
INDUSTRY OVERVIEW

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REPORT COMMISSIONED FROM IPSOS

We commissioned Ipsos, an independent market research and consulting company to conduct an analysis of, and to report on the Chinese medicine market in the PRC, for a total fee of HK\$458,000. The findings and analysis of the industry research are set out in the Ipsos Report.

Founded in Paris, France, in 1975 and publicly-listed on the NYSE Euronext Paris in 1999, Ipsos SA acquired Synovate Ltd. in October 2011. After the combination, Ipsos becomes the third largest research company in the world which employs approximately 16,000 personnel worldwide across 85 countries. Ipsos conducts research on market profiles, market size and market share and performs segmentation analyses, distribution and value analyses, competitor tracking and corporate intelligence.

The information contained in the Ipsos Report is derived from data and intelligence gathering methodology which includes (i) desk research; (ii) client consultation; and (iii) primary research from interviews with key stakeholders and industry experts in the PRC, such as Chinese medicine manufacturers and retailers as well as trade associations. According to Ipsos, this methodology guaranteed a full circle/multi-level information sourcing process, where information gathered was able to be cross-referenced to ensure accuracy. The intelligence gathered by Ipsos was analysed, assessed and validated using their in-house analysis models and techniques.

The projections in the Ipsos Report are based on the assumptions that (i) the PRC economy will maintain steady growth; and (ii) there will be no adverse events, such as financial crisis or natural disasters, which will affect the demand and supply of the products of Chinese medicine industry, during the forecast period from 2014 to 2018.

Our Directors confirm that after taking reasonable care, as at the date of this [REDACTED], there has been no material adverse change in the market information since the issue date of the Ipsos Report.

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THE CHINESE MEDICINE MARKET IN THE PRC

Overview

Chinese medicines have been widely used by the Chinese community for prevention and treatment of diseases as well as health enhancement for more than 2,000 years and have been increasingly popular. Consumers prefer Chinese medicines over Western medicines as Chinese medicines are perceived to have less side effects. Products of the Chinese medicine market in the PRC can be broadly classified into (i) Chinese patent medicines; and (ii) decoction pieces.

Chinese patent medicines are manufactured with Chinese herbs as major ingredients and based on the formulas as set out in the Chinese Pharmacopoeia or the Drug Standards. The products are in various forms, such as oral solutions, pills, capsules, powder and syrup.

The Chinese Pharmacopoeia and the Drug Standards also set out the standards of decoction pieces, including the levels of different ingredients in different types of decoction pieces. Decoction pieces can be further divided into (i) traditional decoction pieces; and (ii) modern decoction pieces. Traditional decoction pieces refer to Chinese herbs after being processed through various procedures, such as boiling, steaming, frying, chopping and slicing. These are generally used by pharmaceutical manufacturers for the production of Chinese patent medicines and consumers for making soups or cooking. According to the Ipsos Report, during the past few years, manufacturers have developed techniques such as ultra-fine pulverisation, additive-free granulation, extraction and concentration to provide various forms of modern decoction pieces. By adopting various advanced techniques, modern decoction pieces generally have higher levels of efficacy, accuracy on the dosage and consumption convenience. Modern decoction pieces mainly comprise (i) granules of cell wall-broken decoction pieces which involve the use of ultra-fine pulverisation techniques; (ii) formulation granules; and (iii) paste or syrup using extraction and concentration techniques.

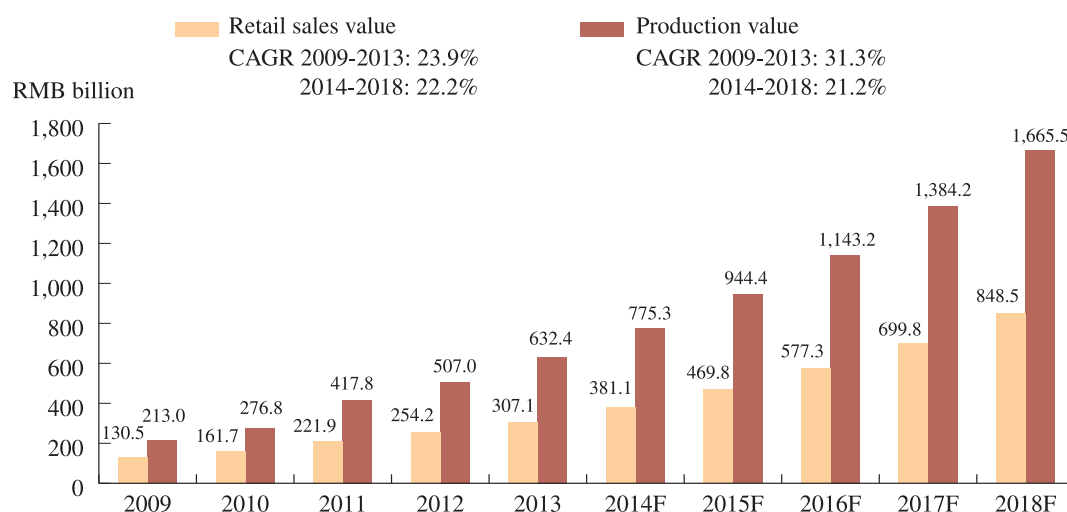
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Rapid growth of the Chinese medicine market in the PRC

The Chinese medicine market in the PRC has experienced rapid growth from 2009 to 2013. According to Ipsos, total production value of Chinese medicines in the PRC increased from approximately RMB213 billion in 2009 to RMB632.4 billion in 2013, representing a CAGR of approximately 31.3%. The total production value of Chinese medicines is expected to further increase at a CAGR of approximately 21.2% from approximately RMB775.3 billion in 2014 to approximately RMB1,665.5 billion in 2018. Such remarkable growth is primarily driven by the increasing global demand on Chinese medicines.

Total retail sales of Chinese medicines in the PRC, which included the sales of Chinese medicines from hospitals, clinics, health centres and pharmacies to end consumers, increased from approximately RMB130.5 billion in 2009 to approximately RMB307.1 billion in 2013, representing a CAGR of approximately 23.9%. It is expected that the total retail sales of Chinese medicines will further grow at a CAGR of approximately 22.2% from approximately RMB381.1 billion in 2014 to approximately RMB848.5 billion in 2018.

**Total retail sales value and production value of Chinese medicines
in the PRC from 2009 to 2018**



Source:

- (1) 2009–2013: National Bureau of Statistics of China
- (2) 2014–2018: Ipsos

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Key growth factors of the Chinese medicine industry in the PRC

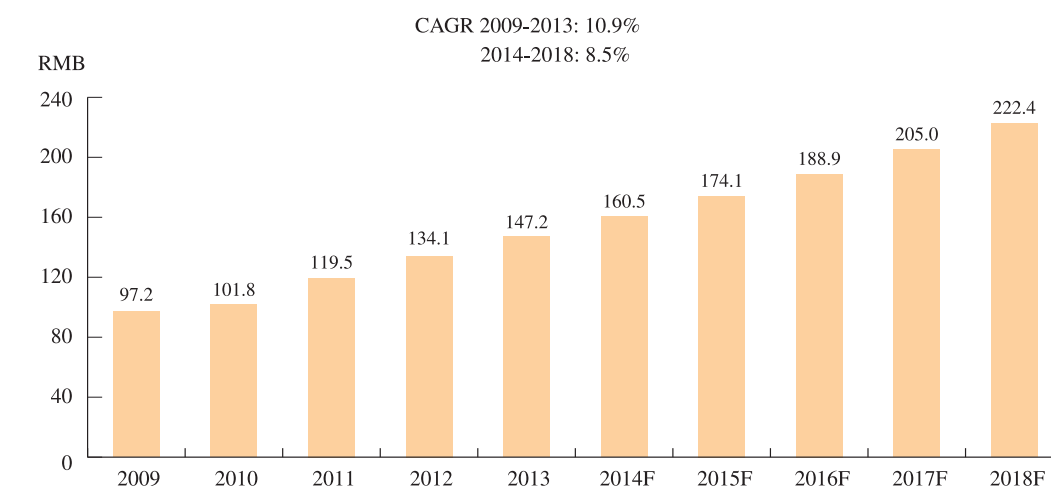
Fast growing GDP and disposable income

PRC is one of the fastest-growing economies in the world. According to Ipsos, PRC was the second largest economy in the world with a GDP reaching US\$9.5 trillion in 2013. Average annual per capita disposable income in the PRC increased from approximately RMB17,175 in 2009 to approximately RMB26,955 in 2013, representing a CAGR of approximately 11.9%. It is expected that the average annual per capita disposable income in the PRC will further increase at a CAGR of approximately 9.0% from approximately RMB29,516 in 2014 to approximately RMB41,664 in 2018.

Increasing health consciousness and healthcare spending

The living standards of PRC residents are gradually improving along with the economic growth and the increasing disposable income. Threatened by the outbreak of epidemics, such as avian flu, swine influenza and Ebola virus diseases, the PRC residents are getting more health-conscious and they are willing to increase their spending on pharmaceutical and healthcare products including Chinese medicines, for prevention of diseases and health improvement. According to Ipsos, average annual per capita consumption expenditure on Chinese medicines in the PRC increased from approximately RMB97.2 in 2009 to RMB147.2 in 2013, representing a CAGR of approximately 10.9%. It is expected that the average annual per capita consumption expenditure on Chinese medicines in the PRC will further increase at a CAGR of approximately 8.5% from approximately RMB160.5 in 2014 to approximately RMB222.4 in 2018.

Average annual per capita consumption expenditure on Chinese medicines in the PRC from 2009–2018



Source:

- (1) 2009–2013: National Bureau of Statistics of China
- (2) 2014–2018: Ipsos

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Growing urbanisation trend

As compared with the rural population, the PRC’s urban population has greater needs for medical care services and pharmaceutical products, and hence their per capita expenditures on medical and healthcare services and products are relatively higher. According to Ipsos, the average annual per capita consumption expenditure on Chinese medicines of the PRC’s urban population increased from RMB145.6 in 2009 to RMB190.1 in 2013, representing a CAGR of approximately 6.9%. The urbanisation rate also grew from 48.3% in 2009 to 53.7% in 2013. It is expected that the growing urbanisation trend in the PRC will drive the demand on Chinese medicines.

Aging population

PRC has the largest elderly population (aged 60 and above) in the world according to Ipsos. The PRC population aged 60 and above increased at a CAGR of approximately 1.2% from approximately 193.4 million in 2009 to 202.6 million in 2013. By the end of 2018, it is expected that the PRC population aged 60 and above will reach approximately 252.5 million in 2018, representing a CAGR of approximately 4.5% from 2014. As the elderly has a higher tendency to consume more medicines, the PRC aging population is expected to continuously drive the demand for pharmaceutical and healthcare products, including Chinese medicines.

Increasing government support related to the Chinese medicine industry

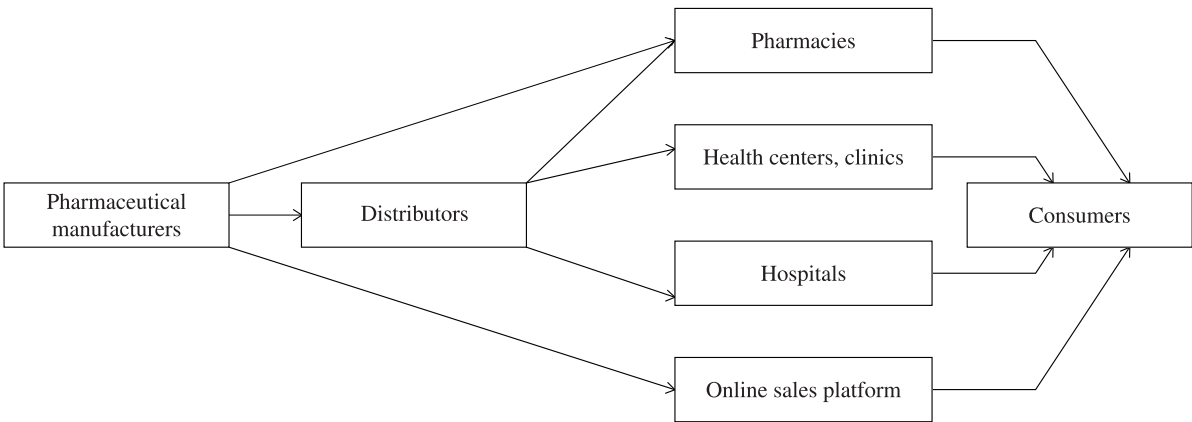
In recent years, the PRC government started to reform the national medical system by introducing a series of policies, namely (i) Opinions of the CPC Central Committee and the State Council on Deepening the Reform of the Medical and Healthcare System (中共中央國務院關於深化醫藥衛生體制改革的意見); (ii) Notice of the State Council on Issuing the Plan on Recent Priorities in Carrying out the Reform of Healthcare System (2009–2011) (醫藥衛生體制改革近期重點實施方案 (2009–2011年)); and (iii) Implementation Plan of Deepening the Medical and Healthcare System Reform during the 12th Five-Year Plan Period (「十二五期間」深化醫藥衛生體制改革規劃暨實施方案).

The medical reform aims to improve the affordability and accessibility of medical services and products in various ways, such as increasing government subsidies, building more hospitals and clinics and increasing the amount of benefits under the social medical insurance programme. The basic medical insurance plan reimburses certain costs of the medicines included in the National List of Essential Drugs. In 2013, the PRC government has broadened such list to further include 309 types of Chinese patent medicines and seven types of decoction pieces. Consequently, it is expected that the public can easily access to medical services and their relevant expenditures on medical services and products will be largely covered by the medical insurance and/or government subsidies, which will in turn increase the the consumption of Chinese medicines.

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Value chain analysis of the Chinese medicine industry in the PRC

The typical value chain of the Chinese medicine industry in the PRC comprises three main segments: (i) upstream manufacturers; (ii) pharmaceutical distributors which include upper-level distributors and lower-level distributors; and (iii) downstream customers which include hospitals, health centres, clinics and pharmacies.



Source: Ipsos

Distributors play and will continue to be an important role in the value chain of the Chinese medicines industry. This is primarily because distributors have extensive logistics network facilitating prompt delivery of Chinese medicines from thousands of manufacturers to numerous and dispersed points of sale. This can relieve the burden of manufacturers to deliver products to and collect payments from the retailers. Therefore, manufacturers can focus their resources on research and development, manufacturing and marketing of their products.

Online sales platform for pharmaceutical products has been increasingly popular, which is believed to provide a cost effective way for product promotion and penetration to the consumer market.

Key entry barriers of the Chinese medicine industry in the PRC

The key entry barriers of the Chinese medicine industry in the PRC include substantial capital investment, strong research and development capability, diversified product portfolio, good and stable product quality and extensive distribution and marketing network.

Capital investment

Chinese medicines manufacturing is a capital intensive business, which requires substantial capital investment in (i) production plants and equipments; (ii) upgrade of production facilities in order to enhance production capacity and efficiency; and (iii) research and development on new products.

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Research and development capability

The future growth and prospect of a Chinese medicines manufacturer rely primarily on its research and development ability. A Chinese medicines manufacturer is required to have a competent research and development team together with sufficient resources for the development of new products, enhancement of the efficacy of existing products, and/or improvement of production methods in a cost effective and efficient manner.

Product portfolio

Chinese medicines manufacturers are required to regularly evaluate and enrich their product portfolios to maintain their competitiveness and to cater for the changing needs of consumers of different ages and consuming power.

Product quality

Product quality is crucial to consumer confidence and the continued growth of the market players in the Chinese medicines industry. In order to ensure the product quality of Chinese medicines, the PRC government has issued a series of national quality standards for the pharmaceutical industry covering various stages of the value chain from product manufacturing to sales and distribution. All pharmaceutical manufacturers are required to comply with the GMP standards, whereas all pharmaceutical distributors and operators of pharmacies are required to comply with GSP standards. For further details of the GMP and GSP standards, please refer to the “Regulation” section in this [REDACTED].

The stringent regulatory standards are expected to significantly increase the cost and difficulties of compliance and force many smaller-sized pharmaceutical companies to close down or to seek larger economies of scale through consolidation in order to lower costs and remain competitive.

Distribution and marketing network

The sales performance of Chinese medicines manufacturers is directly correlated to the level of market penetration of their products. As such, it is essential to have an extensive distribution and marketing network and long and stable business relationships with distributors, which require considerable amount of time and resources to build up and maintain.

In light of the above, the entry barrier to set up and operate a Chinese medicine manufacturing business in the PRC is considered to be high. It is difficult for new entrants to succeed within a short period of time.

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Competitive landscape of the Chinese medicine industry in the PRC

According to Ipsos, the Chinese medicine industry in the PRC is fragmented with different market players of various sizes. In 2013, there were more than 1,500 Chinese patent medicine manufacturers and approximately 1,900 decoction pieces manufacturers in the PRC. In terms of sales revenue, the top five largest manufacturers of Chinese patent medicines and decoction pieces accounted for approximately 3.9% and 5.9% of the total revenue from the Chinese medicine industry in 2013, respectively. Given the fragmentation of the Chinese medicine industry, manufacturers are under intense pressure to compete for business and maintain profits, and must focus on the following competitive issues:

Scale of operation and integration

In general, large-scale manufacturers enjoy cost advantages from economies of scale through bulk purchase of raw materials and mass production. Furthermore, these manufacturers would have more resources for business expansion through vertical and/or horizontal integrations. These may involve the establishment of their own Chinese herbs plantation bases, distribution networks and/or chain pharmacies as well as by way of merger and acquisitions. Such integrations would enable them to (i) better control their production costs; (ii) ensure a stable supply of good quality Chinese herbs, which are the major raw materials of Chinese medicines; (iii) distribute their products in a cost effective manner; and (iv) increase their geographical coverage and therefore market share. It is expected that large-scale fully integrated Chinese medicines manufacturers are in a better position to consolidate and become leaders in the PRC Chinese medicines market.

The significance of branding

Chinese patent medicines are manufactured according to the formula set out in the Chinese Pharmacopoeia or Drug Standards. As such, there is not much differentiation in the product offerings of Chinese patent medicines. Market players with well-established and strong brand names have a competitive advantage as their brand names represent better product quality and efficacy, which in turn enhance consumer confidence and support their growth in sales revenue and market share.

Ability to produce new products

As mentioned above, there is not much differentiation in the product offerings of Chinese patent medicines. On the other hand, the processing procedures of traditional decoction pieces, such as boiling, steaming and slicing do not require advanced technologies, and they are commonly used by the decoction pieces manufacturers. For product differentiation, manufacturers have been putting up with their efforts on research and development to improve the efficacies and consumption conveniences of traditional decoction pieces, such as the production of modern decoction pieces. Apart from introducing new products to the market, manufacturers of these products also aim at achieving a higher profitability as these

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products which require higher production technologies can be priced higher than traditional pharmaceutical products. Manufacturers with better capital resources to support their research and development activities will be more competitive in these aspects.

For further details of our Group’s competitive strengths, please refer to the paragraph headed “Business — Competitive strengths” in this [REDACTED].

CHINESE MEDICINE MARKET IN EASTERN AND SOUTHERN CHINA

Overview of Eastern and Southern China

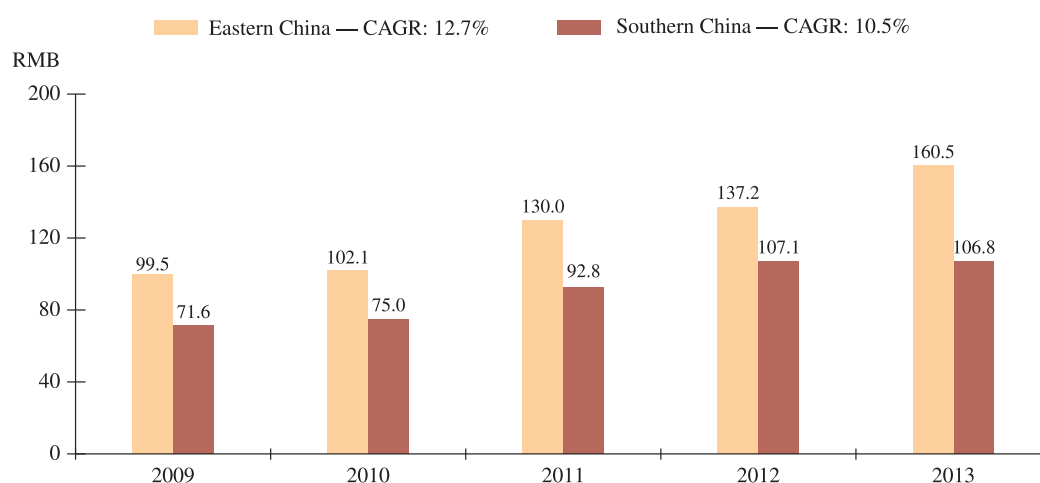
Eastern China consists of seven provinces and municipalities, namely Anhui, Fujian, Jiangsu, Jiangxi, Shandong, Zhejiang and Shanghai. Southern China consists of four provinces and one autonomous region, namely Guangdong, Yunnan, Guizhou, Guangxi and Hainan. From 2009 to 2013, the growth in the population and GDP of these two regions exceeded that in China as a whole. According to Ipsos, these two regions have a population of 643.6 million in 2013, representing a CAGR of approximately 0.6% from 629.6 million in 2009. It is expected the population in these two regions will further increase at a CAGR of 0.6% from 647 million in 2014 to 661.5 million in 2018. Annual GDP growth rates of Eastern and Southern China from 2009 to 2013 ranged from 9.5% to 12.8% and from 10.6% to 13.5%, respectively. It is expected that the annual GDP of these two regions will continue to grow at a rate ranging from 8.6% to 10.3% from 2014 to 2018.

According to Ipsos, the average annual per capita consumption expenditure on Chinese medicines in Eastern China increased at a CAGR of approximately 12.7% from approximately RMB99.5 in 2009 to approximately RMB160.5 in 2013. The average annual per capita consumption expenditure on Chinese medicines in Southern China increased at a CAGR of approximately 10.5% from approximately RMB71.6 in 2009 to approximately RMB106.8 in 2013.

Guangdong province is a geographically well located province in Southern China. Together with its well developed transportation system, Guangdong province is conveniently accessible by all types of transport and it provides a great environment for business activities. It is rated as one of the most prosperous provinces in the PRC, for its significant contributions to the annual GDP growth of Southern China. In light of the aforesaid favorable factors and our Group’s base in Zhongshan, our Directors believe that Guangdong province would provide opportunities for the expansion of our pharmaceutical chain.

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Average annual per capita consumption expenditure on Chinese medicines in Eastern and Southern China from 2009 to 2013



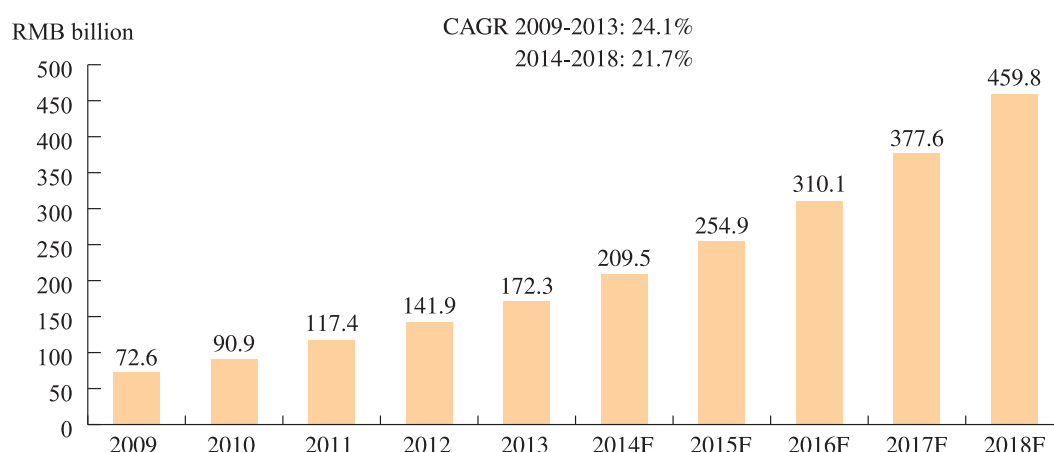
Source: National Bureau of Statistics of China

Retail sales of Chinese medicines in Eastern and Southern China

The total retail sales of Chinese medicines in Eastern and Southern China increased from approximately RMB72.6 billion in 2009 to approximately RMB172.3 billion in 2013, representing a CAGR of approximately 24.1%. It is expected that the total retail sales of Chinese medicines in these two regions will further grow at a CAGR of approximately 21.7% from approximately RMB209.5 billion in 2014 to approximately RMB459.8 billion in 2018. A majority of our Group’s revenue was derived from these two regions during the Track Record Period. Driven by the aforesaid favourable socio-economic factors and leveraging on our experience and well established market reputation in the Eastern and Southern China, our Directors believe that these two regions will continue to have significant contributions to our Group’s revenue.

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Total retail sales value of Chinese medicines in Eastern China and Southern China from 2009 to 2018



Source: Ipsos

CHINESE MEDICINE MARKET IN ZHONGSHAN

Overview of Zhongshan

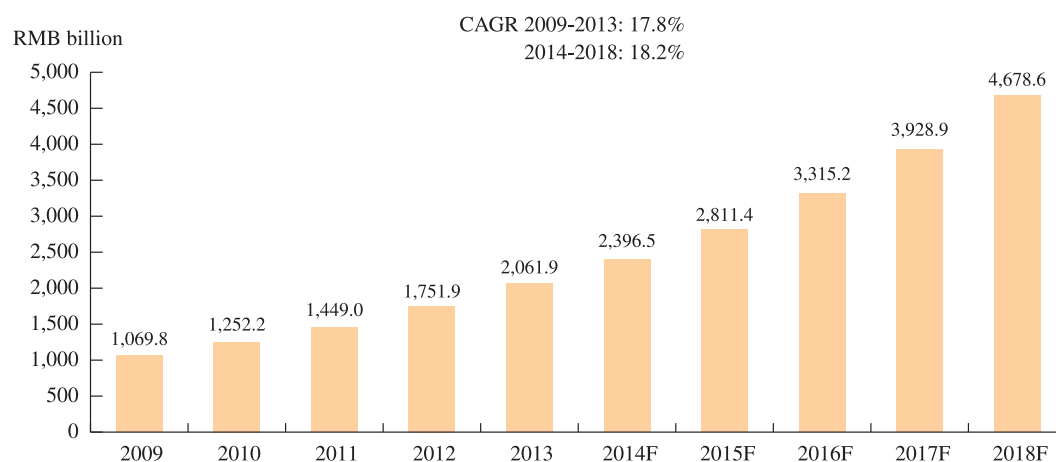
Zhongshan is situated in the Western Pearl River Delta and it is a regional logistics hub connecting the eastern and western reaches of the Pearl River Delta. Its strategic location coupled with continuous government support has attracted many domestic and foreign companies to establish their businesses in Zhongshan. The GDP of Zhongshan is mainly contributed by import and export trading activities and manufacturing businesses, which employ many workers migrated from other rural areas. Given the favourable business environment, annual GDP growth rates of Zhongshan from 2009 to 2013 ranged from 10.0% to 13.5% and its population increased at a CAGR of approximately 3.8% from 3.0 million in 2009 to 3.2 million in 2013 according to Ipsos. The growth rates of GDP and population of Zhongshan outperformed the PRC’s overall growth rates in GDP and population from 2009 to 2013 and such outperformance is expected to sustain during the period from 2014 to 2018.

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Retail sales of Chinese medicines in Zhongshan

According to Ipsos, the total retail sales of Chinese medicines in Zhongshan increased from approximately RMB1,069.8 million in 2009 to approximately RMB2,061.9 million in 2013, representing a CAGR of approximately 17.8%. It is expected that the total retail sales of Chinese medicines in Zhongshan will further grow at a CAGR of approximately 18.2% from approximately RMB2,396.5 million in 2014 to approximately RMB4,678.6 million in 2018.

Total retail sales value of Chinese medicine in Zhongshan from 2009 to 2018



Source: Ipsos

According to Ipsos, average annual per capita disposable income in Zhongshan increased at a CAGR of approximately 10.4% from approximately RMB23,088 in 2009 to approximately RMB34,258 in 2013, driven by the rapidly rising minimum wage at a CAGR of approximately 14.2% from 2009 to 2013. The residents in Zhongshan are getting wealthier and they are more willing to spend in order to improve their living standards. The average annual per capita consumption expenditure in Zhongshan increased at a CAGR of approximately 8.4% from approximately RMB17,415 in 2009 to approximately RMB24,071 in 2013.

It is expected that the aforesaid favourable socio-economic factors will support the increasing trend of the total retail sales of Chinese medicines in Zhongshan.

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Competitive landscape of Chinese medicine retail industry in Zhongshan

The Chinese medicine retail industry in Zhongshan is very fragmented with approximately 687 chain pharmacies and 2,228 individual pharmacies in 2013. In terms of sales revenue and number of pharmacies, our Group is the largest pharmacy chain in Zhongshan according to Ipsos. Revenue from the top five largest retailers accounted for 26% of the total retail sales revenue of Chinese medicines and healthcare products in Zhongshan in 2013, of which our Group contributed 16.3%. Amongst the top five largest retailers in Zhongshan, three of them (including our Group) are based in Zhongshan and the other two are based in Guangzhou and Shenzhen. The remaining 74 % of the total retail sales revenue of Chinese medicines and healthcare products in Zhongshan was contributed by other smaller-sized pharmacy chains and a large number of individual pharmacies.

Pharmacy chains have competitive advantages over individual pharmacies that they can offer consumers more convenient shopping experience through a wider range of products. They are capable of putting more resources on the hiring of experienced management personnel as well as marketing and advertising activities, which can effectively enhance their brand awareness and market positioning. They also achieve economies of scale through bulk purchases. Furthermore, the new GSP standard promulgated by the CFDA on 1 June 2013 further increased the operating costs of individual pharmacies as all pharmacies are required to have a licensed pharmacist on site by end of 2015. It is expected that certain individual pharmacies will be forced out of the market.

For further details of our Group’s competitive strengths, please refer to the paragraph headed “Business — Competitive strengths” in this [REDACTED].

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The table below sets forth the number of pharmacies, headquarter location, revenue and market share of the top five retailers of Chinese medicines and healthcare products (in terms of revenue) in Zhongshan in 2013:

Rank	Company name	Headquarter location	Number of pharmacies in Zhongshan	Revenue in 2013 <i>(in RMB millions)</i>	Market share <i>(Note)</i>
1	Our Group	Zhongshan	195	275.7	16.3%
2	Zhongshan Da Sen Lin Chain Drugstore Co., Ltd.* (中山市大參林連鎖藥業有限公司)	Guangzhou	56	75.7	4.5%
3	Zhongshan Zhongshantang Pharmaceutical Chain Co., Ltd.* (中山市中山堂藥業連鎖有限公司)	Zhongshan	36	34.1	2.0%
4	Zhongshan Furentang Pharmaceutical Chain Co., Ltd.* (中山市福仁堂藥房連鎖有限公司)	Zhongshan	32	28.8	1.7%
5	China Nepstar Chain Drugstore Ltd.* (深圳市海王星辰健康藥房連鎖有限公司)	Shenzhen	39	25	1.5%

Source: Ipsos

Note: The market share was calculated by dividing the revenue of the respective retailer in 2013 by the total retail sales revenue of Chinese medicines and healthcare products in Zhongshan in the same year.