Heng Ren Investments

To the Members of the Special Committee and Board of Directors of China Nepstar Chain Drug Store Ltd.,

Heng Ren Investments LP believes the offer by Chairman Simin Zhang to buy out shareholders of China Nepstar Chain Drug Store Ltd. ("Nepstar" or the "Company"), is priced significantly below a full and fair value of $4.83 per American Depositary share ("ADS," "share" or "stock"), and should be raised by 86%.

If not, the current offer of $2.60 per share from Chairman Zhang should be rejected by Nepstar's Board of Directors as it is detrimental to shareholders now, and in the future.

During your evaluation process, Heng Ren, an investment fund and a shareholder of Nepstar (NYSE:NPD), requests Nepstar's Board of Directors, and the Special Committee appointed by them, to evaluate the proposal and remain mindful of their fiduciary duty, and the required disclosures related to the proposed buyout under applicable laws.

Heng Ren plans to assert our rights as shareholders and seek protections under applicable laws.

You may recall Heng Ren's letter of February 17, 2015 to Nepstar's Board of Directors. In that letter we urged Chairman Zhang and management to change strategy to turn around Nepstar, pursue sustainable profitability, and to protect shareholders after an 91% decline in stock price since its 2007 initial public offering (IPO) on NYSE.[1] We urged store closings, staff reductions, and an emphasis on energizing Nepstar's online sales channel. Nepstar's stock price was $1.53.

These changes were starting to be implemented. Nepstar's stock responded with a +116% appreciation when it rose to a 52-week high of $3.30 on April 23.[2]

In quarterly earnings calls in March and May, Nepstar's management emphasized to shareholders their confidence in the *"regained momentum,"* the company's *"very promising future,"* and pledged *"a better result-driven approach will reward our shareholders in a very positive way in the coming quarters."*

Unfortunately, six weeks after this pledge to reward shareholders, on July 6, Chairman Zhang proposed to buy out shareholders at $2.60 per share – 21% below the 52-week high of $3.30 in April. To Wall Street traders, the proposal may appear to be a good deal for the Chairman – i.e. to buy the company at a discount just as a turnaround emerges. However, it is a bad deal for shareholders to sell a stock after it collapsed from its IPO, is just beginning to turn around, and with a brightening outlook.

Heng Ren believes Nepstar's current offer to buyout shareholders is unreasonable because it not only undervalues the current value of the company to shareholders - it ignores the future benefits to be enjoyed by Chairman Zhang if he succeeds in regaining full control of Nepstar.

[1] All price data as of September 8, 2015. Number of ADS is 98, 723, 470

[2] If Nepstar had optimized our recommendations by assertively streamlining for greater efficiency, profitability, and aimed to reduce stores to 1,500 by 2019 (from 1,980 in 2014), its stock would be worth $6.79.

The offering price from Chairman Zhang of $2.60 per share should be raised 86% to Heng Ren's appraisal of Nepstar's valuation of $4.83 per share. Heng Ren's appraisal reflects the full and fair value of Nepstar's stock based on Discounted Cash Flow (DCF) valuation, China Peer Comparison, and Leveraged Buyout (LBO) valuation. A control premium is included for the transfer of full control of the company and the enjoyment of the lucrative benefits in the future to be solely enjoyed by Chairman Zhang.

This potential payoff from regaining full control of Nepstar is not fantasy. Look no further than 3SBio Inc. (Nasdaq:SSRX) as a cautionary tale. Investor demand in Greater China for health-care related stocks is strong. In 2013 3SBio was the target of a management buyout. The price paid to shareholders was **$370 million**.

Fast forward two years to June 2015. 3SBio executed an IPO on the Hong Kong Stock Exchange (HKG:1530). Its total value - **$2.80 billion** – or **7.6X** the price paid to shareholders in the U.S. Our demand for a considerable control premium is warranted with the potential of such an enormous reward.

The following are benefits that will be realized in the future exclusively by Chairman Zhang if he regains full control of Nepstar:

- **Increased Prescription Drug Sales**: The era of China's $14.0 billion prescription drugs market being captive to hospitals is ending. Retailers on- and off-line (O2O) like Nepstar, China's largest nationwide drug store chain, stand to gain valuable market share.
- **China IPO Revaluation**: The apparent plan of Chairman Zhang, like his peers also executing management buyouts, is to delist Nepstar's stock from NYSE to do an IPO in China, where on average book values for its peers are 3.6x higher.
- **Turnaround Progress**: Fundamentals are improving at Nepstar. In the Second Quarter of 2015 the operating margin, negative for more than one year, was on the verge of turning positive at -0.2% (vs. -2.0% a year ago). Revenues increased by +12.9% versus a year ago, same-store-sales by +16.7% (note store closings flatter this rate), and operating expenses as a percentage of revenue was 39.5% vs. 43.6% the year earlier. This tailwind provided to Nepstar for a profitable return to China was made while turning around on U.S. shareholder time and money.

Heng Ren expects other shareholders will agree with our opinion that Chairman Zhang's current "going private" offer of $2.60 per share needs to be increased to $4.83. If a higher offer does not materialize, the Special Committee should recommend Nepstar's Board of Directors reject Chairman Zhang's offer because it is too low and detrimental now, and in the future, to shareholders in the U.S.

In this letter we outline our rationale and share our valuation appraisal for a significantly higher offering price for Nepstar. We used these methods:

1) **Discounted Cash Flow (DCF).** Based on current strategy and operational metrics.
2) **Peer Comparison.** In the China market, where Nepstar's future valuation is likely to be based.
3) **Leveraged Buyout (LBO).** Based on zero debt and $56.4 million in cash on the balance sheet (as of June 30, 2015).

Heng Ren's Valuation Appraisal of Nepstar

Using the three methodologies to derive a per share valuation, Heng Ren assigned weightings of 50% to the DCF valuation, 25% to the Peer Comparison, and 25% to the LBO valuation. While Heng Ren considers the Peer Comparison and LBO methods important, they entail execution risks (albeit with enormous payoffs). The DCF valuation is given the greatest weighting because it is more conservative.

Method	Weighting	Per Share Value
DCF	50%	$3.51
China Peer Comparison	25%	$5.23
LBO	25%	$7.07
Value of Nepstar per share		**$4.83**

After applying these weightings, Heng Ren has determined a minimum per share price valuation for Nepstar of $4.83, an 86% premium to Chairman Zhang's offer price, is reasonable.

1) Discounted Cash Flow (DCF) Valuation

Result = $3.51; 35% above Chairman Zhang's offer price.

Heng Ren has utilized a discounted cash flow (DCF) model to value Nepstar. A DCF model assesses a company's value based on all of the cash the company could make available to investors. Our assumptions use revenue growth rates of 17% annually per store, in line with the current trend. This results in Same Store Sales increasing from $240k in 2014 to $533k by 2019, with a steady increase its EBITDA margins from 0.6% in 2015 to 3.1% by 2019. (Note the 2014 average EBITDA margin for Nepstar's China peers is 5.5%).

	2015E	2016E	2017E	2018E	2019E
Revenue	$555,477,996	$642,628,302	$743,363,540	$859,785,151	$994,316,669
Net Stores:	1,948	1,927	1,906	1,885	1,864
Same Store Sales	**$285,153**	**$333,486**	**$390,012**	**$456,119**	**$533,432**

In deriving a per share value from our DCF analysis, Heng Ren utilized a terminal value based upon EV/EBITDA. These multiples ranged from 13x to 17x. This range represents the current multiples of publicly traded U.S. Drug Store Chains (in China the peer average is 38x). Heng Ren used the EV/EBITDA methodology based on this multiple to account for current market conditions in its valuation. We discounted Nepstar to 15x EV/EBITDA due to historically weaker performance.

Additionally, all cash flows were discounted at a Weighted Average Cost of Capital (WACC). Heng Ren calculated the current WACC to be 14.25%. Heng Ren calculated the Cost of Equity by taking into account the current risk free rate, the market risk premium, and Nepstar's beta (*see Appendix A*). The risk-free rate

was calculated as the nominal 20-year average of the 10-year treasury, which equaled 4.23%. The market risk premium was calculated to be 6.96% and the beta 1.44. This resulted in a Cost of Equity of 12.4%. Since Nepstar does not have any debt, its cost of equity of 14.25% is its WACC. While typically we do not believe that companies are able to sustain a 100% equity capital structure, Heng Ren believes that Nepstar's operating history, coupled with its large cash balance of $56.4 million, would allow it to sustain a 100% equity capital structure.

After taking into account this premium, the DCF valuation results in a per share price value ranging from $3.06 to $3.99, or a midpoint of $3.51.

		Discount Rate Assumptions for DCF				
	* (EV/EBITDA)	13.3%	13.8%	14.3%	14.8%	15.3%
Implied Price Per Share	13.0x	3.23	3.19	3.15	3.10	3.06
	14.0	3.42	3.38	3.33	3.28	3.24
	15.0	3.61	3.56	3.51	3.46	3.41
	16.0	3.80	3.75	3.69	3.64	3.59
	17.0	3.99	3.93	3.88	3.82	3.77

2) China Peer Valuation Comparison

Result = $5.23 per share; 101% above Chairman Zhang's offer price.

Nepstar had $56.4 million in cash on its balance sheet as of June 30, 2015 and no debt. After adjusting for Net Debt, Nepstar's enterprise value is $157.3 million. We believe because of the sudden recovery toward profitability in 2015, for this valuation it is more prudent to combine the historical average of its EBITDA with the current trends to accurately value the company.

Since 2011, Nepstar's average annual EBITDA is $12.1 million. At this level of EBITDA, Chairman Zhang's offer is 21x EV/EBITDA.

This multiple is far below Nepstar's peers listed on China's stock markets. On average the EV/EBITDA multiples of these peers is 38x, or 81% above the multiple of Chairman Zhang's offer. This is where a significant control premium should be applied to protect shareholders interests.

Below is a sample of valuation of Chinese peers, based on 2014 financial statements:

Ticker	Company Name	Revenue ($M)	EV ($M)	EBITDA ($M)	P/E	P/B	EV/EBITDA	EBITDA Margin
000411.SZ	Zhejiang Int'l Group	2269.97	868.2	54.9	53.2	5.6	15.8	2.4%
600211.SH	Tibet Rhodiola Pharmaceutical	269.04	833.6	7.5	199.1	11.7	110.8	2.8%
600998.SH	Jointown Pharmaceutical	6623.94	7298.1	188.7	52.9	3.9	38.7	2.8%
603883.SH	Laobaixing Pharmacy Chain	635.95	2217.6	62.7	61.8	6.4	35.4	9.9%
603939.SH	Yifeng Pharmacy Chain	359.71	1532.7	38.5	56.3	6.5	39.8	10.7%

As of September 8th, 2015. Source: WIND

**Average EBITDA 2011-2014*

In deriving a per share price via the peer comparison method, Heng Ren used the average EV/EBITDA peer multiple of 38x. This multiple resulted in an implied Enterprise Value for Nepstar of $459.8 million, or $5.23 per share, based on Nepstar's average annual EBITDA of $12.1 million since 2011.

It is believed Chairman Zhang's plan may include in coming years a new IPO of Nepstar in China on the Shanghai Stock Exchange, or in Shenzhen, where Nepstar is headquartered. If that occurs, the transaction would benefit Chairman Zhang and cut out current shareholders. We are being pushed to sell stock well below the current peer average EV/EBITDA multiple (which is 81% higher), and 84% below Nepstar's U.S. IPO price of $16.20. One only needs to recall the cautionary tale of 3SBio to understand the perils of such a deal for shareholders.

If successful, Chairman Zhang will hold exclusive rights to profit from a significant revaluation by bringing Nepstar for an IPO in China. Although Nepstar has had its share of challenges over the years, the value of the company is rebounding due to a turnaround plan, new opportunities in prescription drug retailing in China, and its online sales potential. Nepstar's outlook is promising. Its stock should be valued as such for a management buyout of shareholders unable to enjoy future benefits.

Our peer comparison method results in a per share price of $5.23, or a 101% premium to Chairman Zhang's offer of $2.60.

3) Leveraged Buyout (LBO)

Result = $7.07 per share; 171% above Chairman Zhang's offer price.

Heng Ren also utilized a Leveraged Buyout (LBO) valuation model. An LBO valuation is calculated when a sponsor plans to take a company private using a large amount of debt. Heng Ren's LBO model assumes that in order to purchase Nepstar using this approach, the sponsor will utilize a combination of Nepstar's current cash, debt, and their own capital.

Nepstar is an ideal LBO candidate. It has zero debt and $56.4 million in cash. Heng Ren's LBO model projects Nepstar producing $30.8 million in EBITDA by 2019. Unlike the DCF model, via an LBO the sponsor is able to save costs by no longer being a public company. Heng Ren's LBO model further assumes that the sponsor would sell Nepstar in 2019 at a multiple of EBITDA. EV/EBITDA multiples for peer companies in China range from 15.8x to 110.8x. The average EV/EBITDA multiple of these companies is 38x.

Heng Ren utilized the same methodology in calculating the WACC for the LBO valuation as in the DCF valuation. However, unlike the DCF, the capital structure under the LBO valuation would include debt. To account for the debt in the capital structure, Heng Ren weighted the Cost of Equity of 14.25% and assumed a Cost of Debt of 6.4%, which resulted in a WACC of 12.7%.

This resulted in an LBO valuation for Nepstar of $7.07 per share, a 171% premium to Chairman Zhang's offer price

Heng Ren's LBO model assumes in order to complete the transaction the sponsor would utilize all of Nepstar's current cash on hand of $56.4 million, except for $10 million to continue operations. The model then assumes that the sponsor would obtain debt in the amount of $129.4 million, or 45x the most recent year's EBITDA. The sponsor would then utilize their own cash to complete the transaction.

LBO Valuation	
(In Millions, Except Per Share Price)	
Transaction Date	9/8/2015
Purchase Price	$7.07
Premium to Offer Price ($2.60)	*172.0%*
Fully Diluted Shares Outstanding	98.7
Implied Enterprise Value	$ 641.7

Heng Ren's Case for a Higher Offer From Chairman Zhang

As long-term and patient shareholders, we have been encouraged by the measures taken by Nepstar's management that are aligned with Heng Ren's recommendations, and also the recognition from the market that the value of Nepstar is increasing due to these positive changes. Unfortunately, the proposed buyout offer from Chairman Zhang comes before the full value of these changes have been enjoyed by Nepstar's long-suffering shareholders.

The proposal does not reflect the upward trend in fundamental performance and increase in company value. Our analysis shows both the current and future value of the company is significantly greater than Chairman Zhang's current offer of $2.60. The buyout offer needs to be raised to a full and fair value, of $4.83 per share, to fairly compensate shareholders.

The long-term opportunity for Nepstar in re-listing in China for a higher valuation, as well as its promising outlook as a leader in the increasing role retailers will play in the sale of prescription drugs on- and offline (O2O), is something we believe Chairman Zhang foresees. Current shareholders who have endured collapse in Nepstar's stock since its 2007 IPO are being excluded from this enormous opportunity. They need to be compensated for the transfer of full control to Chairman Zhang and the lucrative payoff he would be entitled to as a result – with the 3SBio example in mind.

The Board of Directors and the Special Committee should be reminded that shareholders are thinking strategically. It is why long-term investors like Heng Ren and others invested in Nepstar in the first place, why we have been patient as Nepstar's stock has collapsed since the IPO, and why we now undertake in-depth analysis to prove Chairman Zhang's proposal, through a professional appraisal of its valuation, is inadequate.

A buyout proposal is not a license to use shareholder funds at a discount, and to take a final and decisive action that blocks patient, long-term shareholders from their fair share of a successful outcome – i.e. the eventual realization of Nepstar's true market value. Current minority shareholders will be unable to

rollover their stake, and unable to benefit from the migration to the premium valuations enjoyed by Nepstar's peers in China's domestic market.

Heng Ren recommends the Board of Directors and the Special Committee refrain from allowing Chairman Zhang to purchase the company from shareholders at the low price of $2.60.

Instead, Heng Ren urges the Special Committee to use our appraisal of Nepstar's valuation of $4.83 per share as your guide.

Minority shareholders have patiently endured the risks and difficulties of owning stock in Nepstar, a company finally adjusting to a rapidly changing marketplace to its benefit. Just when Nepstar began to make the most of its future growth opportunities, it is being taken away from shareholders at a discount.

Again, we request the Board of Directors to reject Chairman Zhang's low offer. If in the future the transaction proves to be a windfall for Chairman Zhang, which we expect could happen (especially if 3SBio is any indication), it well may be attributed to the decision made by Nepstar's Board of Directors, and the evaluation by this Special Committee. This is a significant risk that needs to be seriously considered, especially if a transaction occurs far below fair value and causes severe opportunity cost and damage to current shareholders of Nepstar.

Sincerely,

Peter Halesworth
Managing Partner
Heng Ren Investments LP
September 11, 2015

Appendix A: WACC

Risk Free Rate (1)	4.23%
Market Risk Premium (2)	6.96%
NPD Beta	1.44x
NPD Cost of Equity	**14.25%**

(1) Federalreserve.gov Nominal 20-year average of 10 year treasury as of 8/17/15 calculated daily.

(2) Duff & Phelps 2014 Valuation Handbook. Arithmetic Average of Realized Equity Risk Premiums 1926-2013. Exhibit 3.6 p3-14.

(3) Duff & Phelps 2014 Valuation Handbook. Arithmetic Mean of Returns in Excess of CAPM. 10a Decile Size Premium.