
CONTRACTUAL ARRANGEMENTS

BACKGROUND

Our Group engages in the business of pharmaceutical manufacturing and operation of chain pharmacies. The products we develop, manufacture and sell includes Chinese patent medicines and decoction pieces.

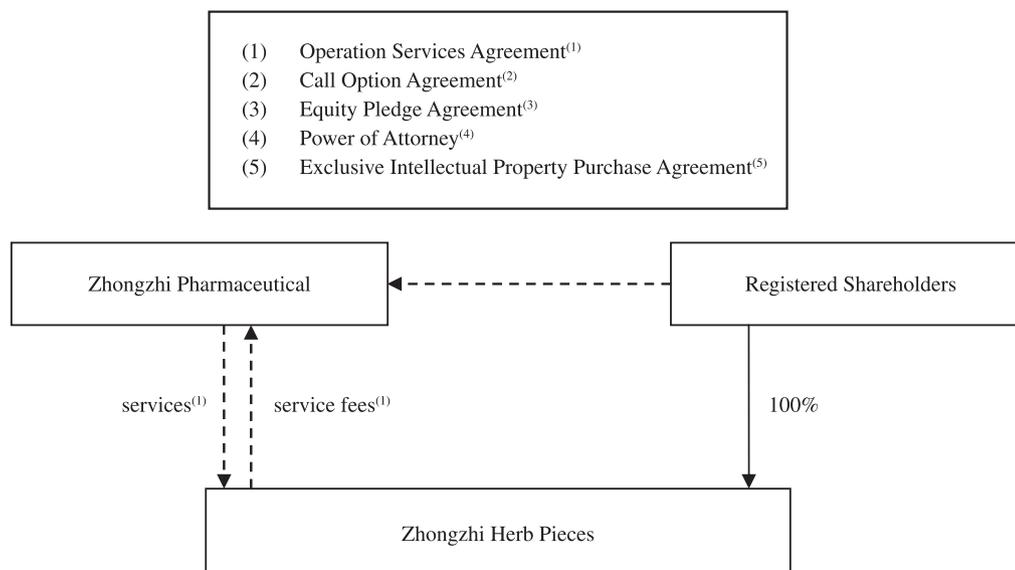
Zhongzhi Herb Pieces is a major operating subsidiary of our Group in the PRC engaged in the production of decoction pieces. Under the relevant PRC laws and regulations, namely the Foreign Investment Catalogue and as confirmed by a competent officer in the GFDA, production of our traditional and modern decoction pieces which involves the application of processing techniques such as steaming, stir-frying, moxibustion and calcination, are prohibited from foreign investment. Please refer to the “Regulation” section in this prospectus for further details. As the production of our traditional and modern decoction pieces involves the application of the aforesaid processing techniques, we are not allowed to hold any equity interest in Zhongzhi Herb Pieces under the applicable PRC laws and regulations.

The Contractual Arrangements which consist of, namely an operation services agreement (the “**Operation Services Agreement**”), a call option agreement (the “**Call Option Agreement**”), an equity pledge agreement (the “**Equity Pledge Agreement**”), a power of attorney (the “**Power of Attorney**”) and an exclusive intellectual property purchase agreement (the “**Exclusive Intellectual Property Purchase Agreement**”), were entered into in order for our Group to manage the business of Zhongzhi Herb Pieces with all economic benefits derived from the business, financial and operating activities of Zhongzhi Herb Pieces flow to Zhongzhi Pharmaceutical by means of service fees payable by Zhongzhi Herb Pieces to Zhongzhi Pharmaceutical.

ARRANGEMENTS UNDER THE CONTRACTUAL ARRANGEMENTS

Operation of the Contractual Arrangements

Zhongzhi Pharmaceutical entered into the Contractual Arrangements with Zhongzhi Herb Pieces and the Registered Shareholders. The following diagram illustrates the operation of the Contractual Arrangements which results in the flow of all economic benefits from Zhongzhi Herb Pieces to our Group stipulated under the Contractual Arrangements:



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Notes:

- (1) Pursuant to the Operation Services Agreement, Zhongzhi Pharmaceutical was engaged exclusively to provide Zhongzhi Herb Pieces with, *inter alia*, management and consultancy services in consideration of service fees payable by Zhongzhi Herb Pieces to Zhongzhi Pharmaceutical.
- (2) Pursuant to the Call Option Agreement, the Registered Shareholders have granted an irrevocable and exclusive option to Zhongzhi Pharmaceutical to purchase all or any part of their entire equity interests in Zhongzhi Herb Pieces according to the terms contained therein.
- (3) Pursuant to the Equity Pledge Agreement, the Registered Shareholders have pledged their entire equity interests in Zhongzhi Herb Pieces (together with the rights derived therefrom) in favour of Zhongzhi Pharmaceutical as security for the performance of all the contractual obligations by Zhongzhi Herb Pieces and the Registered Shareholders under the Operation Services Agreement, the Call Option Agreement, the Power of Attorney and the Exclusive Intellectual Property Purchase Agreement.
- (4) Pursuant to the Power of Attorney, the Registered Shareholders jointly and severally and irrevocably appointed Zhongzhi Pharmaceutical as their attorney to exercise their shareholders' rights in Zhongzhi Herb Pieces.
- (5) Pursuant to the Exclusive Intellectual Property Purchase Agreement, Zhongzhi Herb Pieces and the Registered Shareholders jointly and severally granted an irrevocable and exclusive option to Zhongzhi Pharmaceutical to purchase all or any of the intellectual property that Zhongzhi Herb Pieces has according to the terms contained therein.
- (6) “—” denotes direct legal and beneficial ownership in the equity interest and “- -” denotes contractual relationship.

In accordance with the Call Option Agreement, the Registered Shareholders (being immediate shareholders who together are interested in the entire equity interest in Zhongzhi Herb Pieces) have granted an irrevocable and unconditional exclusive option to Zhongzhi Pharmaceutical to purchase all or part of the equity interest in Zhongzhi Herb Pieces held by the Registered Shareholders as permitted by the applicable PRC laws and regulations. We will unwind the Contractual Arrangements and acquire Zhongzhi Herb Pieces or the production of decoction pieces business it is carrying on when the applicable PRC laws and regulations allow the operation of such business by foreign invested enterprises. When Zhongzhi Pharmaceutical or its nominee(s) exercises the option and acquire the entire equity interest in Zhongzhi Herb Pieces, the Contractual Arrangements will be terminated. Subject to compliance with the PRC laws and regulations, Zhongzhi Pharmaceutical or its nominee(s) may exercise the option mentioned above at any time and in any manner at their sole discretion.

The Contractual Arrangements, taken as a whole, enable the financial results of Zhongzhi Herb Pieces and all economic benefits of its business to flow onto Zhongzhi Pharmaceutical. As a holding company, our Company's ability to pay dividends and other cash distributions to our Shareholders depends on our ability to receive dividends and other distributions from Zhongzhi Pharmaceutical. The amount of dividends and other distributions paid to us by Zhongzhi Pharmaceutical in turn depends to a certain extent on the service fees paid to Zhongzhi Pharmaceutical from Zhongzhi Herb Pieces. However, there are restrictions under PRC laws for the payment of dividends to us by Zhongzhi Pharmaceutical. For instance, the relevant PRC laws and regulations only permit Zhongzhi Pharmaceutical to pay dividends out of its retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. Also, under the PRC laws and regulations, Zhongzhi Pharmaceutical is required to set aside at least 10% of its after-tax profits based on PRC accounting standards each year to fund a statutory reserve until the

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accumulated amount of such reserve has exceeded 50% of its registered capital. This reserve is not distributable as dividends. Consequently, Zhongzhi Pharmaceutical is subject to limits in its ability to transfer a portion of its net assets to us or any of our other subsidiaries in the form of dividends, loans or advances. For further details, please refer to the paragraph headed “Regulation — Restrictions relating to dividend distribution” in this prospectus.

In addition, all the directors and senior management staff of Zhongzhi Herb Pieces are to be nominated by Zhongzhi Pharmaceutical. Through its supervision and control over the selection of the directors and senior management of Zhongzhi Herb Pieces, Zhongzhi Pharmaceutical is able to effectively manage the business, financial and operating activities of Zhongzhi Herb Pieces so as to obtain benefits from its activities and to ensure due implementation of the Contractual Arrangements. The Contractual Arrangements enable Zhongzhi Pharmaceutical to, if and when permitted by the PRC laws and regulations, acquire the equity interests in Zhongzhi Herb Pieces in accordance with such laws and regulations. The Contractual Arrangements also enable Zhongzhi Pharmaceutical to, if and when permitted by PRC laws and regulations, purchase all or any of the intellectual properties that Zhongzhi Herb Pieces has. Our Directors are of the view that the Contractual Arrangements enable our Group to be managed coherently with the power to govern the business, financial and operating activities of Zhongzhi Herb Pieces for the benefit of our Group as a whole. Based on the Contractual Arrangements, taken as a whole, our Directors consider that, notwithstanding the lack of equity ownership in Zhongzhi Herb Pieces, our Group controls Zhongzhi Herb Pieces in substance. On this basis, Zhongzhi Herb Pieces is a consolidated affiliate of the Company and our Group is regarded as a continuing entity resulting from these Contractual Arrangements such that the financial position and operating results of Zhongzhi Herb Pieces are consolidated into our Group’s consolidated financial statements.

Each of the Operation Services Agreement, Call Option Agreement, Power of Attorney and Exclusive Intellectual Property Purchase Agreement is effective from the date of its signing for ten years, which shall be unconditionally renewed at the request of Zhongzhi Pharmaceutical for ten years and for an indefinite number of successive ten years thereafter, whereas the Equity Pledge Agreement shall remain effective until the contractual obligations of the Registered Shareholders and Zhongzhi Herb Pieces under the Contractual Arrangements have been fully performed or the Contractual Arrangements have been terminated. The length of the term of the aforesaid agreements was a commercial decision of the parties determined on arm’s length basis for the benefit of our Company to ensure Zhongzhi Pharmaceutical can exercise its rights over Zhongzhi Herb Pieces for a long period. Our Board is of the view that such term in effect means the relevant agreements shall continue perpetually unless early terminated by Zhongzhi Pharmaceutical, please refer to the right of termination of Zhongzhi Pharmaceutical under the paragraph headed “Termination” in this section.

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Details of the Contractual Arrangements

1. *Operation Services Agreement*

On 31 August 2014, Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces and the Registered Shareholders entered into the Operation Services Agreement, which provides, among others, that:

- (i) Zhongzhi Pharmaceutical was engaged exclusively to provide Zhongzhi Herb Pieces with management and consultancy services, namely strategic consultancy services, advisory services on procurement, production and marketing, human resources services, tax and financial management services, information system services, internal control services, technology and other operational support services as required by Zhongzhi Herb Pieces from time to time. Zhongzhi Herb Pieces shall strictly adopt and follow the advices and decisions made by Zhongzhi Pharmaceutical and shall not raise objection to the same;
- (ii) unless prior written consent of Zhongzhi Pharmaceutical has been obtained, Zhongzhi Herb Pieces shall not directly or indirectly accept services provided by any third party or establish cooperative relationship with any third party in respect of the services to be provided by Zhongzhi Pharmaceutical under the Operation Services Agreement;
- (iii) unless prior written consent of Zhongzhi Pharmaceutical has been obtained, Zhongzhi Herb Pieces and the Registered Shareholders shall not carry out any acts which may affect the assets, business operation, management and other aspects of Zhongzhi Herb Pieces (for example Zhongzhi Herb Pieces shall not without the prior written consent of Zhongzhi Pharmaceutical, distribute dividend or make any kind of distribution, or remove or change any of its directors or any senior management);
- (iv) Zhongzhi Herb Pieces shall pay service fees on an annual basis to Zhongzhi Pharmaceutical for the services provided by Zhongzhi Pharmaceutical under the Operation Services Agreement. The amount of fees payable by Zhongzhi Herb Pieces shall be calculated in accordance with the PRC accounting principles, which shall be the revenue of Zhongzhi Herb Pieces after deducting, *inter alia*, all the expenses (including but not limited to the operation cost, depreciation, tax and other expenses and costs) and reserve fund. Our PRC Legal Advisors have advised that there are no PRC laws or regulations expressly prohibiting Zhongzhi Herb Pieces from making service fee payments to Zhongzhi Pharmaceutical. Zhongzhi Herb Pieces, as a limited liability company, has property rights to deal with its assets accumulated throughout its business operation. Thus, we and our PRC Legal Advisors believe that, the service fee payment arrangement under the Operation Services Agreement is valid and legal, and is not prohibited under the relevant PRC laws and regulations.

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The Operation Services Agreement is effective from the date of its signing for ten years, which shall be unconditionally renewed at the request of Zhongzhi Pharmaceutical for ten years and for an indefinite number of successive ten years thereafter.

2. Call Option Agreement

On 31 August 2014, Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces and the Registered Shareholders entered into the Call Option Agreement, pursuant to which the Registered Shareholders jointly and severally granted an irrevocable and exclusive option to Zhongzhi Pharmaceutical, to purchase all or any part of their equity interests in Zhongzhi Herb Pieces by Zhongzhi Pharmaceutical itself or through its nominee(s) at the lowest price and to the extent permitted by the applicable PRC laws and regulations. Therefore, if Zhongzhi Pharmaceutical exercises this option, all or any part of the equity interest of Zhongzhi Herb Pieces would be transferred to Zhongzhi Pharmaceutical and the benefits and equity ownership would flow to our Company and our Shareholders.

When Zhongzhi Pharmaceutical exercises this option to purchase any equity interest owned by any of the Registered Shareholders in Zhongzhi Herb Pieces, the Registered Shareholder(s) should procure Zhongzhi Herb Pieces to convene a shareholders' meeting to approve the transfer within three days after receiving notice from Zhongzhi Pharmaceutical for exercising the option. The selling Registered Shareholder(s) shall return any consideration received from the equity transfer occurred after the exercise of this option to Zhongzhi Pharmaceutical after the deduction of their actual amount of investment in Zhongzhi Herb Pieces.

Pursuant to this Call Option Agreement, in order to prevent the disposal of the assets of Zhongzhi Herb Pieces to the Registered Shareholders or any third party, Zhongzhi Herb Pieces shall not, and the Registered Shareholders shall not cause Zhongzhi Herb Pieces to, among others, (i) sell, transfer, mortgage or dispose of any assets held by Zhongzhi Herb Pieces; (ii) increase or reduce the registered capital or otherwise alter the capital structure of Zhongzhi Herb Pieces; (iii) enter into any merger or otherwise make any acquisition or investment; (iv) enter into any material contract (i.e. a contract involving the sum of over RMB100,000) other than in the ordinary course of business; (v) provide any loan or guarantee in any form to any third party; (vi) permit Zhongzhi Herb Pieces to incur any debt other than in the ordinary course of business; or (vii) request for or approve any of distribution of dividend or profit to the Registered Shareholders, without the prior written consent of Zhongzhi Pharmaceutical.

The Call Option Agreement is effective from the date of its signing for ten years, which shall be unconditionally renewed at the request of Zhongzhi Pharmaceutical for ten years and for an indefinite number of successive ten years thereafter.

The Call Option Agreement enables Zhongzhi Pharmaceutical to unwind the Contractual Arrangements as soon as the relevant PRC laws and regulations allow foreign investment in relation to the business of Zhongzhi Herb Pieces.

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3. *Equity Pledge Agreement*

On 31 August 2014, Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces and the Registered Shareholders entered into the Equity Pledge Agreement, pursuant to which the Registered Shareholders jointly and severally pledged all their respective equity interests in Zhongzhi Herb Pieces (together with the rights derived therefrom) in favour of Zhongzhi Pharmaceutical as security for the performance of all the contractual obligations of Zhongzhi Herb Pieces and the Registered Shareholders under the Operation Services Agreement, the Call Option Agreement, the Power of Attorney and the Exclusive Intellectual Property Purchase Agreement.

Under the Equity Pledge Agreement, without the prior written consent of Zhongzhi Pharmaceutical, the Registered Shareholders shall not transfer, create or permit the subsistence of any encumbrance over the pledged equity interests in Zhongzhi Herb Pieces. Our Directors believe that the Equity Pledge Agreement can effectively protect the interests of our Group under the Contractual Arrangements.

The Equity Pledge Agreement is effective after the pledges have been registered in Zhongzhi Herb Pieces's register of members and registered with relevant administration for industry and commerce, and the same will remain effective until the contractual obligations of the Registered Shareholders and Zhongzhi Herb Pieces under the Contractual Arrangements have been fully performed or the Contractual Arrangements have been terminated.

The pledge was registered on 12 November 2014 with the Zhongshan Administration for Industry and Commerce* (中山市工商行政管理局) and our PRC Legal Advisors confirmed that the Equity Pledge Agreement has been duly registered with the relevant PRC legal authority pursuant to the PRC laws and regulations.

4. *Power of Attorney*

On 31 August 2014, the Registered Shareholders executed the Power of Attorney, pursuant to which, among others, the Registered Shareholders jointly and severally and irrevocably appointed Zhongzhi Pharmaceutical as their attorney to exercise the shareholders' rights in Zhongzhi Herb Pieces by Zhongzhi Pharmaceutical itself or through its nominee(s). The said shareholders' rights include but not limited to the rights to exercise voting rights in shareholders' meeting, to sign minutes of the shareholders' meetings, to file documents with the relevant government authorities, and to appoint directors and supervisors.

The Power of Attorney is effective from the date of its signing for ten years, which shall be unconditionally renewed at the request of Zhongzhi Pharmaceutical for ten years and for an indefinite number of successive ten years thereafter.

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5. Exclusive Intellectual Property Purchase Agreement

On 31 August 2014, Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces and the Registered Shareholders entered into the Exclusive Intellectual Property Purchase Agreement, pursuant to which Zhongzhi Herb Pieces and the Registered Shareholders jointly and severally granted an irrevocable and exclusive option to Zhongzhi Pharmaceutical to purchase all or any of the intellectual property that Zhongzhi Herb Pieces has by Zhongzhi Pharmaceutical itself or through its nominee(s) at the lowest price and to the extent permitted by the applicable PRC laws and regulations.

Zhongzhi Pharmaceutical shall have absolute discretion as to when and in what manner to exercise the option to purchase the intellectual properties of Zhongzhi Herb Pieces permitted by the PRC laws and regulations.

The Exclusive Intellectual Property Purchase Agreement is effective from the date of its signing for ten years, which shall be unconditionally renewed at the request of Zhongzhi Pharmaceutical for ten years and for an indefinite number of successive ten years thereafter.

Dispute Resolution

Each of the Contractual Arrangements contains a dispute resolution provision. Pursuant to such provision, any dispute arising from the interpretation and implementation of the Contractual Arrangements between the parties shall first be resolved through negotiation, failing which any party may submit the said dispute to the South China International Economic and Trade Arbitration Commission (the “**Commission**”) with a view to resolving the dispute through arbitration in accordance with the arbitration rules of the Commission.

The arbitration shall be conducted in Zhongshan and the arbitral award shall be final and conclusive and binding on all parties. The Commission may award remedies over the equity interests or land or other assets of Zhongzhi Herb Pieces, make injunctive relief (e.g. for the conduct of business or to compel the transfer of assets) or order the winding up of Zhongzhi Herb Pieces. Also, the courts of Hong Kong, the Cayman Islands and the PRC (being the place of incorporation of Zhongzhi Herb Pieces) also have jurisdiction to grant interim remedies.

However, our PRC Legal Advisors are of the opinion that the Commission may not be able to make injunctive relief or winding up orders according to the PRC laws and arbitration rules. Notwithstanding the aforesaid, the parties can apply to the PRC court for interim remedies including asset preservation. Also, the orders or remedies granted by overseas court (such as Hong Kong and Cayman Islands) may not be recognisable or enforceable in the PRC. The uncertainty of enforcement does not affect the validity and legality of the remaining provisions of the dispute resolution clauses and other provisions in the Contractual Arrangements.

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Succession, Bankruptcy and Divorce

Pursuant to the Contractual Arrangements, in the event of the death, bankruptcy and divorce of the Registered Shareholders, the Contractual Arrangements shall continue to be binding on the Registered Shareholders and their successors (as the case may be). The Registered Shareholders agree that the Contractual Arrangements shall prevail over their respective wills, divorce agreements, debt arrangements and other legal instruments in any forms entered into by them, unless prior written consent of Zhongzhi Pharmaceutical is obtained. Accordingly, appropriate arrangements have been made to protect our Company's interest in the event of death, bankruptcy, divorce of the Registered Shareholders to avoid any practical difficulties in enforcing the Contractual Arrangements.

The Contractual Arrangements do not specify the identity of successors to the Registered Shareholders, under the succession law of the PRC, the statutory successors include the spouse, children, parents, brothers, sisters, paternal grandparents and the maternal grandparents and any breach by the successors would be deemed to be a breach of the Contractual Arrangements. In case of a breach, Zhongzhi Pharmaceutical can enforce its rights against the successors.

Therefore, our PRC Legal Advisors are of the view that (i) the Contractual Arrangements have given sufficient protection to our Group even in the event of death of the Registered Shareholders; and (ii) the death of the Registered Shareholders would not affect the validity of the Contractual Arrangements, and Zhongzhi Pharmaceutical can enforce its right under the Contractual Arrangements against the successors of the Registered Shareholders.

Conflicts of Interests

We have implemented measures to protect against the potential conflicts of interest between our Group and the Registered Shareholders. Pursuant to the Operation Services Agreement, the Registered Shareholders have undertaken that they will cause Zhongzhi Herb Pieces to strictly adopt and follow the advices and decisions made by Zhongzhi Pharmaceutical and will not raise objection to the same. If there is any potential conflict of interests between the Registered Shareholders and Zhongzhi Pharmaceutical, especially when the Registered Shareholders are also the directors or senior management of Zhongzhi Pharmaceutical, the Registered Shareholders shall protect, and shall not harm the interests of Zhongzhi Pharmaceutical. Under the Call Option Agreement, the Registered Shareholders granted Zhongzhi Pharmaceutical an irrevocable and exclusive option to purchase all or any part of the equity interests in Zhongzhi Herb Pieces at the lowest price and to the extent permitted by the applicable PRC laws and regulations. Furthermore, under the Power of Attorney executed by the Registered Shareholders, Zhongzhi Pharmaceutical was irrevocably appointed as the attorney of the Registered Shareholders to exercise the shareholders' rights in Zhongzhi Herb Pieces on behalf of the Registered Shareholders. As a result, we have minimised the Registered Shareholders' influence on the business operations of Zhongzhi Herb Pieces.

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Based on the above, our Directors are of the view that the measures we have adopted are sufficient to mitigate the risks associated with the potential conflicts of interest between the Group and the Registered Shareholders and such measures are sufficient to protect our Group's interest in Zhongzhi Herb Pieces.

Loss exposure

Pursuant to the Operation Services Agreement, Zhongzhi Pharmaceutical is exposed to the operation risk of Zhongzhi Herb Pieces and shall provide financial support to Zhongzhi Herb Pieces. As our Group (i) conducts part of its businesses in the PRC through Zhongzhi Herb Pieces; and (ii) Zhongzhi Herb Pieces's financial condition and results of operations are consolidated into our Group's financial condition and results of operations under the applicable accounting principles, our Company's business, financial condition and results of operations would be adversely affected if Zhongzhi Herb Pieces suffers losses. Notwithstanding the aforesaid exposure of losses faced by Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces is a limited liability company and shall be solely liable for its own debts and losses with assets and properties owned by it.

Moreover, the provisions in the Contractual Arrangements are tailored so as to limit, to the greatest extent possible, the potential adverse effect on Zhongzhi Pharmaceutical and our Company resulting from any loss suffered by Zhongzhi Herb Pieces. For instance, according to the Call Option Agreement, Zhongzhi Herb Pieces shall not, and the Registered Shareholders shall not cause Zhongzhi Herb Pieces to sell, transfer, mortgage or dispose of any assets held by Zhongzhi Herb Pieces.

In addition, under the Operation Services Agreement, the prior written consent of Zhongzhi Pharmaceutical shall be obtained in relation to the removal or change of directors or senior management of Zhongzhi Herb Pieces. Zhongzhi Herb Pieces and the Registered Shareholders shall cause those directors and supervisors to resign if Zhongzhi Pharmaceutical shall determine so and the directors of Zhongzhi Herb Pieces appointed by Zhongzhi Pharmaceutical can only be removed at the instruction of Zhongzhi Pharmaceutical. Zhongzhi Pharmaceutical has control over the dividend and other distributions to the Registered Shareholders, the Registered Shareholders and Zhongzhi Herb Pieces have undertaken not to make any distribution without the prior written consent of Zhongzhi Pharmaceutical. Zhongzhi Pharmaceutical also has the right to periodically receive the financial statements of Zhongzhi Herb Pieces and the financial results of Zhongzhi Herb Pieces can be consolidated into our Group's financial information as if it was our Group's subsidiary.

Liquidation

According to the Operation Services Agreement, Zhongzhi Herb Pieces undertakes to appoint a committee designated by Zhongzhi Pharmaceutical as the liquidation committee upon the winding up of Zhongzhi Herb Pieces to manage its assets. Further, as stated in the Call Option Agreement, in the event of liquidation, the Registered Shareholders shall ensure all of the remaining assets (after settlement of the liquidation costs, salary of staff, tax, social insurance and debt) of Zhongzhi

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Herb Pieces shall be transferred to Zhongzhi Pharmaceutical or its nominee(s) at the lowest price permitted by the PRC laws and regulations. If the Registered Shareholders receive any payment as a result of the liquidation, they shall return in full such payment to Zhongzhi Pharmaceutical.

Termination

Each of the Operation Services Agreement, Call Option Agreement, Power of Attorney and Exclusive Intellectual Property Purchase Agreement provides that Zhongzhi Pharmaceutical can early terminate the agreement by serving prior notice on the others, but Zhongzhi Herb Pieces and the Registered Shareholders do not have such right of early termination. Also, the Operation Services Agreement, Call Option Agreement and Power of Attorney shall be automatically terminated if, *inter alia*, the PRC laws and regulations so require or Zhongzhi Pharmaceutical (or its nominee(s)) has acquired all the equity interest of Zhongzhi Herb Pieces subject to the PRC laws and regulations; whereas the Exclusive Intellectual Property Purchase Agreement shall be automatically terminated when all the intellectual property rights of Zhongzhi Herb Pieces have been transferred to Zhongzhi Pharmaceutical (whichever is earlier).

The Equity Pledge Agreement does not contain the aforesaid termination clauses. However, the Equity Pledge Agreement provides that the same shall remain effective until all the contractual obligations of the Registered Shareholders and Zhongzhi Herb Pieces under the Contractual Arrangements have been fully performed and all secured indebtedness under the Contractual Arrangements have been settled or the Contractual Arrangements have been terminated.

Insurance

The Company does not maintain an insurance policy to cover the risks relating to the Contractual Arrangements. Please refer to the paragraph headed “Risk Factors — Risks relating to our Contractual Arrangements” in this prospectus.

LEGALITY OF THE CONTRACTUAL ARRANGEMENTS

PRC Legal Opinions

Our PRC Legal Advisors, after taking reasonable actions and steps to reach its legal conclusions, are of the opinion that:

- (a) Zhongzhi Pharmaceutical and Zhongzhi Herb Pieces are duly established and validly existing under the PRC laws, and has obtained or completed all requisite approvals, permits, registrations or filings for carrying on their respective business operations as required by the applicable PRC laws, regulations and rules;
- (b) the Contractual Arrangements as a whole and each of the contracts comprising the Contractual Arrangements are legal, valid and binding on the parties thereto, and do not, individually or collectively, constitute a breach of any PRC laws and regulations and will

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not be deemed invalid or ineffective under those laws and regulations; in particular, the Contractual Arrangements do not violate the provisions of the PRC Contract Law including “concealing illegal intentions with a lawful form,” the General Principles of the PRC Civil Law and other applicable PRC laws and regulations;

- (c) each of the contracts comprising the Contractual Arrangements does not violate any provisions of the articles of association of Zhongzhi Pharmaceutical and Zhongzhi Herb Pieces;
- (d) the Contractual Arrangements do not require any approvals from or registration with the PRC government, except that the Equity Pledge Agreement shall be registered with the relevant Administration of Industry and Commerce, and such registration has been completed; and
- (e) the Contractual Arrangements are in full compliance with and enforceable under the applicable PRC laws and regulations, except that the Contractual Arrangements provide that the Commission may award remedies over the equity interest or land or other assets of Zhongzhi Herb Pieces or make injunctive relief against Zhongzhi Herb Pieces, and that courts of competent jurisdictions are empowered to grant interim remedies in support of the arbitration pending the formation of an arbitral tribunal. Under the PRC laws, an arbitral body has no power to grant injunctive relief and may not directly issue a provisional or final liquidation order for the purpose of protecting assets of or equity interests in Zhongzhi Herb Pieces in case of disputes. In addition, interim remedies or enforcement orders granted by overseas courts may not be recognisable or enforceable in the PRC.

In preparation for the Listing, our PRC Legal Advisors and the Sole Sponsor have interviewed a competent officer in the GFDA, during which the officer confirmed that it is not necessary to seek their approval before entering into the Contractual Arrangements. Even though no positive regulatory assurance has been obtained from relevant PRC regulatory authorities with respect to the use of the Contractual Arrangements in the pharmaceutical industry, and it is impracticable to obtain such assurance, no relevant PRC regulatory authorities have ever issued any regulations, rules or notices to prohibit the use of such Contractual Arrangements in the pharmaceutical industry.

Company’s confirmation

As at the Latest Practicable Date, our Company has not encountered any interference or encumbrance from any PRC governing bodies in operating our businesses through Zhongzhi Herb Pieces under the Contractual Arrangements.

In light of the opinion from the PRC Legal Advisors, the interview with a competent officer of the GFDA and there being no interference from the PRC government regarding the Contractual Arrangements, our Directors are of the view that the Contractual Arrangements which confer

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significant control and economic benefits from Zhongzhi Herb Pieces to Zhongzhi Pharmaceutical is enforceable under the relevant PRC laws and regulations and the Contractual Arrangements are narrowly tailored to minimise the potential conflict with relevant PRC laws and regulations.

Given that the Contractual Arrangements will constitute continuing connected transactions of our Company, a waiver has been sought from and has been granted by the Stock Exchange, details of which are disclosed in the “Continuing Connected Transactions” section in this prospectus.

Sole Sponsor’s view

The Sole Sponsor is of the view that the Contractual Arrangements adopted by our Group have complied with the requirements set out in the listing decision (HKEx-LD43-3) issued by the Stock Exchange in 2005 and updated in November 2011, August 2012, November 2012, December 2012, November 2013 and April 2014, respectively.

The Draft Foreign Investment Law and the Explanatory Notes

On 19 January 2015, MOFCOM released the Draft Foreign Investment Law and the Explanatory Notes for public consultation. The major changes that the Draft Foreign Investment Law introduces to the foreign investment regime in the PRC are as follows:

- (i) The definitions of “foreign investors” and “foreign investment”

The Draft Foreign Investment Law introduces the concept of “control” and “actual control”. Under Article 18 of the Draft Foreign Investment Law, the term “control” means that any of the following conditions is met in respect of an enterprise:

1. holding, directly or indirectly, more than 50% of shares, equity, share of property, voting power or other similar equities in the enterprise;
2. holding, directly or indirectly, less than 50% of shares, equity, share of property, voting power or other similar equities in the enterprise, but are under any of the following circumstances: (a) being entitled to, directly or indirectly, more than half of the members of the enterprise’s board of directors or the similar decision-making body; (b) being capable of ensuring that its nominated personnel can occupy more than 50% of seats of the enterprise’s board of directors or the similar decision-making body; and (c) the voting power it holds is sufficient to have significant influence on the resolutions of the meetings of shareholders, general assembly of shareholders, board of directors or other decision-making body;
3. exerting decisive influence on the enterprise’s management, finance, human resources or technologies etc by contracts, trust or other ways.

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In respect of “actual control”, the Draft Foreign Investment Law looks at the identity of the ultimate natural person or enterprise that controls the foreign-invested enterprise. “Actual control” refers to the power or position to control an enterprise through investment arrangements, contractual arrangements or other rights and decision-making arrangements. Article 19 of the Draft Foreign Investment Law defined “actual controllers” as the natural persons or enterprises that directly or indirectly control foreign investors or foreign-invested enterprises.

If the concept of “actual control” is applied in assessing whether the Contractual Arrangements will be regarded as a domestic investment, our PRC Legal Advisors are of the view that our Company is likely to be deemed as controlled by Chinese investors based on our Company’s shareholding structure, where Mr. Lai, being a Chinese investor, indirectly held approximately 80.52% Shares through Crystal Talent as at the Latest Practicable Date and approximately 60.39% Shares after completion of the Capitalisation Issue and the Global Offering (without taking into account the Shares which may be allotted and issued pursuant to the exercise of the Over-allotment Option and any options that may be granted under the Share Option Scheme). As such, the Contractual Arrangements are likely to be deemed as a domestic investment. Mr. Lai may submit written supporting materials to the foreign investment regulatory authorities of the State Council to apply for deeming our Company’s investment in Zhongzhi Herb Pieces as an investment made by a Chinese investor under Article 12 and Article 45 of the Draft Foreign Investment Law. The Contractual Arrangements are likely to be permitted to continue. We will unwind the Contractual Arrangements and acquire Zhongzhi Herb Pieces or the production of decoction pieces business it is carrying on when the applicable PRC laws and regulations allow.

The Draft Foreign Investment Law clearly states that contractual arrangement is a form of foreign investments which will be subject to its governance upon its promulgation if a foreign-invested enterprise under contractual arrangements is controlled by foreign investors.

(ii) The Negative List — restrictions on foreign investment

The Draft Foreign Investment Law stipulates restrictions of foreign investment in certain industry sectors. The Negative List classified the relevant prohibited and restricted industries into the Catalogue of Prohibitions and the Catalogue of Restrictions respectively.

Foreign investors are not allowed to invest in any sector set out in the Catalogue of Prohibitions. Where any foreign investor directly or indirectly holds shares, equities, properties or other interests or voting rights in any domestic enterprise, such domestic enterprise is not allowed to invest in any sector set out in the Catalogue of Prohibitions, unless otherwise specified by the State Council.

Foreign investors are allowed to invest in sector set out in the Catalogue of Restrictions, provided that the foreign investors are required to fulfill certain conditions and apply for permission before making such investment.

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For foreign investment outside the Negative List, no application for permission or filing is required save and except the submission of information report.

(iii) Reporting system for foreign investment

Under the Draft Foreign Investment Law, foreign investors or foreign-invested enterprises are required to fulfill reporting obligations in relation to their investments and operations, regardless of whether it is listed on the Negative List or not. There are three categories of information reporting, namely reporting on foreign investment matters, reporting on changes in foreign investment matters and periodic reports.

ACCOUNTING ASPECTS OF THE CONTRACTUAL ARRANGEMENTS

Consolidation of financial results of Zhongzhi Herb Pieces

According to the International Financial Reporting Standards 10 (Consolidated Financial Statements), a subsidiary is an entity that is controlled by another entity (known as the parent). An investor controls an investee when it is exposed, or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Although our Company does not directly or indirectly own Zhongzhi Herb Pieces, the Contractual Arrangements as mentioned above enabled our Company to exercise control over Zhongzhi Herb Pieces during the Track Record Period.

Under the Operation Services Agreement entered into by and among Zhongzhi Pharmaceutical and Zhongzhi Herb Pieces, it was agreed that, in consideration of the services provided by Zhongzhi Pharmaceutical, Zhongzhi Herb Pieces will pay yearly service fees to Zhongzhi Pharmaceutical. The amount of service fees and calculation method shall be determined by Zhongzhi Pharmaceutical at its sole discretion for the best interests of Zhongzhi Pharmaceutical. Under the Operation Services Agreement, Zhongzhi Pharmaceutical may adjust the service fees, at its sole discretion, based on the principle of maintaining the balance of profit and loss for Zhongzhi Herb Pieces so as to allow Zhongzhi Herb Pieces to retain sufficient working capital to carry out its business. Zhongzhi Herb Pieces shall deliver to Zhongzhi Pharmaceutical its management documents and operating data at the request of Zhongzhi Pharmaceutical. Accordingly, Zhongzhi Pharmaceutical has the ability, at its sole discretion, to extract all economic benefits of Zhongzhi Herb Pieces through the Operation Services Agreement.

In addition, under the Call Option Agreement among the parties, Zhongzhi Pharmaceutical has absolute control over the distribution of dividends or any other form of profit to the Registered Shareholders as Zhongzhi Pharmaceutical's prior written consent is required in this respect.

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Under the Power of Attorney, Zhongzhi Pharmaceutical was irrevocably and unconditionally appointed by the Registered Shareholders to be their attorney to exercise the shareholders' rights in Zhongzhi Herb Pieces including the rights to exercise voting rights in shareholders' meetings, to sign minutes of the shareholders' meetings, to file documents with the relevant government authorities, to appoint directors and supervisors.

Under the Equity Pledge Agreement, without the prior written consent of Zhongzhi Pharmaceutical, the Registered Shareholders shall not transfer, create or permit the subsistence of any encumbrance over the pledged equity interests in Zhongzhi Herb Pieces.

Pursuant to the Exclusive Intellectual Property Purchase Agreement, Zhongzhi Pharmaceutical was granted an option to purchase all or any of the intellectual property that Zhongzhi Herb Pieces has at the lowest price and to the extent permitted by the PRC laws and regulations.

As a result of the operation of the Contractual Arrangements described above, our Company has obtained control of Zhongzhi Herb Pieces through Zhongzhi Pharmaceutical and, under our Company's sole discretion, can receive all economic benefits and returns generated by Zhongzhi Herb Pieces. Accordingly, Zhongzhi Herb Pieces's results of operation, assets and liabilities, and cash flows are consolidated into our Company's financial statements in accordance with the relevant accounting standards. For each of the three years ended 31 December 2014, revenue from our own-branded decoction pieces (manufactured by Zhongzhi Herb Pieces) amounted to approximately RMB59.8 million, RMB105.9 million and RMB196.2 million, representing approximately 14.6%, 21.9% and 32.9% of our total revenue, respectively. The remaining portion of our total revenue was contributed by our other PRC subsidiaries, which are engaged in the production and sale of Chinese patent medicines as well as the operation of our chain pharmacies.

The basis of consolidating the financial results of Zhongzhi Herb Pieces is disclosed in note 2.2 to the Accountants' Report set out in Appendix I to this prospectus.

Tax impact of the Contractual Arrangements

Pursuant to the Operation Services Agreement, Zhongzhi Herb Pieces will transfer all its net profit as payment of yearly service fees to Zhongzhi Pharmaceutical. As a result, the Contractual Arrangements will increase our income tax expenses as the aforesaid yearly service fees will be treated as revenue of Zhongzhi Pharmaceutical and subject to PRC EIT at a rate of 25%. If the Contractual Arrangements were effective as at 1 January 2012, our income tax expenses would have increased by approximately RMB1.1 million, RMB2.4 million and RMB2.9 million for each of the three years ended 31 December 2014, respectively.

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The potential impact of the Draft Foreign Investment Law in relation to contractual arrangements generally

Pursuant to the Draft Foreign Investment Law, if a domestic enterprise under the contractual arrangements is controlled by Chinese nationals, such domestic enterprise may be treated as a Chinese investor and the contractual arrangements may be regarded as legal. On the contrary, if the domestic enterprise is controlled by foreign investors, such domestic enterprise will be treated as a foreign investor or foreign-invested enterprise, and the operation of such domestic enterprise may be regarded as illegal if the domestic enterprise is in an industry sector which is on the Negative List and the domestic enterprise does not apply for and obtain the necessary permission.

Notwithstanding the Explanatory Notes do not provide a clear direction in dealing with contractual arrangements existing before the Draft Foreign Investment Law becoming effective, which is still pending for consultation of public views and further study, the Explanatory Notes is contemplating three possible approaches in dealing with foreign-invested enterprises with existing contractual arrangements and conducts business in an industry falling in the Negative List:

- (a) to make a declaration to the competent authority that the actual control vested with Chinese investors, then the contractual arrangements may be retained for its operation;
- (b) to apply to the competent authority for certification of its actual control vested with Chinese investors and upon verification by competent authority, the contractual arrangements may be retained for its operation;
- (c) to apply to the competent authority for permission and the competent authority together with the relevant departments shall make a decision after taking into account the actual control of the foreign-invested enterprise and other factors.

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The potential impact to our Company in the worst scenario that our Contractual Arrangements is not treated as a domestic investment

Under the Draft Foreign Investment Law, the definition of “foreign investment” now expressly includes control by other means in addition to equity ownership. If the Draft Foreign Investment Law is promulgated in the current draft form, our Contractual Arrangements may be treated as a foreign investment. The potential impacts to our Group’s business and financial condition in the worst scenario that our Contractual Arrangements is not treated as a domestic investment would be as follows:

Impact on our business

- *If the production of decoction pieces is no longer in the Negative List*

If the production of decoction pieces is no longer in the Negative List, our Group can legally operate the business of production of decoction pieces. Zhongzhi Pharmaceutical will unwind the Contractual Arrangements in accordance with the Call Option Agreement and to acquire Zhongzhi Herb Pieces or the production of decoction pieces business it is carrying. When Zhongzhi Pharmaceutical or its nominee(s) exercises the option and acquire the entire equity interest in Zhongzhi Herb Pieces, the Contractual Arrangements will be terminated. For details of the procedures to exercise the option, please refer to the paragraph headed “Details of the Contractual Arrangements — Call Option Agreement” in this section.

- *If the production of decoction pieces is in the Negative List*

If the production of decoction pieces is in the Negative List, the Contractual Arrangements of Zhongzhi Pharmaceutical will be viewed as prohibited foreign investment. If the Draft Foreign Investment Law is refined and deviates from the current content of the Explanatory Notes, depending on the treatment of existing contractual arrangements, the Contractual Arrangements may be regarded as invalid and illegal. As a result, our Group would not be able to manufacture decoction pieces through the Contractual Arrangements with Zhongzhi Herb Pieces.

Considering that a number of existing conglomerates are operating under contractual arrangements and some of which have obtained listing status abroad, our PRC Legal Advisors are of the view that it is unlikely, if the Draft Foreign Investment Law is promulgated, the relevant authorities will take retrospective effect to require the relevant enterprises to remove the contractual arrangements. In future, the PRC government is likely to take a relatively cautious attitude towards the aspects of supervision as well as the enactment, and make decisions according to different situations in practice, which has already been reflected in the Explanatory Notes. Our PRC Legal Advisors are of the opinion that the concept of “actual control” will likely be the ultimate standard to solve the issues of the contractual arrangements. In gist, pursuant to the “actual control” standard, enterprises controlled by Chinese investors are regarded as domestic enterprises and will not be subject to the Negative

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List, which means that these enterprises can continue their operation and when they expand the business into new areas notwithstanding such enterprises have foreign investors as shareholders. On the contrary, enterprises controlled by foreign investors will be administered as foreign-invested enterprises, and will be handled according to the special administrative measures in the Negative List.

Impact on our financial position

If the Contractual Arrangements become invalid,

- we may lose our rights to direct the activities of Zhongzhi Herb Pieces and our rights to receive its economic benefits.
- the financial results of Zhongzhi Herb Pieces will not be consolidated into our Group's financial results.
- we would lose our income from the sales of our decoction pieces.
- we would have to derecognise the assets and liabilities of Zhongzhi Herb Pieces according to the relevant accounting standards. An investment loss would be recognised as a result of such derecognition.

For each of the three years ended 31 December 2014, total revenue from the sales of our own-branded traditional and modern decoction pieces amounted to approximately RMB59.8 million, RMB105.9 million and RMB196.2 million, representing approximately 14.6%, 21.9% and 32.9% of our total revenue, respectively. Excluding the retail sales of our own-branded traditional decoction pieces in our self-operated chain pharmacies, our revenue derived from the sales of our own-branded decoction pieces in the corresponding periods amounted to approximately RMB24.8 million, RMB67.8 million and RMB159.9 million, representing 6%, 14% and 26.8% of our total revenue, respectively. Gross profit derived from these sales were approximately RMB18.5 million, RMB51.9 million and RMB122 million in the corresponding periods.

For retail sales of traditional decoction pieces, if the Contractual Arrangements become invalid, we plan to purchase traditional decoction pieces from independent suppliers in order to maintain our product portfolio and market competitiveness of our self-operated chain pharmacies.

If the results related to sales of our modern decoction pieces and wholesales of our traditional decoction pieces have been excluded, our revenue for each of the three years ended 31 December 2014 would have been RMB385.2 million, RMB415 million and RMB435.7 million, respectively. Our net profit for the respective years would have been approximately RMB13.6 million, RMB20.9 million and RMB37.5 million. Accordingly, our Group's operating results would be materially and adversely affected.

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As at 31 December 2014, the net asset value of Zhongzhi Herb Pieces amounted to approximately RMB10.2 million, of which approximately RMB8.8 million was the cost of investment of Zhongzhi Pharmaceutical in Zhongzhi Herb Pieces.

In the event that the Contractual Arrangements become invalid, we would have to derecognise the assets and liabilities of Zhongzhi Herb Pieces according to the relevant accounting standards. Based on the net asset value of Zhongzhi Herb Pieces as at 31 December 2014, we would recognise an investment loss for the Group.

To protect the interest of our Group, Mr. Lai has executed an indemnity to irrevocably indemnify our Group for losses arising from our Group's investment in Zhongzhi Herb Pieces to be incurred in connection with the compliance of the new foreign investment law or regulations (irrespective of whether in the same form and substance as the Draft Foreign Investment Law) to be promulgated and implemented.

Sustainability of our Group's business in the event that our manufacturing of decoction pieces is to be discontinued

In the event that the Contractual Arrangements become invalid, our Group's manufacturing of decoction pieces will be discontinued. Our Directors are of the view that our Group's business will remain sustainable given (i) our revenue derived from the sales of our own-branded traditional and modern decoction pieces only accounted for approximately 32.9% of our total revenue for the year ended 31 December 2014; (ii) our experienced management which is led by Mr. Lai who has over 30 years of experience in the pharmaceutical industry; (iii) our chain pharmacies which for the year ended 31 December 2014, had a revenue accounted for over 50% of our total revenue and had been established for over 10 years is the largest self-operated pharmaceutical chain in Zhongshan in terms of the number of pharmacies and revenue for the three consecutive years from 2012 to 2014; (iv) satisfactory future growth in the retail sales of Chinese medicines in the Guangdong province as forecasted by Ipsos; (v) the strong brand recognition of our core brands "Zeus (中智)" and "Liumian* (六棉牌)" for our Chinese patent medicines in the pharmaceutical industry; (vi) our extensive distribution network for Chinese patent medicines; (vii) our strong research and development capabilities allow us to maintain a pool of pipeline products under development and as at the Latest Practicable Date, we had obtained approvals on 25 types of Chinese patent medicines from the relevant government authorities for production but not yet been launched; and (viii) our plans to further expand our pharmaceutical chain and distribution network and that we will fully reallocate the net proceeds from the Global Offering related to modern decoction pieces to the (a) research and development of Chinese patent medicines; and (b) expansion of the production capacity of our existing Chinese patent medicines and those in our pipeline in the event that the Contractual Arrangements become invalid. For details, please refer to the section headed "Future plans and use of proceeds" in this prospectus. In view of the above, the Sole Sponsor concurs with our Directors' view that our Group's business is sustainable in the event that the Contractual Arrangements have to be unwound and our manufacturing of decoction pieces is to be discontinued.

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Potential measures to maintain control over and receive economic benefits from Zhongzhi Herb Pieces

As mentioned above, our PRC Legal Advisors are of the view that the Contractual Arrangements are likely to be deemed as a domestic investment if the Draft Foreign Investment Law were to become effective in its current form and content. To ensure the Contractual Arrangements to remain a domestic investment so that our Group can maintain control over Zhongzhi Herb Pieces and receive all economic benefits derived from Zhongzhi Herb Pieces, Mr. Lai has given an undertaking to our Company, and our Company has agreed with the Stock Exchange to enforce such undertaking to:

- (a) continue to maintain his Chinese nationality and citizenship;
- (b) remain as a beneficial owner of not less than 50% voting rights of our Company and otherwise maintain control for the purposes of the relevant foreign investment laws and related laws applicable to our Group in relation to domestic investment when they become effective; and
- (c) obtain prior written consent of our Company as to the identity of the transferee(s) before Mr. Lai disposes of or transfers any of our Company's securities that he beneficially owns. Prior to any such disposal, transfer or other transactions which may result in Mr. Lai ceasing to have control of our Company for the purposes of the relevant foreign investment laws, Mr. Lai shall demonstrate to the satisfaction of our Company and the Stock Exchange that the Contractual Arrangements will remain a domestic investment for the purpose of the relevant foreign investment laws and related laws applicable to our Group in relation to domestic investment.

The aforesaid undertaking was made by Mr. Lai to ensure compliance with the relevant foreign investment laws and related laws applicable to our Group from time to time in connection with domestic investment. Such undertaking (a) shall remain effective as long as our Company is required to comply with the relevant foreign investment laws and related laws applicable to our Group in connection with domestic investment; and (b) shall only terminate subject to the approval of our Company and Mr. Lai demonstrating to the satisfaction of our Company and the Stock Exchange that our Group is no longer required to comply with the relevant foreign investment laws and related laws applicable to our Group in relation to domestic investment. Mr. Lai and his associates shall abstain from voting at the Board meeting resolving matters in relation to such undertaking.

Based on the view of our PRC Legal Advisors and the aforesaid undertaking given by Mr. Lai, our Directors and the Sole Sponsor are of the view that (i) the Contractual Arrangements are likely to be deemed as a domestic investment and to be permitted to continue; (ii) our Group can maintain control over Zhongzhi Herb Pieces and receive all economic benefits derived from Zhongzhi Herb Pieces; and (iii) the Draft Foreign Investment Law would have minimal impact on our Group's business operations.

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In respect of his interest in our Company, Mr. Lai has also given a non-disposal undertaking under Rule 10.07(1) of the Listing Rules as detailed in the paragraph headed “Underwriting — Undertakings to the Stock Exchange under the Listing Rules — Undertakings by our Controlling Shareholders” in this prospectus.