



XS CARGO INCOME FUND

Management's Discussion of Financial Condition and Results of Operations

For the quarter and year ended December 31, 2006

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, 2006. 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 16, 2007.

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 (note 3) and XS Cargo LP acquired the net assets (the "Acquired Business") of Famous Brands (Edmonton) Inc. (the "Vendor").

The Fund Units trade on the Toronto Stock Exchange under the symbol XSC.UN.

Basis of Management's Discussion and Analysis

To provide more meaningful information, the following MD&A compares the operating results of the Fund for the year ended December 31, 2006 to those of the combined results for the Vendor and Fund for the year ended December 31, 2005. (See "Non-GAAP Measures"). The Fund commenced operations on May 17, 2005, therefore the Fund results are only available for the period from May 17, 2005 to December 31, 2005 for comparative purposes.

It is management's view that employee profit sharing plan contributions incurred by the Vendor are not relevant when compared to the Fund because of differences between the structure and policies of the Fund to those of the Vendor. Those contributions have been added back when computing earnings from operations as described in "Non-GAAP Measures."

The Business of the Fund

XS Cargo LP operates 36 closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Nova Scotia, Newfoundland and New Brunswick.

Operating Highlights

We continued our successful store expansion strategy in the fourth quarter with new stores opening in Vancouver, Halifax and St. John's on October 26, 2006. Throughout the year, eight new stores were opened bringing the total at year-end to 35. Our 36th store was opened in Moncton, New Brunswick on February 23, 2007. All of the grand openings were successful and all of our stores continue to generate positive earnings from operations and cash flows.

Sales during the fourth quarter were lower than expected due to problems with the allocation of inventory between stores that resulted in higher than normal stock-outs. The inventory allocation problems were the result of difficulties encountered with an upgrade to our point-of-sale and inventory allocation software in the third quarter. Although sales were strong in the three weeks leading into Christmas (same store sales up 2.4% over same period last year), they were not sufficient to compensate for the inventory allocation problems throughout the quarter. Efforts to reallocate inventory between stores contributed to higher freight costs, which rose from 6.8% to 8.8% of sales for the quarter, as well as labour inefficiencies in our distribution centres.

Lower than expected third and fourth quarter sales, higher freight costs and significant upward wage pressures resulted in a decrease in EBITDA over the prior year. Excluding new stores, we experienced a 31% increase in wage expense. The majority of the wage increases were in Alberta where we have our corporate head office, one distribution centre and eight stores. Wages in Alberta represent over 41% of our total wage expense and our average wage rates in Alberta have increased by 22% over the prior year. The wage rate increases combined with the new positions required to support our growth and labour inefficiencies described above, resulted in a 63% increase in Alberta wage costs in the fourth quarter compared to the same period last year. Further wage rate increases will be mitigated by our expansion outside of Alberta, including the three stores that opened in the fourth quarter.

Subsequent to year-end we entered into agreements with JDA® Software Group, Inc. ("JDA") for the purchase of a new point-of-sale and inventory management system and with Retail Process Engineering ("RPE") for consulting and implementation services. The new system implementation is commencing April 1, 2007 with targeted completion by the

end of the third quarter. The total implementation costs are estimated at \$2.5 million for software, hardware and implementation services. We are confident that the new system will not only allow us to effectively address our inventory allocation problems, but will contribute to improved labour efficiencies in our stores, distribution centres and head office.

We commenced processing sales through xscargo.ca on November 16, 2006 with minimal marketing initiatives. We continue to refine our processes and on-line catalogue with the objective of launching our official “E-commerce Grand Opening” in the second quarter of 2007. We achieved our break-even sales level during this soft launch period and our experience to-date indicates that we will be successful expanding our customer base, and increasing sales and earnings through the internet.

SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

Fourth Quarter and Year End Operating Results

The following tables show the unaudited results of the Fund for the quarter and year ended December 31, 2006; the results of the Fund for the quarter ended December 31, 2005 and the combined results of the Fund and the Vendor for the year ended December 31, 2005. 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)	Oct. 1 to Dec. 31, 2006	Oct 1 to Dec. 31, 2005	Change Q4 2006 from 2005
Sales	42,339,077	36,436,104	5,902,973
Cost of Goods Sold	27,784,931	22,670,875	5,114,056
Gross Margin	14,554,146 34.4%	13,765,229 37.8%	788,917
Administrative and Operating Expenses*	9,931,827	7,047,239	2,884,588
Earnings from Operations, as defined*	4,622,319	6,717,990	(2,095,671)

Annual Operating Results (unaudited)	Combined Vendors and Fund		
	Fund January 1 to Dec. 31, 2006	Fund January 1 to Dec. 31, 2005	Change 2006 over 2005
Sales	116,793,895	97,367,234	19,426,661
Cost of Goods Sold	74,328,664	61,348,476	12,980,188
Gross Margin	42,465,231 36.4%	36,018,758 37.0%	6,446,473
Administrative and Operating Expenses*	28,529,052	20,674,133	7,854,919
Earnings from Operations, as defined*	13,936,179	15,344,625	(1,408,446)
Non-recurring operating expenses**	170,000	-	170,000
Earnings from Operations before non-recurring expenses	14,106,179	15,344,625	(1,238,446)

* 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".

** Non-recurring operating expenses consist of expenses relating to the consolidation of the Edmonton distribution facilities.

Sales

Fourth Quarter

The following table compares sales for the three months ended December 31, 2006 to the three months ended December 31, 2005 for new and same stores:

	Sales				Number of Stores as of December 31	
	2006	2005	Change	% change	2006	2005
Same stores	25,095,725	27,634,529	(2,538,804)	(9.2%)	19	19
New stores	17,243,352	8,801,575	8,441,777	95.9%	16	8
Total	42,339,077	36,436,104	5,902,973	16.2%	35	27

Fourth quarter sales increased by \$5.9 million, from \$36.4 million to \$42.3 million, an increase of 16.2%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$8.4 million in sales. The offsetting \$2.5 million decrease represents a 9.2% decrease in same store sales. The decrease in same store sales was primarily due to problems with the allocation of inventory between stores that resulted in higher than normal stock-outs. Implementation problems with an upgrade to our point-of-sale and inventory management software during the third quarter led to the difficulties with inventory allocations..

Annual

Year over year sales have increased by \$19.4 million, from \$97.4 million to \$116.8 million, representing an increase of 20.0%. For the year, same store sales were down 1.4%, excluding three stores that experienced cannibalization from new stores opening in overlapping trading areas. The decrease in same store sales for the year was primarily the result of slower sales in the third and fourth quarter as discussed above.

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

Region	December 31, 2006			December 31, 2005		
	Number of stores, end of quarter	Percentage of sales during the quarter	Percentage of sales during the year	Number of stores, end of quarter	Percentage of sales during the quarter	Percentage of sales during the year
Ontario	15	45.3%	48.0%	12	48.5%	50.4%
Alberta	8	20.8%	22.7%	7	23.8%	24.3%
Saskatchewan and Manitoba	3	8.4%	8.9%	3	10.5%	10.8%
British Columbia	7	18.2%	17.7%	5	17.2%	14.5%
Nova Scotia and Newfoundland	2	7.3%	2.7%	-	0.0%	0.0%
Total	35	100.0%	100.0%	27	100.0%	100.0%

Product Replacement Plan Sales

Sales of two-year product replacement extended warranty plans continue to be strong. During the fifteen months since implementation, \$3.2 million of Product Replacement Plans (“PRPs”) were sold, with \$1.1 million recognized as revenue since inception, approximately \$0.4 million of which was recognized during the fourth quarter. Revenue from PRP sales is deferred and recognized on a straight-line basis over the two-year terms of the PRPs.

Cost of Goods Sold and Gross Margin

Fourth Quarter

Cost of goods sold for the quarter increased by \$5.1 million from \$22.7 million to \$27.8 million, an increase of 22.6%, primarily as a result of new store openings.

Gross margin for the quarter increased by \$0.8 million, from \$13.8 million to \$14.6 million, an increase of 5.7%. This increase is a result of net increases in sales volumes from new store development. Gross margin percentage decreased from 37.8% to 34.4%. The decrease in gross margin was primarily due to higher freight costs, which rose from 6.8% of sales to 8.8% of sales. Reallocation of inventory between stores and rising rates

contributed to the higher freight expense. Additional inventory movement was required because of the inventory allocation problems described under sales above. The cost of products sold rose from 55.5% of sales to 56.9% of sales. This increase is partially due to the temporary impact of changes in the Canadian-US dollar exchange rate, which increased from 1.10 to 1.18 during the quarter.

Annual

Cost of goods sold for the year increased by \$13.0 million, from \$61.3 million to \$74.3 million, an increase of 21.2%, primarily as a result of new store openings.

Gross margin for the year increased by \$6.4 million, from \$36.0 million to \$42.4, an increase of 17.9%. Of this increase, \$7.2 million was a result of net increases in sales volumes from new store development. This was offset by a \$0.8 million decrease as a result of a reduction in gross margin percentage from 37.0% to 36.4%.

Combined Administrative and Operating Expenses

Fourth Quarter

For the quarter, administrative and operating expenses increased by approximately \$2.9 million from \$7.0 million to \$9.9 million. This increase is primarily the result of increases in rent (\$0.4 million increase), wages (\$1.1 million increase) and advertising (\$0.9 million increase). The increases in rent and advertising were primarily the result of new store openings. The increase in wages was the result of new stores openings as well as significant wage rate increases, primarily in Alberta. The components of the wage increases are summarized in the chart below (in \$millions):

	New Stores	Alberta	Other Markets	Total
Wages	0.5	0.5	0.1	1.1
% increase from prior year	100%	63%	8%	46%

(Note: three new stores opened in Alberta are considered part of “New Stores” for the above breakdown)

Our average wages rates in Alberta have increased by 22% over the same quarter in 2005, with the remaining increase in wages a result of adding new positions to support our growth and additional labour hours used in our distribution centre as a result of our inventory allocation problems described above.

Annual

For the year, administrative and operating expenses increased by \$7.9 million from \$20.7 million to \$28.5 million. This increase is primarily the result of increases in rent (\$1.7 million increase), wages (\$3.2 million increase) and advertising (\$1.7 million increase). The increase in rent is the result of new store growth as well as the new distribution centre

that opened in Mississauga, Ontario in May 2005 (\$0.8 million). The increase in advertising expense is entirely due to new store growth. The increase in wage expense is the result of new store growth, the new distribution centre as well as significant upward wage pressures, particularly in Alberta. In addition, incremental public company administrative expenses accounted for \$0.1 million of the increase. Included in year-to-date administrative and operating costs are \$0.2 million of non-recurring expenses related to the consolidation of the Edmonton distribution facilities that were incurred in the first quarter.

The components of the wage increase are summarized in the table below (in \$millions):

	New Stores	Alberta	Other Markets	Total
Wages	1.5	1.5	0.2	3.2
% increase from prior year	100%	55%	3%	40%

(Note: three new stores opened in Alberta are considered part of “New Stores” for the above breakdown)

Our average wages rates in Alberta have increased by 22% over 2005, with the remaining increase in wages a result of adding new positions to support our growth and additional labour hours used in our distribution centre as a result of our inventory allocation problems described above.

Earnings from Operations

Fourth Quarter

For the quarter, earnings from operations decreased by \$2.1 million, from \$6.7 million to \$4.6 million, a decrease of 31.2%, as a result of the factors discussed previously.

Annual

For the year, earnings from operations decreased by \$1.4 million, from \$15.3 million to \$13.9 million, a decrease of 9.2%, as a result of the factors discussed previously.

Fund Net Earnings

For the three months ended December 31, 2006, the Fund had net earnings of \$1.7 million or \$0.286 per unit on a basic and diluted basis.

For the twelve months ended December 31, 2006, the Fund had net earnings of \$5.2 million or \$0.848 per unit on a basic and diluted basis.

Financial Position

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

	Dec 31, 2006	Dec. 31, 2005
Cash and cash equivalents	1,017,824	7,442,496
Inventory	22,288,806	15,752,388
Total current assets	31,179,577	28,388,003
Total assets	144,349,830	140,941,626
Total current liabilities	16,359,176	9,085,481
Term loan	17,500,000	15,000,000
Non-controlling interest	57,493,942	59,527,529
Unitholders' equity	54,571,224	56,833,747

Distributable Cash and Cash Distributions

The Fund's policy is to distribute annually to unitholders available cash from operations after cash required for capital expenditures, working capital reserve and other reserves considered advisable by the Trustees of the Fund. The policy allows the Fund to make stable monthly distributions to its unitholders based on its estimate of distributable cash for the year. The Fund pays cash distributions on or about the 15th of the month to unitholders of record on the last business day of the previous month.

The Fund uses cash provided by operating activities, excluding changes in non-cash working capital, as its basis to calculate distributable cash. The operations of the Fund are seasonal in nature with as much as 40% of annual distributable cash generated in the fourth quarter. The regular build-up and draw down of inventory levels due to seasonal shopping patterns creates significant fluctuations of non-cash working capital from quarter to quarter. Management believes that excluding these changes in non-cash working capital better reflects the cash available for distribution to unitholders.

Deferred revenue and deferred charges relating to 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.

The Fund expects that the first three quarters will have distributions declared in excess of distributable cash earned. As the fourth quarter generates as much as 40% of the annual distributable cash, the prior three quarters' distribution deficit is funded by excess created in the fourth quarter. If on an annual basis, the payout ratio exceeds 100%, the difference is funded by the operating loan.

The following table summarizes the distributions from January 1, 2006 to December 31, 2006:

Record Date	Payment Date	Fund Units		Exchangeable LP Units and Subordinated LP Units		Total	
		Declared \$	Paid \$	Declared \$	Paid \$	Declared \$	Paid \$
Jan. 31, 2006	Feb. 15, 2006	572,438	572,438	326,148	326,148	898,586	898,586
Feb. 28, 2006	March 15, 2006	572,437	572,437	326,148	326,148	898,585	898,585
March 31, 2006	April 15, 2006	629,681	629,681	1,056,051	1,056,051	1,685,732	1,685,732
April 30, 2006	May 15, 2006	629,682	629,682	358,763	358,763	988,445	988,445
May 31, 2006	June 15, 2006	629,681	629,681	358,763	358,763	988,444	988,444
June 30, 2006	July 15, 2006	629,681	629,681	1,102,247	1,102,247	1,731,928	1,731,928
July 31, 2006	Aug. 15, 2006	629,681	629,681	359,479	359,479	989,160	989,160
Aug. 31, 2006	Sept. 15, 2006	629,681	629,681	359,479	359,479	989,160	989,160
Sept. 30, 2006	Oct. 15, 2006	629,681	629,681	1,103,235	1,103,235	1,732,916	1,732,916
Oct. 31, 2006	Nov. 15, 2006	629,682	629,682	359,479	359,479	989,161	989,161
Nov. 30, 2006	Dec. 15, 2006	629,682	629,682	359,479	359,479	989,161	989,161
Dec. 31, 2006	Jan. 15, 2007	629,681	-	1,103,236	-	1,732,917	-
		<u>7,441,688</u>	<u>6,812,007</u>	<u>7,172,506</u>	<u>6,069,271</u>	<u>14,614,194</u>	<u>12,881,278</u>

Distributions are paid on Fund Units, XS Cargo LP Exchangeable LP Units and XS Cargo LP Subordinated LP Units. As of December 31, 2006 the following number of units were outstanding:

Fund Units (Note 9)	6,106,000
XS Cargo LP Exchangeable LP Units (Note 10)	3,485,858
XS Cargo LP Subordinated LP Units (Note 10)	<u>2,404,058</u>
	<u>11,995,916</u>

During the three months ended December 31, 2006, the Fund approved distributions of an aggregate of \$0.309375 per Fund Unit to unitholders. It is the Fund's policy to review the

monthly distribution amount at least quarterly. The monthly distribution rate at the time of the initial public offering was \$0.09375 per unit. The monthly distribution rate was increased to \$0.103125 per unit in March 2006.

The Fund announced a reduction in the distribution rate back to the level at the time of the IPO of \$1.125 per unit for Fund and Exchangeable LP Units. Distributions on Subordinated LP Units have been suspended. Monthly distributions will be reduced to \$0.09375 per Fund and Exchangeable LP Unit, beginning with the March 2007 distribution, which is payable on April 15, 2007 to unitholders of record at the close of business on March 31, 2007.

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

	Oct. 1 to Dec. 31, 2006 (unaudited)	Jan. 1 to Dec. 31, 2006 (unaudited)	Since Inception on May 17, 2005 (unaudited)
Cash provided by (used for) operating activities	10,805,061	8,030,109	23,709,232
Less: Net change in non-cash working capital	(5,602,604)	5,713,262	1,872,104
Less: Deferred charges, net of costs recognized	112,820	207,385	331,799
Less: Deferred revenue, net of revenue recognized	(464,478)	(1,365,935)	(2,135,840)
Less: Lease inducements received, net of amortization of lease inducements	(86,985)	(175,859)	(317,975)
Less: Maintenance capital expenditures ¹	(191,430)	(425,244)	(620,249)
Distributable cash ²	3,852,384	11,983,718	22,839,071
Average Units outstanding during the period	11,995,916	11,990,098	11,987,817
Distributable cash per Unit	0.32	1.00	1.91
Distributions declared	3,711,239	14,614,194	23,017,504
Distributions declared per Unit	0.31	1.22	1.92
Ratio of distributions declared to distributable cash (payout ratio)	96%	122%	101%

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.

Since inception, the Fund has had distributable cash per unit of \$1.91 and has declared distributions of \$1.92 per unit. For the fourth quarter, the Fund had distributable cash per unit of \$0.32 and declared distributions of \$0.31 per unit. Basic and diluted earnings per unit were \$0.31 for the fourth quarter.

During the three months ended December 31, 2006, distributable cash exceeded distributions declared. The monthly cash distributions are based on management's estimate of distributable cash for the year. Since the Fund's business is seasonal in nature, with approximately 40% (actual figure of 32.1% in 2006) of the annual distributable cash being generated in the fourth quarter, it is expected that cash distributions based on annual cash flows will exceed distributable cash during the first three quarters and be less than distributable cash in the fourth quarter.

For the year, the Fund declared distributions in excess of distributable cash generated. This is a result of lower than anticipated sales and earnings as discussed earlier in the "Operating Highlights" section. The Fund plans to use credit facilities to finance the shortfall between distributable cash and distributions declared until the fourth quarter of 2007.

EBITDA

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

	Oct. 1 to Dec. 31, 2006 (unaudited)	Jan. 1 to Dec. 31, 2006 (unaudited)	Since Inception on May 17, 2005 (unaudited)
Net earnings for the period	1,745,044	5,179,165	10,162,564
Add: non-controlling interest	1,683,289	4,991,919	9,789,400
Add: Interest expense	427,970	1,333,126	1,838,048
Add: Amortization of property and equipment	273,981	898,878	1,236,026
Add: Amortization of intangible assets	298,000	1,192,000	1,937,000
EBITDA³	4,428,284	13,595,088	24,963,038

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

Unitholders' Equity and Non-controlling Interest

The following table outlines the Fund Units and non-controlling interest outstanding as of December 31, 2006.

	Units	Issue Costs	Unitholders' Equity	Non-controlling Interest
	#	\$	\$	\$
Fund Units	6,106,000	4,928,124	54,571,224	-
Special Voting Units	5,889,916	-	-	-
Non-controlling Interest	5,889,916	-	-	57,493,942

On June 30, 2006, 6,944 Exchangeable Units, 4,789 Subordinated Units and 11,733 Special Voting Units were issued to the Chief Financial Officer as described in Note 13.

LIQUIDITY AND CAPITAL RESOURCES

Distributable Cash and Cash Distributions

The Fund's policy is to make stable monthly distributions to its Unitholders based on its estimate of distributable cash for the year. It has a policy to pay cash distributions on or about the 15th of each month to Unitholders of record on the last business day of the previous month.

During the three and twelve months ended December 31, 2006, the Fund declared distributions of \$0.309375 and \$1.218750 per Fund Unit respectively to Unitholders, or \$1,889,043 and \$7,441,688 in total.

Credit Facilities

The Fund has established credit facilities with a Canadian chartered bank. These credit facilities consist of a \$12.5 million demand revolving operating loan (which is increased from \$10.0 million between the months of August and December, to facilitate the build up of inventories for the fourth quarter holiday shopping season) and a committed non-revolving term loan to a maximum amount of \$17.5 million. On May 17, 2005 the Fund drew \$15.0 million on the term loan in connection with the acquisition described on page 1. During August 2006, an additional \$2.5 million was drawn on the term loan. As at December 31, 2006, \$17.5 million remains outstanding on the term loan and \$Nil was outstanding on the operating loan.

Subsequent to December 31, 2006, the Fund amended its available credit facilities. The limit on the demand revolving operating loan has been increased to \$12.5 million for the period from January 1 to July 31 annually and to \$20.0 million from August 1 to December 31 annually. The limit on the term loan has been increased from \$17.5 million to \$25.0 million. The increases in the credit facilities are to fund the new point-of-sale and

inventory management system as well as working capital and capital requirements related to the continued store expansion in 2007. Interest on the term loan is charged at the lender's Canadian prime rate or U.S. base rate plus 0.25% to 0.75% or the bankers' acceptance rate plus 1.75% to 2.25%, depending on the Fund's senior debt to EBITDA ratio. Interest on the operating loan will vary between the lender's prime rate and the lender's prime rate plus 0.50% depending on the Fund's ratio of senior debt to EBITDA.

Debt Covenants

Both the Term Loan and Operating Loan require the Fund to maintain certain financial covenants, including a maximum senior debt to EBITDA ratio of 1.5:1.0, a minimum current ratio of 1.5:1.0 and a minimum fixed charge coverage ratio of 1.0:1.0. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions in excess of distributable cash and other changes in the business without approval of the Lender.

In March 2007, the Fund entered into amending agreements for both Loans that amended or waived certain financial covenants as of December 31, 2006, with which the Fund otherwise would not have complied. After obtaining waivers on two covenants the Fund was in compliance with all Loan agreements as of December 31, 2006. The new covenants include a maximum senior debt to EBITDA ratio of 2.5:1.0, a minimum current ratio of 1.5:1.0 and a minimum fixed charge coverage ratio of 0.85:1.0.

Capital Expenditures

During the quarter, the Fund acquired \$769,408 of property and equipment which was financed using the term loan. Of this, \$577,978 related to new store openings, distribution infrastructure and head office capacity and the remaining \$191,430 related to capital expenditures at existing stores and warehouses ("maintenance capital expenditures").

Subsequent to December 31, 2006, the Fund opened a new store in Moncton, New Brunswick. The new store required capital expenditures of approximately \$140,000. In addition, leases have been finalized for Kamloops, British Columbia; Belleville, Ontario; Peterborough, Ontario and Sarnia, Ontario. Kamloops is scheduled to open at the end of the first quarter and the other three stores are scheduled to open in the second quarter of 2007. As discussed above, the Fund has credit facilities available to finance these and other growth related capital expenditures planned for the remainder of 2007.

Interest Rate Risk and Sensitivity

The Fund is not significantly impacted by interest rate changes. The Fund's long-term debt bears interest with floating rates based on the bank's prime rate, thus exposing the Fund to interest rate fluctuations. A 1.0% increase in interest rates would have an impact of \$175,000 annually (\$43,750 during the quarter) on distributable cash based on \$17.5 million of debt outstanding.

Contractual Obligations

The table below sets forth the contractual obligations of the Fund as of December 31, 2006, due in the years indicated, which relate to various premises operating leases and the \$17.5 million outstanding on the term loan, with \$2,5 million due on September 30, 2007 and the remainder that matures on May 16, 2008.

(unaudited)	Total	2007	2008	2009	2010	2011	2012 and thereafter
Operating Leases	23,254,398	4,399,644	4,258,081	3,831,128	2,794,582	2,016,472	5,954,491
Term loan	17,500,000	2,500,000	15,000,000	-	-	-	-
Total	40,754,398	6,899,644	19,258,081	3,831,128	2,794,582	2,016,472	5,954,491

Summary of Quarterly Results (unaudited)

	2006				2005		
	Q4	Q3	Q2	Q1	Q4	Q3	May 17 to June 30, 2005
Sales	42,339,077	25,960,077	27,822,876	20,671,865	36,436,104	20,775,101	11,755,952
Net earnings	1,745,044	1,108,744	1,601,832	723,545	3,062,775	1,173,328	747,296
Basic and diluted earnings per unit	0.286	0.182	0.262	0.118	0.502	0.192	0.122

Due to seasonal shopping trends, the fourth quarter is typically the strongest quarter for XS Cargo and the first quarter is weakest.

Selected Annual Information

	January 1 to December 31, 2006	May 17 to December 2005
Sales	116,793,895	68,967,157
Net earnings	5,179,165	4,983,399
Basic and diluted earnings per unit	0.848	0.816
Total assets	144,349,830	140,941,626
Total long-term financial liabilities	15,000,000	15,000,000
Distributions declared per unit	1.22	0.70

Off-Balance Sheet Arrangements

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

Critical Accounting Estimates

Goodwill

Goodwill is not amortized, but is tested for impairment annually or more frequently if circumstances indicate a potential impairment. Goodwill is tested for impairment by comparing the estimated fair value of the reporting unit to its carrying value. If the carrying value of the reporting unit exceeds its fair value, the fair value is allocated to the assets and liabilities of the reporting unit and the resulting difference between the carrying value and fair value of goodwill is recorded as an impairment loss and recorded in earnings of the current period.

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. In addition, accrued supplier rebates are allocated between cost of goods sold and a reduction of inventory based on the estimated proportion related to goods remaining in inventory at the end of a 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.

Changes in Accounting Policies Including Initial Adoptions

Management is not aware of any recent accounting pronouncements or developments that will affect the Fund's financial statements. Management will continue to monitor and assess the impact of accounting pronouncements on the financial statements of the Fund as they become available.

Future accounting changes - Financial instruments

The CICA has issued three new accounting standards:

- Section 3855, *Financial Instruments – Recognition and Measurement*, effective for fiscal years beginning on or after October 1, 2006. This section describes the standards for recognizing and measuring financial instruments in the balance sheet and the standards for reporting gains and losses in the financial statements. Financial assets available for sale, assets and liabilities held for trading and derivative financial instruments, part of a hedging relationship or not, have to be measured at fair value. The impact of remeasuring our financial assets and liabilities at fair value will be recognized in opening deficit and

opening accumulated other comprehensive income as appropriate. The impact of the adoption of this new section on the consolidated financial statements is not expected to be material.

- Section 1530, *Comprehensive Income*, effective for fiscal years beginning on or after October 1, 2006. It describes reporting and disclosure recommendations with respect to comprehensive income and its components. Comprehensive income is the change in Unitholders' equity, which results from transactions other than those resulting from investments by Unitholders and distributions to Unitholders. These transactions and events include unrealized gains and losses resulting from changes in fair value of certain financial instruments.

- Section 3865, *Hedges*, effective for fiscal years beginning on or after October 1, 2006. The recommendations expand the guidelines outlined in Accounting Guideline 13 ("AcG-13"), *Hedging Relationships*. This Section describes when and how hedge accounting can be applied as well as the disclosure requirements. Hedge accounting enables the recording of gains, losses, revenues and expenses from the derivative financial instruments in the same period as for those related to the hedged item. The impact of the adoption of this new section on the consolidated financial statements is not expected to be material.

These standards will be effective for the Fund as of January 1, 2007 and will be adopted on a retroactive without restatement basis.

Transactions with Related Parties

Transactions with related parties include XS Cargo LP's purchase of the assets of the business from the Vendor on May 17, 2005. During the three and twelve months ended December 31, 2006, there were no related party transactions.

Outlook

With plans to further increase the rate of our new store development; management believes that sales growth will be strong in 2007. Our Moncton, New Brunswick store opened on February 23 and Kamloops, British Columbia is scheduled to open March 22. Leases have been signed for stores in Belleville, Sarnia and Peterborough, Ontario which are scheduled to open in the second quarter. We will continue to look for improved efficiencies in order to control wage and freight costs. We believe that the implementation of a new point of sale and inventory management system will improve inventory allocations and allow us to realize labour efficiencies in our stores and distribution centres. As we are working with our existing systems throughout the implementation process, we will continue to experience higher freight costs and downward pressure on same store sales.

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, 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. Specifically, management believes that EBITDA is the appropriate measure from which to make adjustments to determine the distributable cash of the Fund. 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.

Earnings from operations disclosure under “Fourth Quarter and Year End Operating Results” has been calculated as described below. In the case of the Fund, earnings from operations have been derived by adding interest expense, amortization of property and equipment and intangible assets, unit-based compensation and non-controlling interest to net earnings for the period. In the case of the Vendor, earnings from operations have been derived by adding amortization expense, employee profit sharing plan contributions, interest expense, and income tax expense to net earnings (loss) for the period.

EBITDA, distributable cash and earnings from operations are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP. Investors are cautioned that EBITDA, distributable cash and earnings from operations 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 and earnings from operations may differ from the methods used by other issuers and may not be comparable to similar measures presented by other issuers.

DISCLOSURE CONTROLS AND PROCEDURES

The Fund's disclosure controls and procedures (as defined under Multilateral Instrument 52-109 ("MI 52-109") of the Canadian Securities Administrators) have been designed to provide reasonable assurance that material information relating to the Fund, including its consolidated subsidiaries, is made known to the Chief Executive Officer and the Chief Financial Officer of the GP, the administrator of the Fund and the general partner of XS Cargo LP, by others within those entities, particularly during the period in which the annual filings are being prepared.

Management of the Fund has evaluated the effectiveness of the Fund's disclosure controls and procedures as of December 31, 2006, and has concluded that the design and effectiveness of these controls and procedures provides reasonable assurance that material information relating to the Fund, including its consolidated subsidiaries, will be made known to management on a timely basis to ensure adequate disclosure.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

Management of the Fund is responsible for designing internal controls over financial reporting for the Fund as defined under MI 52-109. Management has designed such internal controls over financial reporting, or caused them to be designed under its supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with GAAP.

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.

On October 31, 2006, the Minister of Finance (Canada) announced new tax proposals concerning the taxation of income trusts and other flow-through entities. The October 31, 2006 Proposal was followed by the release of draft legislation by the Department of

Finance on December 21, 2006. The 2006 Proposed Amendments, if enacted as currently drafted, will subject the Fund to trust level taxation as of January 1, 2011. In addition, the taxable distributions received by investors from the Fund, would be treated as taxable dividends.

There can be no assurance that the Fund will be able to retain the benefit of the deferred application of the new tax regime until 2011. If the Fund is deemed to have undergone "undue expansion" during the period from November 1, 2006 to December 31, 2010, as described in the Normal Growth Guidelines issued by the Department of Finance on December 15, 2006, the 2006 Proposed Amendments would become effective on a date earlier than January 1, 2011.

The Normal Growth Guidelines indicate that the Fund will not lose the benefit of the deferred application of the new tax regime to 2011 if the equity capital of the Fund does not grow as a result of issuances of new equity (which includes trust units, debt that is convertible into trust units, and potentially other substitutes for such equity) before 2011 by an amount that exceeds the greater of \$50 million and an objective "safe harbour" amount based on a percentage of the Fund's October 31, 2006 Market Capitalization. The Normal Growth Guidelines provide for a "safe harbour" amount equal to 40% of the October 31, 2006 Market Capitalization for the period from November 1, 2006 to the end of 2007, and 20% for each of the 2008 to 2010 calendar years. These amounts of "safe harbour" are cumulative during the transition period. The Fund's October 31, 2006 Market Capitalization was approximately \$86.2 million. It is therefore assumed, for the purposes of this summary that the Fund will not be subject to the 2006 Proposed Amendments until January 1, 2011. However, in the event that the Fund issues additional Units or convertible debentures (or other equity substitutes) on or before 2011, the Fund may become subject to the 2006 Proposed Amendments prior to 2011. No assurance can be given that the 2006 Proposed Amendments will not apply to the Fund prior to 2011. Loss of the benefit of the deferred application of the new tax regime until 2011 could have a material and adverse effect on the value of units of the Fund.

Currently, a trust will not be considered to be a mutual fund trust if it is established or maintained primarily for the benefit of non-residents of Canada unless all or substantially all of its property is property other than "taxable Canadian property" as defined in the Tax Act. The management of the Fund has stated that the Fund has adopted mechanisms to ensure that the Fund is not maintained primarily for the benefit of non-residents of Canada.

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.