



XS CARGO INCOME FUND

Management's Discussion of Financial Condition and Results of Operations

For the quarter and year ended December 31, 2009

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 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. 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 March 23, 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 fourth quarter featured a marked improvement in operating results. Earnings from operations increased by 172.3% to \$5.9 million compared to \$2.2 million in the fourth quarter of 2008. Fourth quarter sales increased \$3.3 million or 8.4% compared to 2008. Same store sales increased 5.6%.

Annual sales declined by \$4.1 million or 3.7 % compared to the prior year. Earnings from operations for the year were \$5.8 million a decrease of \$0.2 million from 2008. Gross margins as a percentage of sales for the year were 37.5% versus 36.9% in 2008.

Annual results were negatively impacted by economic recession, particularly in the first half of the year. First half sales were down 12.4% from the prior year. As economic conditions improved, sales and inventory trended upwards. Sales for the second half of 2009 increased 2.8% over 2008.

SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

Fourth Quarter and Annual Operating Results

The following tables show the unaudited results of the Fund for the quarter and the audited results of the Fund for the year ended December 31, 2009 compared to the quarter and year ended December 31, 2008. The results of operations for these periods are not necessarily indicative of the results of operations to be expected in any given period.

Fourth Quarter Operating Results (unaudited)	Three Months Ended December 31, 2009	Three Months Ended December 31, 2008	Change Q4 2009 from Q4 2008
Sales	41,964,691	38,713,064	3,251,627
Cost of Goods Sold	25,514,284	26,789,605	(1,275,321)
Gross Margin	16,450,407 39.2%	11,923,459 30.8%	4,526,948 8.4%
Administrative and Operating Expenses*	10,585,420	9,769,879	815,541
Earnings from Operations, as defined*	5,864,987	2,153,580	3,711,407
Net Earnings (Loss)	2,106,827	(18,203,917)	20,310,744

Annual Operating Results	Year Ended December 31, 2009	Year Ended December 31, 2008	Change 2009 from 2008
Sales	106,035,278	110,085,560	(4,050,282)
Cost of Goods Sold	66,306,372	69,442,097	(3,135,725)
Gross Margin	39,728,906 37.5%	40,643,463 36.9%	(914,557) 0.5%
Administrative and Operating Expenses*	33,900,385	34,642,682	(742,297)
Earnings from Operations, as defined*	5,828,521	6,000,781	(172,260)
Net Loss	(195,320)	(18,625,173)	18,429,853

* 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

Fourth Quarter

The following table compares sales for the three months ended December 31, 2009 to the three months ended December 31, 2008:

	Sales			
	2009	2008	Change	% change
Sales	41,964,691	38,713,064	3,251,627	8.4%

For the fourth quarter, sales increased by \$3.3 million, from \$38.7 million to \$42.0 million, an increase of 8.4% compared to the same period in 2008. The increase in sales was primarily the result of improved economic conditions and expanded product mix.

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

Region	December 31, 2009		December 31, 2008	
	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	49.3%	18	47.1%
Alberta	7	17.4%	8	19.8%
British Columbia	8	17.9%	8	17.7%
Saskatchewan and Manitoba	3	9.5%	3	9.3%
Atlantic Canada	3	5.9%	3	6.1%
Total	41	100.0%	40	100.0%

Annual

The following table compares sales for the year ended December 31, 2009 to the year ended December 31, 2008:

	Sales			
	2009	2008	Change	% change
Sales	106,035,278	110,085,560	(4,050,282)	(3.7%)

Annual sales decreased by \$4.1 million, from \$110.1 million to \$106.0 million, representing a decrease of 3.7% compared to prior year. The decrease in sales was primarily the result of reduced customer traffic and spending due to poor economic conditions through the first three quarters.

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

Region	December 31, 2009		December 31, 2008	
	Number of stores, end of quarter	Percentage of sales during the year	Number of stores, end of quarter	Percentage of sales during the year
Ontario	20	47.8%	18	46.0%
Alberta	7	18.1%	8	20.1%
British Columbia	8	19.3%	8	19.0%
Saskatchewan and Manitoba	3	9.3%	3	9.0%
Atlantic Canada	3	5.5%	3	5.9%
Total	41	100.0%	40	100.0%

Cost of Goods Sold and Gross Margin

Fourth Quarter

Cost of goods sold as a percentage of sales for the quarter decreased by 8.4%, from 69.2% to 60.8% compared to the same period in 2008. The decrease is primarily due to a reduction of inventory shrink due to stronger inventory control processes, reduced product returns and a more favorable United States dollar exchange rate.

Gross margin percentage for the quarter increased by 8.4%, from 30.8% to 39.2% compared to the same period in 2008. This increase is due to cost of goods sold variances discussed above.

Annual

Cost of goods sold as a percentage of sales for the year decreased by 0.6%, from 63.1% to 62.5% compared to 2008. The decrease is due to a decline in the value of the Canadian dollar and accelerated write-offs of warranty returns in the first half of the year. This is offset in the second half of the year by a reduction of inventory shrink due to stronger inventory control processes, reduced product returns and a more favorable United States dollar exchange rate.

Gross margin percentage for the year increased by 0.6%, from 36.9% to 37.5% compared to 2008. This increase is due to cost of goods sold variances discussed above.

Combined Administrative and Operating Expenses

Fourth Quarter

For the quarter, administrative and operating expenses increased by approximately \$0.8 million from \$9.8 million to \$10.6 million compared to the same period in 2008. This increase is primarily the result of increases in sales bonuses and advertising initiatives (\$0.3 million) to drive fourth quarter sales; rent (\$0.1 million) due to the opening of two new stores in Ontario; consulting and professional fees (\$0.3 million); and commissions related to third party inventory purchases (\$0.1 million).

Annual

For the year, administrative and operating expenses decreased by approximately \$0.7 million from \$34.6 million to \$33.9 million compared to 2008. This decrease is primarily the result of decreases in wages (\$0.4 million) primarily from efficiencies in distribution and a reduction of staff in the head office; rent (\$0.1 million) due to closing of the service centre in Burlington; travel (\$0.1 million); and recruitment fees (\$0.1 million) because of reduced turnover.

Earnings from Operations

Fourth Quarter

For the quarter, earnings from operations increased by \$3.7 million, from earnings of \$2.2 million to \$5.9 million, an increase of 172.3% compared to the same period in 2008, as a result of the factors discussed above.

Annual

For the year, earnings from operations decreased by \$0.2 million, from earnings of \$6.0 million to \$5.8 million, a decrease of 2.9% compared to 2008, as a result of the factors discussed above.

Fund Net Earnings

For the quarter, the Fund had net earnings of \$2.1 million or \$0.35 per unit on a basic and diluted basis. This compares with the prior year's net loss of \$18.2 million or \$2.98 per unit on a basic and diluted basis.

For the year, the Fund had a net loss of \$0.2 million or \$0.03 per unit on a basic and diluted basis. This compares with the prior year's net loss of \$18.6 million or \$3.05 per unit on a basic and diluted basis. Prior year's loss was impacted by a goodwill impairment of \$18.4 million.

Financial Position

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

	December 31, 2009	December 31, 2008
Cash and cash equivalents	832,854	-
Inventory	16,391,551	17,677,390
Total current assets	20,474,113	19,691,313
Total assets	26,201,456	27,248,471
Total current liabilities excluding term loan and subordinated loan	8,592,190	10,892,858
Term loan	6,750,000	6,665,444
Subordinated loan	14,829,366	13,199,409
Non-controlling interest	699,564	891,083
Unitholders' equity	(5,927,765)	(5,715,572)

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.

No distributions were paid on Fund Units, Exchangeable LP Units or Subordinated LP Units during 2008 and 2009.

As of December 31, 2009 the following number of units was outstanding:

Fund Units (Note 10)	6,054,000
XS Cargo LP Exchangeable LP Units (Note 11)	3,492,802
XS Cargo LP Subordinated LP Units (Note 11)	2,408,847
	<u>11,955,649</u>

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.

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

	Three months ended		Year ended	
	December 31, 2009 (unaudited)	December 31, 2008 (unaudited)	December 31, 2009 (unaudited)	December 31, 2008 (unaudited)
Cash provided by operating activities	15,057,075	14,038,271	4,063,874	850,036
Less: Net change in non-cash working capital	(9,720,538)	(12,521,136)	(732,824)	2,616,780
Less: Deferred charges, net of costs recognized	87,571	(5,398)	67,609	(139,387)
Less: Deferred revenue, net of revenue recognized	(323,638)	(134,038)	199,791	126,034
Less: Lease inducements received, net of amortization of lease inducements	38,404	34,394	26,349	137,701
Less: Maintenance capital expenditures ¹	(46,283)	(178,763)	(111,014)	(392,376)
Distributable cash ²	5,092,591	1,233,330	3,513,785	3,198,788
Average Units outstanding during the period ³	12,004,649	12,004,649	12,004,649	12,004,649
Distributable cash per Unit	0.42	0.10	0.29	0.27
Distributions declared	-	-	-	-
Distributions declared per Unit	-	-	-	-
Ratio of distributions declared to distributable cash (payout ratio)	-	-	-	-

¹ 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.

² See discussion under “Non-GAAP Measures” below.

³ The average units outstanding during the period (12,004,649) differ from the number of units outstanding at December 31, 2009 (11,955,649) by 49,000 units (52,000 units – 2008). The 49,000 units represent units bought by the Fund to cover employment contract obligations.

EBITDA

Management believes that EBITDA³ is a useful measure in evaluating the performance of the Fund.

	Three months ended		Year ended	
	December 31, 2009 (unaudited)	December 31, 2008 (unaudited)	December 31, 2009	December 31 2008
Net earnings (loss) for the period	2,106,827	(18,203,917)	(195,320)	(18,625,173)
Add: non-controlling interest	2,053,808	(17,603,331)	(191,519)	(18,010,688)
Add: Interest expense and foreign exchange	1,133,788	1,238,401	3,996,384	3,871,690
Add: Impairment of goodwill	-	36,226,599	-	36,226,599
Add: Amortization of property and equipment	377,236	359,677	1,475,967	1,428,430
Add: Amortization of intangible assets	190,759	126,776	759,882	1,088,048
EBITDA	5,862,239	2,144,205	5,845,395	5,978,906

Fund Units and Non-controlling Interest

The following table outlines the Fund Units and non-controlling interest outstanding as of December 31, 2009.

	Units	Issue Costs	Fund Units	Non-controlling Interest
	#	\$	\$	\$
Fund Units	6,054,000	4,928,124	56,110,694	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	699,564

In December 2008 the Fund acquired 52,000 Fund Units held for unit-based compensation. There have been no changes in the number of Special Voting Units from December 31, 2008 to December 31, 2009. During the fourth quarter of 2008 the Fund issued 1 million warrants as part of its renewal of the subordinated loan credit facility.

The Fund has also approved an option plan for its employees, directors, trustees and consultants at its annual general meeting in June 2009. The Fund has awarded 300,000 options in 2009 that will vest over the period to January 2, 2012.

³ EBITDA refers to earnings before interest, taxes, depreciation and amortization. See discussion under "Non-GAAP Measures" below.

During the year the Fund transferred 3,000 Fund Units to an employee for unit-based compensation. The remaining 49,000 units were not granted as the employee did not meet the contractual conditions. These units are currently held by the Fund as Treasury Units.

LIQUIDITY AND CAPITAL RESOURCES

Credit Facilities

The Fund has available under its amended credit facilities agreement a \$17,500,000 (\$12,500,000 available from January to July annually each year) 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 term loan agreement expired on April 30, 2009, but repayment has not been demanded. 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% or the bankers' acceptance rate plus 5.75%. Management is currently attempting to negotiate a renewal satisfactory to both parties.

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, 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. The principal balance was due on August 20, 2008; however the subordinated loan was renegotiated on November 5, 2008 and the maturity date was extended to June 30, 2009. As part of the extension, the Fund also issued 1,000,000 fund unit purchase warrants, exercisable at \$0.60 at any time within 36 months of issuance, with a cashless exercise feature at the option of subordinated lenders.

The cashless exercise feature allows the subordinated lenders the option of exercising the warrants to acquire units of the fund, without a cash payment, by netting out the difference between the trading price of units at the date of exercise of the warrant and the warrant exercise price of \$0.60 per unit and then issuing the proportionately reduced number of fully paid units to the warrant holder.

Interest on the subordinated loan has increased from 16% to 18% effective September 26, 2008, with the Fund's option to capitalize up to 10.0% per annum.

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 December 31, 2009, the Fund was not in compliance with the minimum adjusted trailing twelve months EBITDA, and total funded debt to adjusted EBITDA covenants. The Fund is working with its lenders to negotiate mutually acceptable financial covenants.

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

There can be no assurance that these initiatives will be successful and these circumstances lend significant doubt as to the ability of the Fund to continue as a going concern.

Capital Expenditures

Fourth Quarter

During the fourth quarter, the Fund acquired \$48,718 of property and equipment. Of this, \$46,283 is related to "maintenance capital expenditures" and the remaining \$2,434 is related to "growth capital expenditures".

	Stores and Warehouses	Head Office and Infrastructure	Total
Maintenance Expenses	43,578	2,705	46,283
Growth Expenses	2,435	-	2,435
Total	46,013	2,705	48,718

Annual

During the year, the Fund acquired \$334,349 of property and equipment. Of this, \$111,014 is related to “maintenance capital expenditures” and the remaining \$223,335 is related to “growth capital expenditures” the opening of 2 new stores in Ontario.

	Stores and Warehouses	Head Office and Infrastructure	Total
Maintenance Expenses	81,231	29,783	111,014
Growth Expenses	223,335	-	223,335
Total	304,566	29,783	334,349

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 \$67,500 annually on distributable cash and interest expense based on \$6,750,000 of debt outstanding at December 31, 2009.

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 ending on or after December 31, 2006 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 December 31, 2009, 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.

	Total	2010	2011	2012	2013	2014	2015 and thereafter
Operating Leases	19,835,065	4,799,725	3,997,355	3,234,273	2,628,341	2,142,535	3,032,836
Term Loan	6,750,000	6,750,000	-	-	-	-	-
Subordinated Loan	14,829,366	14,829,366	-	-	-	-	-
Total	41,414,431	26,379,091	3,997,355	3,234,273	2,628,341	2,142,535	3,032,836

Summary of Quarterly Results (unaudited)

	2009				2008			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Sales	41,964,691	23,034,046	21,605,018	19,431,523	38,713,064	24,525,830	25,080,819	21,765,847
Net earnings (loss) before impairment of goodwill	2,106,827	84,015	(472,939)	(1,913,223)	(208,063)	(20,378)	248,174	(649,052)
Net earnings (loss)	2,106,827	84,015	(472,939)	(1,913,223)	(18,203,917)	(20,378)	248,174	(649,052)
Basic and diluted earnings (loss) per unit	0.35	0.01	(0.08)	(0.32)	(2.98)	0.00	0.04	(0.11)

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%.

Changes in Accounting Policies Including Initial Adoptions

Effective January 1, 2009, the Fund adopted Canadian Institute of Chartered Accountants (“CICA”) Handbook section 3064: Goodwill and intangible assets.

This section replaced section 3062, “Goodwill and Other Intangible Assets,” and 3450, “Research and Development Costs.” The new standard establishes standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets. The adoption of this standard did not result in a change in the recognition of the Fund's goodwill and intangible assets. However, the Fund has retroactively reclassified intangible assets relating to software with a net book value of \$2,125,631 at December 31, 2008 from “Property and equipment” to “Intangible assets” on the consolidated balance sheet. The Fund also retroactively reclassified amortization of software of \$546,424 for the year ended December 31, 2008 from “Amortization of property and equipment” to “Amortization of intangible assets.” There is no impact on net earnings in the current or prior periods as a result of this change.

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

On August 20, 2007, the Fund entered into a 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. The subordinated loan was renegotiated on November 5, 2008 and the maturity date of the subordinated loan agreements had been extended to June 30, 2009. As part of the extension, the Fund also issued 1,000,000 fund unit purchase warrants, exercisable at \$0.60 at any time within 36 months of issuance, with a cashless exercise feature at the option of subordinated lenders. See "Credit Facilities" above for further details regarding this agreement.

Interest expense totaling \$1,374,625 was recorded on the portion of the loan outstanding to the related party during the year ended December 31, 2009.

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 \$130,000 were charged to the fund by Fleming LLP during the year ended December 31, 2009.

Outlook

This year a number of changes and new initiatives were undertaken to improve operating results. The Vice President of Distribution and Logistics became Vice President of Operations assuming responsibility for store operations. The National Sales Manager position was eliminated in favor of two Regional Managers. Almost 50% of store management was replaced. New policies and procedures aimed at reducing write-offs from customer returns and inventory shrink have been successful. Store operations management is committed to the continued improvement in our customers' shopping experience.

Our product offering was expanded in 2009 with the addition of televisions, computers, cell phones, and toys. Management expects to maintain a presence in these categories. Two new stores were opened in 2009. Both stores had successful openings and contributed positively to earnings. Three new stores are planned in 2010.

Improvements in store operations and the addition of new product categories contributed to a positive sales trend. Sales in the second half of 2009 increased 2.8% compared to a decline of 12.4% in the first six months of the year. Fourth quarter sales increased 8.4% over 2008.

Management is pleased with the progress and particularly encouraged by the fourth quarter results. Same store sales increased 5.6% in a difficult economy. This forms the basis of our expectation that sales will continue to trend upward in 2010.

Additional Information

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

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

Fourth Quarter (unaudited)	Three Months Ended December 31, 2009	Three Months Ended December 31, 2008
Net income (loss)	2,106,827	(18,203,917)
Add:		
Non-controlling interest	2,053,808	(17,603,331)
Impairment of Goodwill	-	36,226,599
Foreign exchange loss (gain)	97,869	(3,062)
Interest on term and subordinated loans	811,973	1,042,579
Interest on operating loan	223,945	198,884
Amortization of intangible assets	190,579	126,776
Amortization of property and equipment	377,236	359,677
Unit based compensation expense	2,750	9,375
Earnings from Operations, as defined	<u>5,864,987</u>	<u>2,153,580</u>

Annual	Year Ended December 31, 2009	Year Ended December 31, 2008
Net (loss)	(195,320)	(18,625,173)
Add:		
Non-controlling interest	(191,519)	(18,010,688)
Impairment of Goodwill	-	36,226,599
Foreign exchange loss (gain)	130,769	(120,274)
Interest on term and subordinated loans	3,332,642	3,447,185
Interest on operating loan	532,973	544,779
Amortization of intangible assets	759,882	1,088,048
Amortization of property and equipment	1,475,967	1,428,430
Unit based compensation expense (recovery)	(16,873)	21,875
Earnings from Operations, as defined	<u>5,828,521</u>	<u>6,000,781</u>

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 these risks and other risks associated with an investment in Fund Units, see "Risk Factors" detailed in the Fund's Annual Information Form available at 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.