



## **XS CARGO INCOME FUND**

### **Management's Discussion of Financial Condition and Results of Operations**

**For the three and six months ended June 30, 2010**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This management's discussion and analysis ("MD&A") should be read in conjunction with the consolidated financial statements and accompanying notes (the "Financial Statements") of XS Cargo Income Fund (the "Fund") for the three and six months ended June 30, 2010 and the year ended December 31, 2009. These financial statements, management's discussion and analysis and other documents filed with regulatory authorities can be found on SEDAR at [www.sedar.com](http://www.sedar.com). Results are reported in Canadian dollars unless otherwise stated and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Certain dollar amounts have been rounded to the nearest thousand dollars, while other amounts have been rounded to the nearest hundred thousand dollars. References to notes are to the notes to the Financial Statements of the Fund unless otherwise stated.

This MD&A is dated August 17, 2010.

Readers are referred to the advisories regarding forward-looking information and non-GAAP measures in the "Forward Looking Statements" and "Non-GAAP Measures" sections of this MD&A.

### **OVERVIEW OF THE FUND**

#### **Issuance of Fund Units and Acquisition**

XS Cargo Income Fund is an unincorporated open-ended trust established under the laws of the Province of Alberta. The Fund invests in the broadline closeout retail business, through an indirect controlling interest in XS Cargo Limited Partnership ("XS Cargo LP") and its general partner ("GP") (collectively "XS Cargo"), and such other investments as the Trustees may determine.

The Fund commenced business operations on May 17, 2005, when it completed an initial public offering (the "IPO") of 6,106,000 trust units ("Fund Units"), at a price of \$10 per unit, for aggregate gross proceeds of \$61,060,000. Concurrent with the closing of the IPO, the Fund acquired a 51% indirect interest in XS Cargo LP and XS Cargo LP acquired the net assets (the "Acquired Business") of Famous Brands (Edmonton) Inc. (the "Vendor").

The Fund Units trade on the TSX Venture Exchange under the symbol XSC.UN.

#### **The Business of the Fund**

XS Cargo LP operates 41 closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Nova Scotia, Newfoundland and New Brunswick.

## **Operating Highlights**

The Fund continued to post strong sales gains in the second quarter. Sales increased by \$3.7 million or 17.0% over the second quarter of 2009. Same store sales increased 13.5%. Improved store merchandising and an expanded product mix contributed significantly to the results.

Second quarter earnings from operations were \$1.5 million, an increase of \$1.0 million compared to the same period in 2009. Second quarter earnings were reduced by certain non-recurring expenses for consulting, and moving expenses related to new distribution facilities. These one time expenses totaled \$0.3 million.

During the second quarter the Fund's eastern distribution centre was moved to a larger facility, eliminating the need for seasonal third party warehousing.

## SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

### Second Quarter and Year-to-date Operating Results

The following tables show the unaudited results of the Fund for the three and six month periods ended June 30, 2010 compared to the three and six month periods ended June 30, 2009. The results of operations for these periods are not necessarily indicative of the results of operations to be expected in any given period.

<b>Second Quarter Operating Results</b> (unaudited)	<b>Three Months</b> <b>Ended</b> <b>June 30, 2010</b>	<b>Three Months</b> <b>Ended</b> <b>June 30, 2009</b>	<b>Change Q2 2010</b> <b>from Q2 2009</b>
Sales	25,283,763	21,605,018	3,678,745
Cost of Goods Sold	15,479,157	13,480,803	1,998,354
Gross Margin	9,804,606 38.8%	8,124,215 37.6%	1,680,391 1.2%
Administrative and Operating Expenses*	8,346,505	7,581,895	764,610
Earnings from Operations, as defined*	1,458,101	542,320	915,781
Net Loss	(47,023)	(472,939)	425,916

<b>Year-to-date Operating Results</b> (unaudited)	<b>Six Months</b> <b>Ended</b> <b>June 30, 2010</b>	<b>Six Months</b> <b>Ended</b> <b>June 30, 2009</b>	<b>Change 2010</b> <b>from 2009</b>
Sales	47,152,834	41,036,541	6,116,293
Cost of Goods Sold	29,350,547	27,158,760	2,191,787
Gross Margin	17,802,287 37.8%	13,877,781 33.8%	3,924,506 4.0%
Administrative and Operating Expenses*	16,363,078	15,527,616	835,462
Earnings (loss) from Operations, as defined*	1,439,209	(1,649,835)	3,089,044
Net Loss	(818,108)	(2,386,162)	1,568,054

\* Earnings from operations have been calculated as described under "Non-GAAP Measures". For purposes of this table, administrative and operating expenses exclude the expenses outlined in the calculation of Earnings from Operations as described under "Non-GAAP Measures".

## Sales

### Second Quarter

The following table compares sales for the three months ended June 30, 2010 to the three months ended June 30, 2009:

	Sales			% change
	2010	2009	Change	
Same Store Sales	24,161,540	21,284,532	2,877,008	13.5%
New or Closed Store Sales	1,122,223	320,486	801,737	250.2%
Total Sales	25,283,763	21,605,018	3,678,745	17.0%

Second quarter sales increased by \$3.7 million, from \$21.6 million to \$25.3 million, an increase of 17.0% compared to the same periods in 2009. New or closed stores, defined as stores that have not been open for a full 12 months in the current and prior period, experienced a second quarter increase of \$0.8 million. Same stores produced a second quarter sales increase of \$2.9 million or 13.5% compared to the same periods in 2009. The increase in total sales was primarily the result of improvements in store merchandising and an expanded product mix.

The following table outlines the number of stores and percentage of store sales by geographical region:

Region	June 30, 2010		June 30, 2009	
	Number of stores, end of quarter	Percentage of sales during the quarter	Number of stores, end of quarter	Percentage of sales during the quarter
Ontario	20	48.4%	19	47.0%
Alberta	7	18.2%	7	18.7%
British Columbia	8	18.3%	8	20.0%
Saskatchewan and Manitoba	3	9.6%	3	9.2%
Atlantic Canada	3	5.5%	3	5.1%
Total	41	100.0%	40	100.0%

*Year-to-Date*

The following table compares sales for the six months ended June 30, 2010 to the six months ended June 30, 2009:

	Sales			% change
	2010	2009	Change	
Same Store Sales	45,106,825	40,388,825	4,718,000	11.7%
New or Closed Store Sales	2,046,009	647,716	1,398,293	215.9%
Total Sales	47,152,834	41,036,541	6,116,293	14.9%

For the year-to-date, sales increased by \$6.1 million, from \$41.0 million to \$47.2 million, an increase of 14.9% compared to the same periods in 2009. New or closed stores, defined as stores that have not been open for a full 12 months in the current and prior period, experienced a year-to-date increase of \$1.4 million. Same stores produced year-to-date sales increase of \$4.7 million or 11.7% compared to the same periods in 2009. The increase in total sales was primarily the result of improvements in store merchandising and an expanded product mix.

The following table outlines the number of stores and percentage of store sales by geographical region:

Region	June 30, 2010		June 30, 2009	
	Number of stores, end of quarter	Percentage of sales during the 6 month period	Number of stores, end of quarter	Percentage of sales during the 6 month period
Ontario	20	48.3%	19	45.9%
Alberta	7	18.4%	7	19.4%
British Columbia	8	18.3%	8	20.1%
Saskatchewan and Manitoba	3	9.5%	3	9.4%
Atlantic Canada	3	5.5%	3	5.2%
Total	41	100.0%	40	100.0%

## **Cost of Goods Sold and Gross Margin**

### *Second Quarter*

Cost of goods sold as a percentage of sales for the quarter decreased by 1.2%, from 62.4% to 61.2% compared to the same periods in 2009. The percentage decrease against the same periods in 2009 is primarily the result of lower product costs and reduced shrink partially offset by an increase in freight costs.

Gross margin percentage for the quarter increased by 1.2% from 37.6% to 38.8% of sales compared to the same periods in 2009. This increase is due to cost of goods sold variances discussed above.

### *Year-to-Date*

Cost of goods sold as a percentage of sales for the year-to-date decreased by 4.0%, from 66.2% to 62.2% compared to the same periods in 2009. The percentage decrease against the same periods in 2009 is primarily the result of lower product costs and reduced shrink partially offset by an increase in freight costs.

Gross margin percentage for the year-to-date increased by 4.0%, from 33.8% to 37.8% compared to the same periods in 2009. This increase is due to cost of goods sold variances discussed above.

## **Combined Administrative and Operating Expenses**

### *Second Quarter*

For the quarter, administrative and operating expenses increased by approximately \$0.8 million from \$7.6 million to \$8.4 million as compared to the same period in 2009. This increase is primarily the result of increases in wages (\$0.2 million) primarily from two additional stores in Ontario and a store bonus plan that was not in place in Q2 2009, rent (\$0.2 million) due to additional stores in Ontario and increased rent expense for the new eastern distribution center, consulting fees (\$0.1 million), relocation for the eastern warehouse and eastern head office (\$0.2 million) and various other operating expenses (\$0.1 million).

### *Year-to-Date*

For the year-to-date, administrative and operating expenses increased by approximately \$0.9 million from \$15.5 million to \$16.4 million as compared to the same period in 2009. This increase is primarily the result of increased consulting fees (\$0.4 million), rent (\$0.3 million) due to additional stores in Ontario and increased rent expense for the new eastern distribution center, and relocation costs for the eastern distribution center (\$0.2 million).

## Earnings from Operations

### *Second Quarter*

For the quarter, earnings from operations increased by \$1.0 million, from earnings of \$0.5 million to \$1.5 million compared to the same period in 2009, as a result of the factors discussed above.

### *Year-to-Date*

For the year-to-date, earnings from operations increased by \$3.0 million, from a loss of \$1.6 million to earnings of \$1.4 million compared to the same period in 2009, as a result of the factors discussed above.

## Fund Net Earnings

For the second quarter, the Fund had a net loss of \$47 thousand or \$0.01 per unit on a basic and diluted basis. This compares with the prior year's second quarter net loss of \$0.5 million or \$0.08 per unit on a basic and diluted basis.

Year to date, the Fund had a net loss of \$0.8 million or \$0.14 per unit on a basic and diluted basis. This compares to a net loss of \$2.4 million or \$0.39 per unit on a basic and diluted basis for the same period in 2009.

## Financial Position

The following are the significant assets, liabilities and equity of the Fund as at the specified dates:

	<b>June 30, 2010</b>	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Cash and cash equivalents	134,880	134,880	832,854
Inventory	16,703,878	19,706,568	16,391,551
Total current assets	21,519,369	22,318,045	20,474,113
Total assets	26,500,835	27,703,914	26,201,456
Total current liabilities excluding term loan and subordinated loan	9,689,612	11,358,919	8,592,190
Term loan	6,750,000	6,750,000	6,750,000
Subordinated loan	15,579,824	15,198,025	14,829,366
Non-controlling interest	(97,956)	(52,116)	699,564
Unitholders' equity	(6,743,373)	(6,697,600)	(5,927,765)

## Distributable Cash and Cash Distributions

On December 17, 2007, the Fund announced that it was suspending monthly cash distributions on Fund Units and Exchangeable LP Units beginning with the December 2007 distribution. There have been no distributions since this time.

As of June 30, 2010 the following number of units was outstanding:

Fund Units (Note 4)	6,054,000
XS Cargo LP Exchangeable LP Units (Note 5)	3,492,802
XS Cargo LP Subordinated LP Units (Note 5)	2,408,847
	<u>11,955,649</u>

## Distributable Cash per Unit (Fund Units, XS Cargo LP Exchangeable LP Units, XS Cargo LP Subordinated LP Units)

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>June 30, 2010</b>	<b>June 30, 2009</b>	<b>June 30, 2010</b>	<b>June 30, 2009</b>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Cash provided by (used for) operating activities	1,958,603	505,663	(5,223,538)	(2,236,392)
Less: Net change in non-cash working capital	(899,826)	(568,549)	5,513,706	(716,075)
Less: Deferred charges, net of costs recognized	(12,718)	(13,002)	(9,123)	(37,130)
Less: Deferred revenue, net of revenue recognized	120,571	195,737	265,114	415,160
Less: Lease inducements received, net of amortization of lease inducements	(244,238)	(22,322)	(205,834)	11,620
Less: Maintenance capital expenditures <sup>1</sup>	(157,026)	(1,490)	(171,403)	(9,800)
Distributable cash <sup>2</sup>	765,366	96,037	168,922	(2,572,617)
Average Units outstanding during the period <sup>3</sup>	12,007,649	12,007,649	12,007,649	12,007,649
Distributable cash per Unit	0.06	0.01	0.01	(0.21)
Distributions declared	-	-	-	-
Distributions declared per Unit	-	-	-	-
Ratio of distributions declared to distributable cash (payout ratio)	-	-	-	-

<sup>1</sup> Maintenance capital expenditures refer to acquisitions of property and equipment to replace or upgrade equipment and information systems at existing stores and distribution centres. See discussion under "Capital Expenditures" below.

<sup>2</sup> See discussion under "Non-GAAP Measures" below.

<sup>3</sup> The average units outstanding during the period (12,007,649) differ from the number of units outstanding in the financial statements at June 30, 2010 (11,955,649) by 52,000 units. The 52,000 units represent units bought by the Fund to cover employment contract obligations.

Deferred revenue and deferred charges relating to Product Replace Plans (“PRPs”), net of revenue or costs recognized, are adjusted as the revenue and direct costs related to the PRPs are deferred and recognized over the term of the PRPs. The amounts will be included in net earnings once they are recognized.

Lease inducements received, net of amortization of lease inducements is also adjusted as the inducements received from landlords are deferred and recognized over the course of the leases. The amounts will be included in net earnings once they are amortized.

### **EBITDA**

Management believes that EBITDA<sup>4</sup> is a useful measure in evaluating the performance of the Fund.

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>June 30, 2010</b>	<b>June 30, 2009</b>	<b>June 30, 2010</b>	<b>June 30, 2009</b>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net (loss) for the period	(47,023)	(472,939)	(818,108)	(2,386,162)
Add: non-controlling interest	(45,840)	(461,265)	(797,520)	(2,327,266)
Add: Interest expense and foreign exchange	917,508	950,996	1,849,342	1,978,757
Add: Amortization of property and equipment	387,482	366,683	765,915	726,861
Add: Amortization of intangible assets	244,724	189,755	437,080	379,510
<b>EBITDA</b>	<b>1,456,851</b>	<b>573,230</b>	<b>1,436,709</b>	<b>(1,628,300)</b>

### **Unitholders’ Equity and Non-controlling Interest**

The following table outlines the Fund Units and non-controlling interest outstanding as of June 30, 2010.

	<b>Units</b>	<b>Issue Costs</b>	<b>Unitholders’ Equity</b>	<b>Non- controlling Interest</b>
	#	\$	\$	\$
Fund Units	6,051,000	4,928,124	56,110,694	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	(97,956)

There have been no changes in the number of Special Voting Units from December 31, 2009 to June 30, 2010.

<sup>4</sup> EBITDA refers to earnings before interest and foreign exchange, taxes, depreciation and amortization. See discussion under “Non-GAAP Measures” below.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Credit Facilities**

The Fund has available under its amended credit facilities agreement a \$12,500,000 demand revolving loan. Under the terms of the credit facility agreement, the operating loan is collateralized by a first charge on all present and after required personal property and an assignment of inventory. Interest on the operating loan is charged at the lender's Canadian prime rate plus 4.50%. If funds are withdrawn in U.S. dollars, interest will be charged at the lender's U.S. base rate plus 4.50%. The Fund is also required to pay a standby charge of 1.00% based on the amount equal to the operating facility commitment amount less the aggregate principal amount under the operating facility.

The maximum available on the term loan facility is \$6,750,000. The term loan is collateralized along with the operating loan as described above. Under the agreement interest on the term loan facility is charged at the lender's Canadian prime rate plus 4.50%. The term loan agreement expired on April 30, 2009, however repayment has not been demanded.

The subordinated loan consists of a \$12,000,000 loan funded 50% by an independent third party and 50% by a company owned by the President and CEO of the Fund. The subordinated loan is collateralized by a second charge on all of the present and future undertakings and property including an acknowledged assignment of leases and material contracts. Interest on the subordinated loan is charged at a fixed rate of 18%, with the Fund's option to capitalize up to 10% per annum as part of the outstanding principal balance. The subordinated loan agreement expired on June 30, 2009, however repayment has not been demanded.

### **Financial Covenants**

The bank indebtedness, term loan and subordinated loan require the Fund to maintain certain financial covenants, including a maximum senior debt to adjusted EBITDA ratio of 2.5:1.0; a minimum current ratio of 1.4:1.0, and a minimum adjusted trailing twelve months EBITDA value of \$8,000,000. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions and other changes in the business without approval of the lenders.

The subordinated loan agreement also requires the Fund to maintain a total funded debt to adjusted EBITDA ratio of less than 3.5:1.0.

As at June 30, 2010, the Fund is in compliance with all financial covenants mentioned above. For the period from December 31, 2008 to February 28, 2010, the Fund was in breach of certain financial covenants mentioned above and these breaches have not been waived by the lender.

The Fund continues to manage its liquidity risk by monitoring actual and projected cash flows taking into consideration the seasonality of its business.

The Fund continues to work closely with its lenders in order to achieve a long term financing solution which is acceptable to all parties. There can be no assurance that this initiative will be successful, and there remains significant doubt that the Fund will be able to continue as a going concern.

## Capital Expenditures

### *Second Quarter*

During the second quarter, the Fund acquired \$280,273 of property and equipment at the stores and warehouses and head office. Of this, \$157,026 is related to “maintenance capital expenditures” and \$123,047 is related to “growth capital expenditures”.

	<b>Stores and Warehouses</b>	<b>Infrastructure and Head Office</b>	<b>Total</b>
Maintenance Expenses	130,684	26,342	157,026
Growth Expenses	123,247	-	123,247
<b>Total</b>	<b>253,931</b>	<b>26,342</b>	<b>280,273</b>

### *Year to Date*

For the year-to-date, the Fund acquired \$294,649 of property and equipment at the stores and warehouses and head offices. Of this, \$171,403 is related to “maintenance capital expenditures” and \$123,246 is related to “growth capital expenditures”.

	<b>Stores and Warehouses</b>	<b>Infrastructure and Head Office</b>	<b>Total</b>
Maintenance Expenses	142,504	28,899	171,403
Growth Expenses	123,246	-	123,246
<b>Total</b>	<b>265,750</b>	<b>28,899</b>	<b>294,649</b>

## Interest Rate Risk and Sensitivity

The Fund’s term and operating loans bear interest with floating rates based on the bank’s prime rate, thus exposing the Fund to interest rate fluctuations. A 1.0% change in interest rates would have an impact of \$115,740 annually on interest expense based on \$11,574,000 of debt outstanding at June 30, 2010.

## XS Cargo LP Subordinated LP Units

The Subordinated LP Units will be automatically exchanged for Exchangeable LP Units on a one-for-one basis and the subordination provisions will apply until the end of any fiscal year if, for that fiscal year the Fund has earned EBITDA (earnings before interest, taxes, depreciation and amortization) of at least \$14.432 million and the Fund has paid distributions of at least \$1.125 per Fund Unit for such fiscal year. For the year ended December 31, 2009, the criteria were not met for the automatic exchange to occur.

## Contractual Obligations

The table below sets forth the contractual obligations of the Fund as of June 30, 2010, due in the years indicated which relate to various premises operating leases, the term loan that matured on April 30, 2009, and the subordinated loan that matured on June 30, 2009.

	<b>Total</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015 and thereafter</b>
Operating Leases	24,834,210	3,972,245	5,039,998	4,295,243	3,742,876	3,319,595	4,464,253
Subordinated Loan	15,579,824	15,579,824	-	-	-	-	-
Term loan	6,750,000	6,750,000	-	-	-	-	-
<b>Total</b>	<b>47,164,034</b>	<b>26,302,069</b>	<b>5,039,998</b>	<b>4,295,243</b>	<b>3,742,876</b>	<b>3,319,595</b>	<b>4,464,253</b>

As noted above, the Fund's term and subordinated loans are past due.

## Summary of Quarterly Results (unaudited)

	<b>2010</b>		<b>2009</b>				<b>2008</b>	
	<b>Q2</b>	<b>Q1</b>	<b>Q4</b>	<b>Q3</b>	<b>Q2</b>	<b>Q1</b>	<b>Q4</b>	<b>Q3</b>
Sales	25,283,763	21,869,071	41,964,691	23,034,046	21,605,018	19,431,523	38,713,064	24,525,830
Net earnings (loss) before impairment of goodwill	(47,023)	(771,085)	2,106,827	84,015	(472,939)	(1,913,223)	(208,063)	(20,378)
Net (loss) earnings	(47,023)	(771,085)	2,106,827	84,015	(472,939)	(1,913,223)	(18,203,917)	(20,378)
Basic and diluted (loss) earnings per unit	(0.01)	(0.13)	0.35	0.01	(0.08)	(0.32)	(2.98)	0.00

Due to seasonal shopping trends, the fourth quarter is typically the strongest quarter for XS Cargo and the first quarter is weakest. The fourth quarter of 2008 was impacted by a goodwill impairment of \$18.4 million.

## Off-Balance Sheet Arrangements

The Fund has not entered into any off-balance sheet arrangements.

## **Critical Accounting Estimates**

### *Inventory Valuation*

Inventory is valued at the lower of cost and estimated net realizable value. Inventory cost includes freight charges, which are allocated to inventory based on a percentage of freight paid during a period compared to the total purchases made during the period. Management believes that the estimates, assumptions and allocation methods are reasonable in the circumstances. It is possible that materially different results would be reported using different assumptions or allocation methods.

### *Intangible Asset Valuation*

Intangible assets acquired at the time of the IPO represent management's estimate of the fair value of the XS Cargo brand name and trademark, database of sales and purchasing history, and the value attributed to property leases at less than market rates. The intangible asset related to the brand name and trademark has an indefinite life and is not amortized. The intangible assets related to property leases are amortized over the remaining terms of the leases. The intangible asset related to the database of the sales and purchasing history is amortized over its five year expected life. The Fund will assess the carrying value of intangible assets that are not subject to amortization annually or more frequently if events or changes in circumstances indicate a potential impairment. Intangible assets that are amortized are assessed for impairment when events or changes in circumstances warrant such a review. An impairment loss is recorded when it is determined that the carrying amount is no longer recoverable and exceeds its fair value. Software is recorded at cost and amortized on a straight-line basis at a rate of 20%.

## **Future accounting changes**

The CICA has issued the following new accounting standards applicable to the Fund in future years:

### *International Financial Reporting Standards (IFRS)*

The use of IFRS for financial reporting in Canada will become applicable for the year beginning January 1, 2011. The Fund will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the first quarter ended March 31, 2011, with comparative information.

The Fund commenced its IFRS conversion project in 2008 by completing an analysis of the pertinent accounting and reporting differences between IFRS and Canadian GAAP. Management determined that the most significant impacts of IFRS conversion relate to the assessment of alternatives available under IFRS 1, *First Time Adoption of International Financial Reporting Standards*, property and equipment, intangible assets, the presentation of non-controlling interest, and asset impairment.

Management has assessed the alternatives available under IFRS 1 and made the following key elections:

- Business combinations – the Fund has decided to use the IFRS 1 election to not restate past business combinations prior to the date of transition. This is expected to minimize any opening balance sheet differences.
- Property and equipment and intangible assets – the Fund is electing to use recent fair value as deemed cost. Taking this election allows the Fund to use previous GAAP revaluations of property and equipment and intangible assets as deemed costs for assets acquired in a business combination. This is also expected to minimize any opening balance sheet differences.
- Borrowing costs – the Fund is electing to apply IAS 23 after January 1, 2010 for borrowing costs on qualifying assets. This is also expected to minimize any opening balance sheet differences.

One significant difference between IFRS and Canadian GAAP identified to date that could lead to an opening transition adjustment is the presentation of Fund units, non-controlling interest, warrants, and options. The Fund is still assessing the terms of the Fund units, as well as the Exchangeable and Subordinated LP shares that comprise the non-controlling interest, but there is the potential that this assessment could result in these balances being classified as liabilities under IFRS. The presentation of warrants and options related to such instruments would also follow the related presentation of the instrument.

The IASB has several projects slated for completion in 2010 and 2011 that may significantly impact the transition to IFRS and the consolidated financial statements of the Fund. In particular, the Leases project will likely result in all assets and liabilities arising under lease contracts to be recognized on the balance sheet. This is in contrast to Canadian GAAP where operating leases are not recognized on the balance sheet.

The Fund continues to monitor the IASB's progress on these projects and their impact on the Fund's transition to IFRS. As a result of these various projects, not all transition date financial statement adjustments are determinable at this time and the quantification of the impact of adoption of IFRS on the consolidated financial statements and operating performance measures cannot be finalized until closer to the changeover date.

The Fund also continues to assess the impact of conversion on internal controls, accounting systems and other business solutions and processes, as well as develop training to assist appropriate employees in the transition to and ongoing compliance with IFRS. Activities in connection with management's IFRS implementation plan will continue throughout 2010, and the Fund will continue provide the required disclosures regarding the status of this plan.

## **Transactions with Related Parties**

Under its credit facilities, the Fund has an outstanding subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by Michael McKenna, the President, CEO and a director of XS Cargo GP Inc., the administrator of the Fund. Interest expense totaling \$356,902 and \$680,602 respectively were recorded on the portion of the loan outstanding to the related party during the three and six months ended June 30, 2010. The loan and related interest have been recorded at the exchange amount, which represents fair value.

Mr. William Gray, a director of the XS Cargo GP Inc, is a partner of Fleming LLP, a law firm which provides legal services to the Fund. Legal fees totaling approximately \$53,500 and \$84,500 respectively were charged to the Fund by Fleming LLP during the three and six months ended June 30, 2010.

## **Outlook**

Management expects the strong growth in sales to continue. Our growth strategy is two fold. Firstly management has undertaken to expand our product offerings while maintaining XS Cargo's proven value proposition. Additional expansion will come through new store openings. One new store will open in the third quarter and two additional openings are planned this year.

## Additional Information

Additional information relating to the Fund, including the Fund's AIF, is available on SEDAR ([www.sedar.com](http://www.sedar.com)) and on the Fund's website at [www.xscargo.com](http://www.xscargo.com).

## Non-GAAP Measures

References to "EBITDA" are to earnings before interest and foreign exchange, income taxes, depreciation and amortization and references to "distributable cash" are to cash available for distribution to Unitholders in accordance with the distribution policies of the Fund. Management believes that, in addition to income or loss, EBITDA is a useful supplemental measure of performance and cash available for distribution before debt service, changes in working capital, capital expenditures and income taxes. Distributable cash of the Fund is a measure generally used by open-ended trusts as an indicator of financial performance. As one of the factors that may be considered relevant by prospective investors is the cash distributed by the Fund relative to the price of the Units, management believes that distributable cash of the Fund is a useful supplemental measure that may assist prospective investors in assessing an investment in the Fund.

Net earnings (loss) before impairment of goodwill and intangible assets disclosure under "Summary of Quarterly Results" has been calculated by adding back the goodwill and intangible assets impairment to net earnings (loss).

Loss from operations disclosure under "Second Quarter Operating Results" has been calculated as described below. Loss from operations have been derived by adding interest expense, foreign exchange, amortization of property and equipment and intangible assets, unit-based compensation, future income taxes and non-controlling interest to net earnings for the period. The following table details the reconciliation from net earnings:

	<b>Three Months Ended June 30, 2010</b>	<b>Three Months Ended June 30, 2009</b>	<b>Six Months Ended June 30, 2010</b>	<b>Six Months Ended June 30, 2009</b>
Net Loss	(47,023)	(472,939)	(818,108)	(2,386,162)
Add:				
Non-controlling interest	(45,840)	(461,265)	(797,520)	(2,327,266)
Foreign exchange loss (gain)	(1,455)	4,643	49,085	(1,823)
Interest on term and subordinated loans	829,557	863,973	1,605,554	1,808,731
Interest on operating loan	89,406	82,380	194,703	171,849
Amortization of intangible assets	244,724	189,755	437,080	379,510
Amortization of property and equipment	387,482	366,683	765,915	726,861
Unit based compensation expense	1,250	(30,910)	2,500	(21,535)
Earnings (loss) from Operations, as defined	1,458,101	542,320	1,439,209	(1,649,835)

EBITDA, distributable cash, earnings from operations and gross margin before non-recurring expenses are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP. Investors are cautioned that EBITDA, distributable cash, earnings from operations and gross margin before non-recurring expenses should not replace net income or loss (as determined in accordance with GAAP) as an indicator of the Fund's performance, of its cash flows from operating, investing and financing activities or as a measure of its liquidity and cash flows. The Fund's methods of calculating EBITDA, distributable cash, earnings from operations and gross margin before non-recurring expenses may differ from the methods used by other issuers and may not be comparable to similar measures presented by other issuers.

## **CONTROLS AND PROCEDURES**

Management has established processes, which are in place to provide them sufficient knowledge to support management representations that they have exercised reasonable diligence that (i) the audited annual financial statements do not contain any untrue statement of material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it is made, as of the date of and for the periods presented by the unaudited interim financial statements and that (ii) the audited annual financial statements fairly present in all material respects the financial condition, results of operations and cash flows of the Fund, as of the date of and for the periods presented by the audited financial statements.

In contrast to the certificate required under National Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings (NI 52-109), the Fund utilizes the Venture Issuer Basic Certificate which does not include representations relating to the establishment and maintenance of disclosure controls and procedures ("DC&P") and internal controls over financial reporting ("ICFR"), as defined in NI 52-109. In particular, the certifying officers filing the Venture Issuer Basic Certificate are not making any representations relating to the establishment and maintenance of:

- i. controls and other procedures designed to provide reasonable assurance that information required to be disclosed by the issuer in its annual filings, interim filings or other reports filed or submitted under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation; and,
- ii. a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP.

The Chief Executive Officer and the Chief Financial Officer of the GP (the "Certifying Officers"), the administrator of the Fund and the general partner of XS Cargo LP, are responsible for ensuring that processes are in place to provide them with sufficient knowledge to support the representations they are making in this certificate.

Investors should be aware that inherent limitations on the ability of certifying officers of the Fund to design and implement on a cost effective basis DC&P and ICFR as defined in NI 52-109 may result in additional risks to the quality, reliability, transparency and timeliness of interim and annual filings and other reports provided under securities legislation.

## **RISK FACTORS**

The Fund's results of operations, business prospects, financial condition, cash distributions to unitholders and the trading price of the Fund's units are subject to a number of risks. These risk factors include: the ability to maintain profitability and manage growth; the ability to expand through new store openings; the ability to source products in adequate quantities and on acceptable terms; changes in trends and consumer tastes; economic conditions and consumer spending; the success of the Fund's marketing efforts and increased marketing expenditures; competition; reliance on centralized distribution centres; freight costs; ability to maintain comparable store sales; seasonality and fluctuations in quarterly results; reliance on management information systems; increase in the cost of, or disruption in the flow of, imported products; successful management of exposure to merchandise returns; foreign exchange fluctuations; costs and availability of insurance coverage; protection of intellectual property; reliance on key personnel; labour matters, including increased labour costs and labour shortages; absence of history as a public company; dependence on external funding sources; environmental regulation; uncertainties arising from world events; property taxes; the Fund's dependence on its operating subsidiaries; the unpredictability and volatility of the market price of the Fund Units; the nature of the Fund Units; the lack of certainty regarding cash distribution levels; cash on cash yield; the structural subordination of the Fund Units; leverage and restrictive covenants; restrictions on potential growth; changes in income tax legislation and other tax related risks; future sales of Fund Units from treasury; future sales of Fund Units by insiders; the rights of the Vendor in relation to XS Cargo LP; conflicts of interest; unitholder limited liability; the distribution of securities on redemption or termination of the Fund; and the restrictions on certain unitholders and the liquidity of Fund Units. For a discussion of significant risks associated with an investment in Fund Units, see "Risk Factors" detailed in the Fund's Annual Information Form available at [www.sedar.com](http://www.sedar.com).

## **FORWARD LOOKING STATEMENTS**

This MD&A contains forward-looking statements. All statements other than statements of historical fact contained in this MD&A are forward-looking statements, including, without limitation, statements regarding the future financial position, cash distributions, proposed store openings, budgets, litigation, projected costs and plans and objectives of or involving the Fund or XS Cargo LP. You can identify many of these statements by looking for words such as “believe”, “expects”, “will”, “intends”, “projects”, “anticipates”, “estimates”, “continues” or similar words or the negative thereof. These forward-looking statements include statements with respect to the amount and timing of the payment of distributions of the Fund. There can be no assurance that the plans, intentions or expectations upon which these forward-looking statements are based will occur. Forward-looking statements are subject to risks, uncertainties and assumptions, including, but not limited to, those discussed elsewhere in the MD&A. There can be no assurance that such expectations will prove to be correct.

Some of the factors that could affect future results and could cause results to differ materially from those expressed in the forward-looking statements contained herein include, but are not limited to, those discussed under “Risk Factors”.

The information contained in this MD&A, including the information set forth under “Risk Factors”, identifies additional factors that could affect the operating results and performance of the Fund and XS Cargo LP.

The forward-looking statements contained herein are expressly qualified in their entirety by this cautionary statement. The forward-looking statements included in this MD&A are made as of the date of this MD&A and, except as required by law, the Fund assumes no obligation to update or revise them to reflect new events or circumstances.