## INDUSTRY OVERVIEW

### Overview of the PRC pharmaceutical distribution market

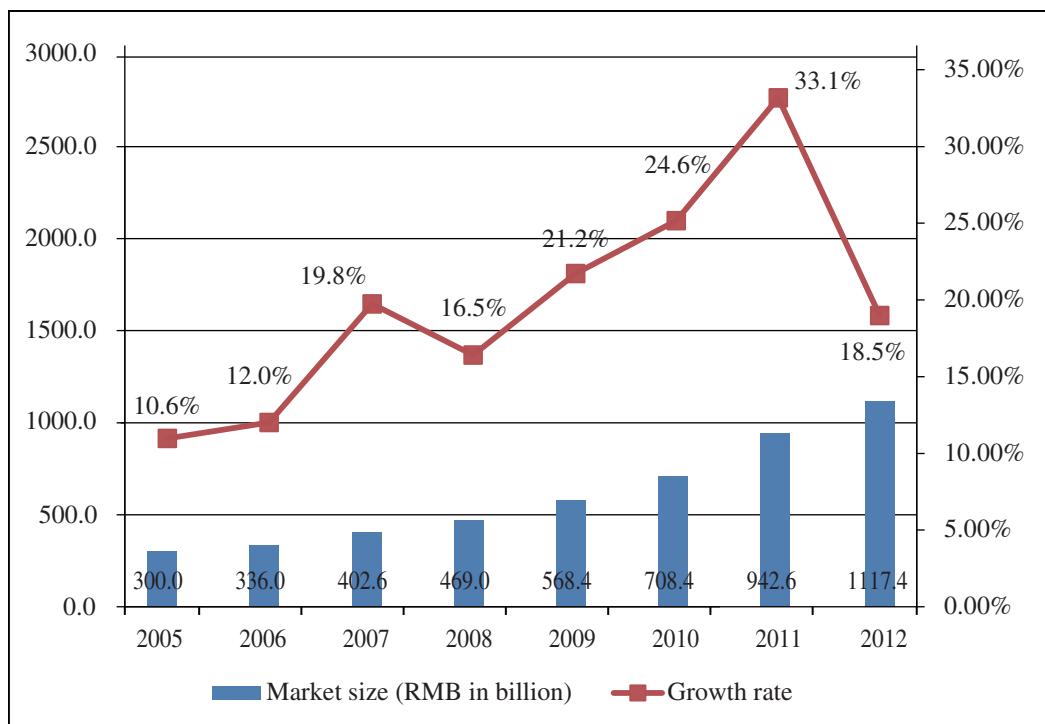
Distributors connect pharmaceutical companies with drug dispensers, including hospitals, medical institutions, retail pharmacies and drugs sales outlets. Typically, distributors enter into agreements to purchase pharmaceutical products from pharmaceutical companies. Usually, distributors also seek from pharmaceutical companies the right to exclusively distribute a particular medicine or groups of medicines in certain regions or national-wide market. In this relation, the distributors normally have to pay the deposits and/or prepayments to obtain those exclusive distribution rights from the pharmaceutical companies instead of consideration. Distributors generate revenue by reselling these pharmaceutical products to their distributor customers and providing relevant services to customers in the retail market. In the event that distributors encounter any shortage of certain products, they would request their suppliers to arrange and liaise with other distributors with excessive inventories. During the process, the suppliers of the products will not be involved in any sales and purchase relationship with those distributors. Distributors can help pharmaceutical companies increase their operational efficiencies by providing expertise in product delivery to and payment collection from drug dispensers. As resellers of pharmaceutical products, distributors can also reduce transaction costs and improve efficiencies for drug dispensers, by allowing drug dispensers to keep fewer inventories on hand and ensuring that inventory will be replenished in time. Distributors sell pharmaceutical products to drug dispensers as well as other distributors.

Regarding the provincial tender process for pharmaceutical products, the manufacturers would normally appoint the national-wide agent to coordinate. The provincial and/or regional agents would be responsible for dealing in the local affairs, including submitting the tender documents on behalf of the manufacturers, liaising with government and experts, and formulating the pricing strategies. However, the manufacturers themselves may sometimes be involved in the tender process, and the national-wide agents would be responsible for both coordination and local affairs. The job allocation regarding the provincial tender process for pharmaceutical products may vary from one to another. There were approximately 7,041 medicines which had participated the collective tendering process held in 2010.

## INDUSTRY OVERVIEW

The PRC pharmaceutical distribution market had grown from 2005 to 2012. In light of the favourable socioeconomic factors that have also driven the PRC's overall healthcare industry, the PRC pharmaceutical distribution market is expected to further grow. The following chart sets out the market size and growth rate in the PRC pharmaceutical distribution market for the periods indicated:

Chart III – The size of the PRC pharmaceutical distribution market



## INDUSTRY OVERVIEW

### COMPETITIVE LANDSCAPE OF THE PRC PHARMACEUTICAL DISTRIBUTION MARKET

#### Competition in the PRC pharmaceutical distribution market

The PRC pharmaceutical distribution market is fragmented. In 2012, there were approximately 16,295 pharmaceutical distributors in the PRC. In 2011, the aggregate revenue of the three largest distributors, namely, Sinopharm Group Company Limited, Shanghai Pharmaceuticals and China Resources-Pharmaceutical Group Limited, accounted only for approximately [28.5]% of the total pharmaceutical distribution market, whereas the three largest U.S. distributors accounted for approximately 97% of the U.S. distribution market in 2009.

The Eastern China Region, the largest regional pharmaceutical distribution market of the seven geographical regions of the PRC, accounted for approximately 40.5% of the PRC pharmaceutical distribution market in 2012. Zhejiang province accounted for approximately 7.15% of the PRC pharmaceutical distribution market, ranked fourth. The following tables set forth the PRC pharmaceutical distribution market by geographical regions in 2012:

Table I – Regional shares of the PRC pharmaceutical distribution market

| Region               | 2007          | 2008          | 2009          | 2010         | 2011         | 2012          |
|----------------------|---------------|---------------|---------------|--------------|--------------|---------------|
| <b>Eastern China</b> | <b>37.51%</b> | <b>38.43%</b> | <b>39.12%</b> | <b>44.2%</b> | <b>42.0%</b> | <b>40.50%</b> |
| Northern China       | 19.00%        | 19.43%        | 15.69%        | 19.62%       | 19.3%        | 18.90%        |
| Southern China       | 15.47%        | 14.12%        | 12.14%        | 9.29%        | 8.33%        | 9.78%         |
| Central China        | 9.27%         | 9.29%         | 12.42%        | 11.09%       | 10.77%       | 10.22%        |
| Southwest China      | 7.68%         | 7.61%         | 10.67%        | 8.1%         | 11.6%        | 12.00%        |
| Northeast China      | 6.60%         | 6.58%         | 5.31%         | 4.8%         | 5.0%         | 5.00%         |
| Northwest China      | 4.47%         | 4.53%         | 4.64%         | 2.9%         | 3.0%         | 3.60%         |

Source: NHFPC, [●]

Table II – Provincial shares and ranking of Top 10 pharmaceutical distribution markets

| Rank in 2012 | Region          | 2010         | 2011         | 2012         |
|--------------|-----------------|--------------|--------------|--------------|
| <b>1</b>     | <b>Shanghai</b> | <b>9.92%</b> | <b>9.25%</b> | <b>9.23%</b> |
| 2            | Beijing         | 9.73%        | 8.74%        | 9.02%        |
| 3            | Guangdong       | 7.07%        | 6.36%        | 7.61%        |
| 4            | Jiangsu         | 8.34%        | 7.11%        | 7.48%        |
| 5            | Anhui           | 6.64%        | 8.30%        | 7.34%        |
| <b>6</b>     | <b>Zhejiang</b> | <b>7.96%</b> | <b>7.18%</b> | <b>7.15%</b> |
| 7            | Shandong        | 7.07%        | 6.47%        | 5.80%        |
| 8            | Chongqing       | 3.18%        | 4.79%        | 4.77%        |
| 9            | Tianjin         | 4.36%        | 4.79%        | 4.07%        |
| 10           | Hubei           | 4.01%        | 3.99%        | 3.69%        |

Source: NHFPC, [●]



## INDUSTRY OVERVIEW

As at 19 March 2013, there were approximately [527] pharmaceutical distributors in Zhejiang province. Among them, Huadong Medicine Co., Ltd (華東醫藥股份有限公司), Zhejiang Intec Medicine Co., Ltd (浙江英特藥業有限責任公司), Ningbo Pharmaceutical Co., Ltd (寧波醫藥股份有限公司) and Zhejiang Pharmaceutical Industry Corp., Ltd (浙江省醫藥工業有限公司) are top market players in terms of revenue.

The entry barriers for a new distributor in a region can be summarised as follows:-

1. New market entrants can hardly establish distribution networks and accumulate up-stream resources within a short period of time. Pharmaceutical manufacturers would choose the distributors with established distribution networks, and sub-distributors and drug dispensers would choose to source pharmaceutical products of reasonable price and good quality from distributors with abundant up-stream resources.
2. Recruitments of experienced management and licensed pharmacists, as well as the establishment of quality control and management system, require sufficient time.
3. New market entrants are required to obtain proper licences such as Pharmaceutical Operation Permit and GSP certificate to start operation.
4. New market entrants are required to satisfy a significant working capital commitment for securing the products warehousing and logistic arrangement and supply.

Accordingly, compared to distributors from other regions or new market entrants, an established distributor in a region tends to enjoy certain competitive advantages, such as long-term relationships with manufacturers, other distributors and drug dispensers including hospitals.

The pharmaceutical distribution market is fragmented at the national level, but monopolised at regional level with clear regional characteristics. On national level, Sinopharm Group Company Limited, Shanghai Pharmaceuticals and China Resources-Pharmaceutical Group Limited are the major distributors, which accounted only for approximately [28.5]% of the total pharmaceutical distribution market in 2011. On regional level, Eastern China, Northern China and Southwest China are the major regional markets. The regional pharmaceutical distributors have controlled the major local network resources, which make inter-regional distribution business difficult to succeed. The pharmaceutical distribution market will be shared amongst major national distributors and regional distributors.

The distributors must be able to expand their customer base and secure their suppliers while maintaining the profitability to succeed in this fragmented market. A distributor with strong financial position, proven track records, and the ability to penetrate new markets will have greater competitive advantages. Distributors that meet all the above criteria will benefit from the growing PRC pharmaceutical distribution market. It is a common industry practice in the PRC to pay a deposit to suppliers to secure a steady supply of products especially for the ones with market potential.

## INDUSTRY OVERVIEW

### Market size of our major products

The PRC pharmaceutical distribution market is highly fragmented. The sales volumes of pharmaceutical products are related to various factors, including its usage, price, promotion approaches and status in Medical Insurance Drugs Catalogs, National List of Essential Drugs and provincial collective tendering, rather than the operation size of its manufacturers. The ranking and market shares of our 11 major types of products (including 17 specifications) provide better illustration to our operation. The following paragraphs illustrate the ranking, market shares and growth rates of our 11 major types of products (including 17 specifications):

#### Levocarnitine Injection (左卡尼汀注射劑)

The total sales value of Levocarnitine Injection in the PRC increased from approximately RMB1.4 billion in 2011 to approximately RMB1.5 billion in 2012, representing a growth rate of approximately 7.1%, and the total sales value of Levocarnitine Injection in Zhejiang province increased from approximately RMB47.7 million in 2011 to approximately RMB92.0 million in 2012, representing a rapid growth rate of approximately 92.9%.

#### Cefodizime Sodium for Injection (注射用頭孢地嗪鈉)

The total sales value of Cefodizime Sodium for Injection decreased from approximately RMB1.5 billion in 2011 to approximately RMB1.2 billion in 2012, representing a decrease of approximately 20.0%, and the total sales value of Cefodizime Sodium for Injection in Zhejiang province decreased from approximately RMB244.0 million in 2011 to approximately RMB214.0 million in 2012, representing a decrease of approximately 12.3%.

#### Thymosin $\alpha$ 1 for Injection (注射用胸腺法新)

The total sales value of Thymosin  $\alpha$  1 for Injection in the PRC increased from approximately RMB1.9 billion in 2011 to approximately RMB2.2 billion in 2012, representing a growth rate of approximately 15.8%, and the total sales value of Thymosin  $\alpha$  1 for Injection in Shanghai increased from approximately RMB254.0 million in 2011 to approximately RMB297.0 million in 2012, representing a growth rate of approximately 16.9%.

#### Ozagrel of Sodium for Injection (注射用奧紮格雷鈉)

The total sales value of Ozagrel of Sodium for Injection in the PRC decreased from approximately RMB1.6 billion in 2011 to approximately RMB1.5 billion in 2012, representing a decrease of approximately 6.3%, and the total sales value of Ozagrel of Sodium for Injection in Zhejiang province increased from approximately RMB38.1 million in 2011 to approximately RMB51.1 million in 2012, representing a growth rate of approximately 34.1%.

#### Isepamicin Sulfate Injection (硫酸異帕米星注射劑)

The total sales value of Isepamicin Sulfate Injection in the PRC decreased from approximately RMB247.0 million in 2011 to approximately RMB184.0 million in 2012, representing a decrease of approximately 25.5%, and the total sales value of Isepamicin Sulfate Injection in Zhejiang province increased from approximately RMB53.3 million in 2011 to approximately RMB54.3 million in 2012, representing a growth rate of approximately 1.9%.

## INDUSTRY OVERVIEW

### **Alanyl Glutamine for Injection (注射用丙氨酰谷氨酰胺)**

The total sales value of Alanyl Glutamine for Injection in the PRC increased from approximately RMB1.6 billion in 2011 to approximately RMB1.9 billion in 2012, representing a growth rate of approximately 18.8%, and the total sales value of Alanyl Glutamine for Injection in Zhejiang province increased from approximately RMB28.7 million in 2011 to approximately RMB33.8 million in 2012, representing a growth rate of approximately 17.8%.

### **Cefixime Dispersible Tablets (頭孢克肟分散片)**

The total sales value of Cefixime Dispersible Tablet in the PRC increased from approximately RMB3.0 billion in 2011 to approximately RMB3.4 billion in 2012, representing a growth rate of approximately 13.3%, and the total sales value of Cefixime Dispersible Tablets in Zhejiang province increased from approximately RMB34.6 million in 2011 to approximately RMB36.9 million in 2012, representing a growth rate of approximately 6.6%.

### **Cefoxitin Sodium for Injection (注射用頭孢西丁鈉)**

The total sales value of Cefoxitin Sodium for Injection in the PRC increased from approximately RMB3.21 billion in 2011 to approximately RMB3.25 billion in 2012, representing a growth rate of approximately 1.2%, and the total sales value of Cefoxitin Sodium for Injection in Zhejiang province increased from approximately RMB184.0 million in 2011 to approximately RMB207.0 million in 2012, representing a growth rate of approximately 12.5%.

### **Ceftizoxime Sodium for Injection (注射用頭孢唑肟鈉)**

The total sales value of Ceftizoxime Sodium for Injection in the PRC increased from approximately RMB2.8 billion in 2011 to approximately RMB3.2 billion in 2012, representing an increase of approximately 14.3%, and the total sales value of Ceftizoxime Sodium for Injection in Zhejiang province decreased from approximately RMB201.0 million in 2011 to approximately RMB189.0 million in 2012, representing a decrease of approximately 6.0%.

### **Sulbenicillin Sodium for Injection (注射用磺苄西林鈉)**

The total sales value of Sulbenicillin Sodium for Injection in the PRC increased from approximately RMB[0.9] billion in 2011 to approximately RMB[1.5] billion in 2012, representing an increase of approximately [66.7]%, and the total sales value of Sulbenicillin Sodium for Injection in Zhejiang province increased from approximately RMB[226.0] million in 2011 to approximately RMB[312.0] million in 2012, representing an increase of approximately [38.1]%.

### **Clostridium Butyricum Capsule (酪酸梭菌活菌膠囊)**

The total sales value of Clostridium Butyricum Capsule in the PRC increased from approximately RMB[0.3] billion in 2011 to approximately RMB[0.4] billion in 2012, representing an increase of approximately [33.3]%, and the total sales value of Clostridium Butyricum Capsule in Zhejiang province increased from approximately RMB[26.0] million in 2011 to approximately RMB[58.0] million in 2012, representing an increase of approximately [123.1]%.