



XS CARGO INCOME FUND

Management's Discussion of Financial Condition and Results of Operations

For the quarter and year ended December 31, 2007

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, 2007. 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 27, 2008.

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 Toronto Stock Exchange under the symbol XSC.UN.

The Business of the Fund

XS Cargo LP operates 40 closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Nova Scotia, Newfoundland and New Brunswick.

Operating Highlights

Sales during the fourth quarter were lower than expected due to a significant supply chain disruption related to the implementation of the new Merchandise Management System. The fourth quarter was the first period following full roll out and operational reliance on the new JDA Software Inc.[®] Merchandise Management System. The implementation imposed several additional steps in receiving, picking, and shipping. These additional steps, although designed to increase efficiencies, overwhelmed the distribution centres. Distribution centre throughput dropped dramatically causing significant additional external freight and logistics requirements, higher than normal stock-outs, increased third party warehousing and increased distribution centre labour hours.

Higher than normal stock-outs negatively impacted same store sales. For the fourth quarter, same store sales decreased by 7.2% over the same period in the prior year, with a decrease of 8.2% year over year.

Gross margin for the quarter was also impacted by the system implementation due to significant additional external freight costs, increased third party warehousing, increased service inventory write-offs, and provisions for deposits on inventory.

Freight costs as a percentage of sales for the quarter were 16.0% compared with 8.8% in the fourth quarter of 2006. On an annual basis, freight costs represent 11.5% of sales versus 7.7% in 2006.

During the fourth quarter, \$1.37 million of service inventory was written off. The write-off was the result of a substantial processing backlog of customer warranty returns. The backlog was the result of chronic labour shortages in Edmonton, with processing delays causing obsolescence issues contributing to the increased write-off. The Returns Processing Centre was moved from Edmonton to Burlington, Ontario in September of 2007. Total service inventory written off during 2007 was \$1.8 Million or 1.4% of sales, versus \$0.5 Million or 0.40% of Sales in 2006.

In addition, due to the time demands of the system implementation, as well as staff shortages and turnover in the finance department, timely follow-up and reconciliation of deposits on inventory was not carried out on a consistent basis during 2007. Therefore, a provision for \$1.2M has been recorded as a charge against cost of sales in the fourth quarter to reduce this account to its estimated net realizable amount.

Several initiatives are underway to remediate the problems associated with the merchandise management system implementation. In January 2008, the GP hired a Vice President of Logistics and Distribution, who has assumed responsibility for warehousing and distribution logistics and reverse logistics including returns processing. We have also identified timely follow up and reconciliation of deposits on inventory as a priority, and have begun the process of communicating with vendors to determine collectability of these amounts, as well as continue to reconcile and monitor outstanding balances.

Due to the lower than expected fourth quarter sales and the factors mentioned above, the Fund experienced a decrease in EBITDA (refer to non-GAAP measures on page 23) over the prior year.

In addition, as at December 31, 2007, the Fund was not in compliance with certain of its financial covenants under its credit facilities, giving the lenders the right to demand repayment. Repayment has not been demanded, and the Fund continues to work with its lenders to remedy the breaches and negotiate mutually acceptable terms as quickly as possible.

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 year ended December 31, 2007 compared to the quarter and year ended December 31, 2006. 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, 2007	Three Months Ended December 31, 2006	Change Q4 2007 from Q4 2006
Sales	42,653,087	42,339,077	314,010
Cost of Goods Sold	32,231,166	27,784,931	4,446,235
Gross Margin	10,421,921 24.4%	14,554,146 34.4%	(4,132,225)
Administrative and Operating Expenses*	11,860,328	9,931,827	1,928,501
Earnings (loss) from Operations, as defined*	(1,438,407)	4,622,319	(6,060,725)
Net Earnings (loss)	(36,283,954)	1,745,044	(38,028,998)
<i>Normalized Gross Margin:</i>			
Gross Margin (as reported)	10,421,921	14,554,146	(4,132,225)
Non-recurring expenses included in Cost of Goods Sold**	2,179,500	-	2,179,519
Gross Margin before non-recurring expenses**	12,601,421 29.5%	14,554,146 34.4%	(1,952,706)

Annual Operating Results	Year Ended December 31, 2007	Year Ended December 31, 2006	Change 2007 over 2006
Sales	125,080,159	116,793,895	8,286,264
Cost of Goods Sold	86,128,554	74,328,664	11,799,890
Gross Margin	38,951,605 31.1%	42,465,231 36.4%	(3,513,626)
Administrative and Operating Expenses*	37,912,922	28,529,052	9,383,870
Earnings from Operations, as defined*	1,038,683	13,936,179	(12,897,496)
Net Earnings (loss)	(37,369,629)	5,179,165	(42,548,794)
<i>Normalized Gross Margin:</i>			
Gross Margin (as reported)	38,951,605	42,465,231	(3,513,626)
Non-recurring expenses included in Cost of Goods Sold**	2,179,500	-	2,179,519
Gross Margin before non-recurring expenses**	41,131,105 32.9%	42,465,231 36.4%	(1,334,107)

* 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".

**Gross Margin before non-recurring expenses is described under "Non-GAAP Measures". Non-recurring expenses include \$1,245,000 relating to provisions taken against deposits on inventory, and \$934,500 of service inventory write-off in the fourth quarter of 2007.

Sales

Fourth Quarter

The following table compares sales for the three months ended December 31, 2007 to the three months ended December 31, 2006 for new and same stores:

	Sales				Number of Stores as of December 31	
	2007	2006	Change	% change	2007	2006
Same stores	30,519,249	32,881,105	(2,361,856)	(7.2%)	27	27
New stores	12,133,838	9,457,972	2,675,866	28.3%	13	8
Total	42,635,087	42,339,077	314,010	0.7%	40	35

Fourth quarter sales increased by \$0.3 million, from \$42.3 million to \$42.6 million, an increase of 0.7%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$2.7 million in sales. The offsetting \$2.4 million decrease represents a 7.2% decrease in same store sales. The decrease in same store sales was primarily due to the supply chain disruption related to the implementation of our Merchandise Management System.

Annual

The following table compares sales for the year ended December 31, 2007 to the year ended December 31, 2006, for new and same stores:

	Sales			
	2007	2006	Change	% change
Same stores	92,384,926	100,659,997	(8,275,071)	(8.2%)
New stores	32,695,233	16,133,898	16,561,335	102.6%
Total	125,080,159	116,793,895	8,286,264	7.1%

Year over year sales have increased by \$8.3 million, from \$116.8 million to \$125.1 million, representing an increase of 7.1%. For the year, same store sales were down 8.2%. The decrease in same store sales for the year was primarily the result of lower than expected sales as a result of the supply chain disruption discussed above.

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

Region	December 31, 2007			December 31, 2006		
	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	18	46.5%	44.6%	15	45.3%	48.0%
Alberta	8	19.4%	20.4%	8	20.8%	22.7%
British Columbia	8	18.5%	19.9%	7	18.2%	17.7%
Saskatchewan and Manitoba	3	8.7%	8.4%	3	8.4%	8.9%
Atlantic Canada	3	6.9%	6.7%	2	7.3%	2.7%
Total	40	100.0%	100.0%	35	100.0%	100.0%

Product Replacement Plan Sales

Sales of two-year product replacement extended warranty plans continue to be strong. During the twenty-seven months since implementation, \$5.3 million of Product Replacement Plans (“PRPs”) were sold, with \$3.1 million recognized as revenue since inception, approximately \$0.6 million of which was recognized during the fourth quarter of 2007 and approximately \$2.1 million for the year. 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 \$4.4 million from \$27.8 million to \$32.2 million, an increase of 16.0%. This increase resulted from a combination of new store openings, increased freight costs, as well as a write-off of inventory in our repair centre and a provision for deposits on inventory.

Gross margin for the quarter decreased by \$4.1 million, from \$14.5 million to \$10.4 million, a decrease of 28.4%. This decrease is a result of the decrease in same store sales and increased cost of goods sold as discussed above. Gross margin percentage decreased from 34.4% to 24.4%. When normalizing these results for the provision for deposits on inventory of \$1.245 million and abnormal service inventory write-off of \$0.934 million, gross margin for the quarter before non-recurring expenses is \$12.6 million or 29.5%. The remaining decrease in gross margin was primarily due to higher freight costs, which rose from 8.8% of sales to 16.0% of sales, primarily as a result of the supply chain disruption noted above.

Annual

Cost of goods sold for the year increased by \$11.8 million, from \$74.3 million to \$86.1 million, an increase of 15.9%, primarily as a result of new store openings and the factors relating to the fourth quarter as discussed above.

Gross margin for the year decreased by \$3.5 million, from \$42.5 million to \$39.0 million, a decrease of 8.3%. Gross margin percentage decreased from 36.4% to 31.1%. When normalizing annual results for the provision for deposits on inventory of \$1.245 million and abnormal service inventory write-off of \$0.934 million, gross margin for the year before non-recurring expenses is \$41.1 million, or 32.9%.

Combined Administrative and Operating Expenses

Fourth Quarter

For the quarter, administrative and operating expenses increased by approximately \$2.0 million from \$9.9 million to \$11.9 million. This increase is primarily the result of increases in rent (\$0.2 million increase), wages (\$0.9 million increase), advertising (\$0.2 million increase), bank charges (\$0.2 million increase) and consulting fees (\$0.2 million increase). The increases in rent, advertising and bank charges were primarily the result of new store openings. The increase in consulting fees is due in part to maintenance and other fees related to the new Merchandise Management System. The increase in wages was the result of new stores openings, continued wage increases and additional labour costs related to the supply chain disruption discussed above.

Annual

For the year, administrative and operating expenses increased by \$9.4 million from \$28.5 million to \$37.9 million. This increase is primarily the result of increases in rent (\$1.7 million increase), wages (\$3.5 million increase), advertising (\$1.5 million increase), bank charges (\$0.4 million increase) and consulting fees (\$0.6 million increase). The increases in rent, advertising and bank charges were primarily the result of new store openings. The increase in consulting fees is due in part to expenses incurred with respect to the online Web store, as well as an increased use of recruitment services during the year. The increase in wages was the result of new stores openings, continued wage increases and additional labour costs related to the supply chain disruption discussed above.

Earnings from Operations

Fourth Quarter

For the quarter, earnings from operations decreased by \$6.1 million, from \$4.6 million to a loss of \$1.4 million, a decrease of 131.1%, as a result of the factors discussed previously.

Annual

For the year, earnings from operations decreased by \$12.9 million, from \$13.9 million to \$1.0 million, a decrease of 92.5%, as a result of the factors discussed previously.

Fund Net Earnings

For the three months ended December 31, 2007, the Fund had a net loss of \$36.3 million or \$5.95 per unit on a basic and diluted basis. This is due to the factors described above, as well as a recovery of future income tax expense of \$0.8 million, and an impairment of goodwill and intangibles of \$68.9 million, net of adjustments for non-controlling interest.

For the twelve months ended December 31, 2007, the Fund had a net loss of \$37.4 million or \$6.121 per unit on a basic basis, and \$6.125 on a diluted basis. This represents a decrease from 2006 of \$42.5 million, due to the factors discussed previously, as well as the fourth quarter impairment of goodwill and intangible assets described above, net of adjustments for non-controlling interest.

Financial Position

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

	Dec 31, 2007	Dec 31, 2006
Cash and cash equivalents	1,709,959	1,017,824
Inventory	21,144,060	22,288,806
Total current assets	25,914,581	30,834,402
Total assets	71,860,825	144,349,830
Total current liabilities excluding term loan and subordinated loan	15,374,236	13,859,176
Term loan	11,250,000	17,500,000
Subordinated loan	12,162,695	-
Non-controlling interest	18,901,771	57,493,942
Unitholders' equity	12,784,920	54,571,224

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 has previously allowed the Fund to make stable monthly distributions to its unitholders based on its estimate of distributable cash for the year.

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.

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 following table summarizes the distributions from January 1, 2007 to December 31, 2007:

Record Date	Payment Date	Fund Units		Exchangeable LP Units and Subordinated LP Units		Total	
		Declared \$	Paid \$	Declared \$	Paid \$	Declared \$	Paid \$
Jan. 31, 2007	Feb. 15, 2007	629,681	629,681	359,479	359,479	989,160	989,160
Feb. 28, 2007	March 15, 2007	629,681	629,681	359,479	359,479	989,160	989,160
March 31, 2007	April 15, 2007	572,438	572,438	326,799	326,799	899,237	899,237
April 30, 2007	May 15, 2007	572,438	572,438	326,799	326,799	899,237	899,237
May 31, 2007	June 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
June 30, 2007	July 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
July 31, 2007	Aug. 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
Aug. 30, 2007	Sep. 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
Sep. 30, 2007	Oct. 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
Oct. 31, 2007	Nov. 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
Nov. 30, 2007	Dec. 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
		<u>4,407,771</u>	<u>4,407,771</u>	<u>2,518,631</u>	<u>2,518,631</u>	<u>6,926,402</u>	<u>6,926,402</u>

Distributions were paid on Fund Units, XS Cargo LP Exchangeable LP Units and XS Cargo LP Subordinated LP Units. As of December 31, 2007 the following number of units were outstanding:

Fund Units (Note 10)	6,103,000
XS Cargo LP Exchangeable LP Units (Note 11)	3,492,802
XS Cargo LP Subordinated LP Units (Note 11)	<u>2,408,847</u>
	<u>12,004,649</u>

During the three months ended December 31, 2007, the Fund approved distributions of an aggregate of \$0.093796 per Fund Unit to unitholders. It is the Fund's policy to review the monthly distribution amount at least quarterly. For the first two months of 2007, the monthly distribution rate was \$0.103125 per unit. Effective March 2007, the distribution rate was reduced to the monthly level at the time of the IPO of \$0.09375 per unit (from \$0.103125 per unit) for Fund and Exchangeable LP Units. Distributions on Subordinated LP Units were suspended in March 2007.

The Fund announced a further reduction in the monthly distribution rate to \$0.046875 per Fund Unit and Exchangeable LP Unit, beginning with the May 2007 distribution, and the suspension of distributions beginning with the December 2007 distribution.

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

	Three months ended		Year ended	
	Dec. 31, 2007	Dec. 31, 2006	Dec. 31, 2007	Dec. 31, 2006
	(unaudited)	(unaudited)		
Cash provided by (used for) operating activities	14,151,914	10,805,061	8,035,959	8,030,109
Less: Net change in non-cash working capital	(15,661,662)	(5,602,604)	(8,554,358)	5,758,367
Less: Deferred charges, net of costs recognized	(83,215)	112,820	(64,723)	207,385
Less: Deferred revenue, net of revenue recognized	(199,691)	(464,478)	(206,696)	(1,411,040)
Less: Lease inducements received, net of amortization of lease inducements	(168,061)	(86,985)	(530,552)	(175,859)
Less: Maintenance capital expenditures ¹	(167,787)	(191,430)	(535,062)	(425,244)
Distributable cash ²	(2,128,502)	3,852,384	(1,855,432)	11,983,718
Average Units outstanding during the period	12,004,649	11,995,916	12,002,489	11,990,098
Distributable cash per Unit	(0.18)	0.32	(0.15)	1.00
Distributions declared	899,888	3,711,239	6,926,402	14,614,194
Distributions declared per Unit	0.07	0.31	0.58	1.22
Ratio of distributions declared to distributable cash (payout ratio)	n/a ³	96%	n/a ³	122%

For the fourth quarter, the Fund had negative distributable cash per unit of \$0.18 and declared distributions of \$0.07 per unit. Basic and diluted loss per unit was \$5.95 for the fourth quarter.

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 Under the Fund’s distribution policy, the Fund did not generate distributable cash for the periods noted. Therefore, payout ratio data is not presented for these periods.

During the three months ended December 31, 2007, distributable cash did not exceed 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 as much as 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. However, due to the factors on earnings described above, distributable cash for the quarter did not exceed distributions.

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 excess of distributions over distributable cash was funded by the Fund's credit facilities.

EBITDA

Management believes that EBITDA⁴ is a useful measure in evaluating the performance of the Fund.

	Three months ended		Year ended	
	Dec. 31, 2007 (unaudited)	Dec. 31, 2006 (unaudited)	Dec. 31, 2007	Dec. 31, 2006
Net earnings for the period	(36,283,954)	1,745,044	(37,369,629)	5,179,165
Add: non-controlling interest	(35,099,291)	1,683,289	(36,146,900)	4,991,919
Add: Interest expense	777,897	427,970	2,654,435	1,333,126
Add: Impairment of goodwill	65,561,827	-	65,561,827	-
Add: Impairment of intangible assets	3,385,000	-	3,385,000	-
Add: Future Income Tax	(780,160)	-	-	-
Add: Amortization of property and equipment	472,404	273,981	1,408,620	898,878
Add: Amortization of intangible assets	302,300	298,000	1,256,500	1,192,000
EBITDA	(1,663,977)	4,428,284	749,853	13,595,088

⁴ 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, 2007.

	Units	Issue Costs	Unitholders' Equity	Non-controlling Interest
	#	\$	\$	\$
Fund Units	6,103,000	4,928,124	56,116,612	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	18,901,771

On June 30, 2007, 6,944 Exchangeable Units, 4,789 Subordinated Units and 11,733 Special Voting Units were issued to the former Chief Financial Officer as described in Note 14.

There have been no changes in the number of Fund Units or Special Voting Units from December 31, 2007 to March 27, 2008.

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. However, 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.

During the three and twelve months ended December 31, 2007, the Fund declared distributions of \$0.093796 and \$0.722230 per Fund Unit respectively to Unitholders, or \$572,438 and \$4,407,771 in total.

Credit Facilities

The Fund has established credit facilities with a Canadian chartered bank. These credit facilities consist of a \$20.0 million demand revolving operating loan (which is increased from \$12.5 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 \$11.25 million, which was reduced from \$21.25 million on July 31, 2007. Interest on the term loan is charged at the lender's Canadian prime rate or U.S. base rate plus 0.25% to 1.25% 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 1.00% depending on the Fund's ratio of senior debt to EBITDA. If funds are

withdrawn in U.S. dollars, interest will vary between the lender's U.S. base rate and the lender's U.S. base rate plus 1.00%, depending on the Fund's ratio of senior debt to EBITDA. As of December 31, 2007, \$11.25 million was outstanding on the term loan and \$nil was outstanding on the operating loan.

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by a third party and 50% by a company owned by the President and CEO of the Fund. The principal balance is due after twelve months but is renewable for an additional six months at the option of the Fund. The subordinated loan is collateralized by a second charge on all present and future undertaking and property of the Fund, including an acknowledged assignment of leases and material contracts. An arrangement fee of 2% was charged on the principal balance of the subordinated loan. Interest on the subordinated loan is charged at 16%, with the Fund's option to capitalize up to 8.0% per annum. As of December 31, 2007, \$12.0 million was outstanding on the loan, with \$0.4 million of interest capitalized as part of the outstanding principal balance.

Debt Covenants

Both the Term Loan and Operating Loan ("Loans") require the Fund to maintain certain financial covenants, including a maximum senior debt to EBITDA ratio of 3.5:1.0 until December 31, 2007, at which time the ratio reduces to 2.0:1.0; a minimum current ratio of 1.5:1.0, a minimum fixed charge coverage ratio of 1.0:1.0 and a minimum EBITDA value of \$5,500,000 on a rolling twelve month basis. For 2007, the minimum fixed charge coverage ratio has been waived by the lender. 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. The limitation on declaring distributions in excess of distributable cash had been waived by the lender until December 31, 2007.

The subordinated loan requires the Fund to maintain certain financial covenants, including a total funded debt to EBITDA ratio of less than 5.0:1.0 until December 31, 2007, at which point the ratio reduces to 3.75:1.0. There are additional restrictive covenants that limit the Fund's ability to undertake mergers, acquisitions, new indebtedness and other changes in the business without approval of the lenders.

As at December 31, 2007, the Fund was not in compliance with its senior debt to EBITDA covenant, total debt to EBITDA covenant and the minimum twelve-month EBITDA covenant. All loans are presented as current liabilities. The Fund is working with its lenders to remedy the breaches and negotiate mutually acceptable terms as quickly as possible.

The Fund's term and subordinated loans mature in 2008. The Fund is presently evaluating its options with respect to the repayment and possible renegotiation of these loans.

Capital Expenditures

During the fourth quarter, the Fund acquired \$966,693 of property and equipment which was financed using the term loan. Of this, \$798,906 related to new store openings, distribution infrastructure and head office capacity and the remaining \$167,787 related to capital expenditures at existing stores and warehouses (“maintenance capital expenditures”).

During the year, the Fund acquired \$4,077,445 of property and equipment which was financed using the term loan. Of this, \$3,542,383 related to new store openings, distribution infrastructure, head office capacity, and the new Merchandise Management System, and the remaining \$535,062 related to capital expenditures at existing stores and warehouses (“maintenance capital expenditures”).

Interest Rate Risk and Sensitivity

The Fund is not significantly impacted by interest rate changes. The Fund’s term loan 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 \$112,500 annually (\$28,125 for a quarter) on distributable cash and interest expense based on \$11.25 million of debt outstanding.

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, 2007, 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, 2007, due in the years indicated, which relate to various premises operating leases, the \$11.25 million outstanding on the term loan, that matures on May 16, 2008, and the subordinated loan due on August 20, 2008.

	Total	2008	2009	2010	2011	2012	2013 and thereafter
Operating							
Leases	24,039,148	5,041,045	4,630,737	3,728,341	2,951,188	2,166,824	5,521,013
Subordinated							
Loan	12,000,000	12,000,000	-	-	-	-	-
Term loan	11,250,000	11,250,000	-	-	-	-	-
Total	47,289,148	28,291,045	4,630,737	3,728,341	2,951,188	2,166,824	5,521,013

As noted above, the Fund's term and subordinated loans mature in 2008. The Fund is presently evaluating its options with respect to the repayment and possible renegotiation of these loans.

Summary of Quarterly Results (unaudited)

	2007				2006			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Sales	42,653,087	29,250,232	29,519,184	23,657,656	42,339,077	25,960,077	27,822,876	20,671,865
Net earnings (loss)	(36,283,954)	415,980	(554,670)	(946,985)	1,745,044	1,108,744	1,601,832	723,545
Basic and diluted earnings per unit	(5.95)	0.07	(0.09)	(0.16)	0.29	0.18	0.26	0.12

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, 2007	January 1 to December 31, 2006
Sales	125,080,159	116,793,895
Net earnings (loss)	(37,369,629)	5,179,165
Basic and diluted earnings per unit	(6.121)	0.848
Total assets	71,860,825	144,349,830
Total long-term financial liabilities	-	15,000,000
Distributions declared per unit	0.58	1.22

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.

Due to the net loss in the current year, coupled with a reduction in the trading price of the Fund Units, the two-step impairment test identified that the fair value of goodwill did not exceed its recorded value. As such, a non-cash impairment charge of \$65,561,827 has been recognized.

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

(a) On January 1, 2007, the Fund adopted the following recommendations of the Canadian Institute of Chartered Accountants ("CICA") Handbook:

Section 3855: Financial Instruments – Recognition and Measurement

This Section describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. The adoption of these new standards has had no material impact on the consolidated financial statements.

The Fund has made the following classifications:

- Cash and cash equivalents are classified as “held for trading”, which are carried at fair value, with changes in fair value recognized through net income in the period they arise.
- Rebate and other receivables are classified as “loans and receivables”, which are initially measured at fair value, and subsequently measured at amortized cost using the effective interest method.

- Accounts payable and accrued liabilities, operating, term and subordinated loans have been classified as “other financial liabilities”, which are initially measured at fair value and subsequently measured at amortized cost using the effective interest method. For the term and subordinated loans and any other non-operating loans, the Fund has elected to add transaction costs that are directly attributable to issuance to the initial carrying amount.

Section 1530: Comprehensive Income

This Section describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in the Fund’s net assets that result from transactions, events or circumstances from sources other than the Fund’s Unitholders. The adoption of these new standards has had no material impact on the consolidated financial statements as the Fund does not have any items that should be presented as other comprehensive income.

Section 3865: Hedges

This Section establishes standards for when and how hedge accounting, which is optional, may be applied. As the Fund does not use hedge accounting, the adoption of these new standards has had no impact on the consolidated financial statements.

On December 31, 2007, the Fund adopted the following additional financial instruments sections:

Section 3862: Financial Instruments – Disclosures and Section 3863: Financial Instruments – Presentation

Section 3862 modifies the disclosure requirements for financial instruments that had previously been included in Section 3861, Financial Instruments – Disclosure and Presentation. The objective of this Section is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- (a) the significance of financial instruments for the entity's financial position and performance; and
- (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the entity manages those risks.

Section 3863 deals with the classification of financial instruments between liabilities and equity, the classification of related interest, dividends, losses and gains, and the circumstances in which financial assets and financial liabilities are offset.

(b) Section 1506: Accounting Changes

This standard establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors, and was amended to prescribe the criteria for changing accounting policies and related accounting treatment and disclosures of accounting principles.

The adoption of this amended accounting standard impacted the change in accounting policy with respect to future income taxes, as described in note 2 and note 18 of the consolidated financial statements.

Future accounting changes

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

Section 1535, Capital Disclosures, effective for fiscal years beginning on or after October 1, 2007. This new standard established disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund is presently evaluating the impact of this new standard.

Section 3031, Inventories, effective for fiscal years beginning on or after January 1, 2008. In June 2007, the CICA issued this new standard which provides guidance in determining the cost of inventory and its subsequent recognition as an expense. The standard is effective for fiscal periods beginning on or after January 1, 2008 and requires the retrospective application to prior period financial statements. The Fund does not expect this section to have a significant impact on the consolidated financial statements..

Section 1400: General Standards of Financial Statement Presentation was amended in June 2007 to include requirements for management to assess and disclose an entities ability to continue as a going concern. These requirements are effective for interim and annual financial statements for years beginning on or after January 1, 2008.

Section 3064, Goodwill and intangible assets. In February 2008, the CICA issued this new standard which provides guidance over the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The standard is effective for fiscal periods beginning on or after October 1, 2008 and requires retrospective application to prior period financial statements. The Fund is presently evaluating the impact of this new standard.

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. See "Credit Facilities" above for further details regarding this agreement.

Interest expense totaling \$433,030 was recorded on the portion of the loan outstanding to the related party during the year. There were no other related party transactions during the three and twelve month periods ended December 31, 2007.

Outlook

Although difficulties were encountered with the implementation of the Merchandise Management System, we are confident that the initiatives currently underway to remediate these problems will be effective. Our recently hired Vice President of Logistics and Distribution has focused on the system implementation issues impacting both sales and freight costs in 2007, and improvements have been noted.

We also continue to monitor the returns processing centre and related inventory, and have designed procedures which we feel will be effective in reducing future write-offs.

The deposits on inventory balances continue to be monitored and reconciled, and we have begun the process of communicating with vendors to determine collectability of these balances.

Negotiations are ongoing with our lenders to remedy the breaches of financial covenants and to work out mutually acceptable arrangements to enable these credit facilities to remain in place on a continuing basis.

We are encouraged by the progress to date, and believe that the action steps outlined above will enable the Fund to return to profitability in 2008.

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. 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. 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, 2007	Three Months Ended December 31, 2006
Net Earnings (loss)	(36,283,954)	1,745,044
Add:		
Non-controlling interest	(35,099,291)	1,683,289
Future income taxes	(780,160)	-
Impairment of Goodwill	65,561,827	-
Impairment of intangible assets	3,385,000	-
Foreign exchange (gain) loss	(30,706)	150,534
Interest on term and subordinated loans	788,484	304,859
Interest on operating loan	235,589	123,112
Amortization of intangible assets	328,100	298,000
Amortization of property and equipment	472,404	273,981
Unit based compensation expense	(15,700)	43,500
Earnings (loss) from Operations, as defined	<u>(1,438,407)</u>	<u>4,622,319</u>

Annual	Year Ended December 31, 2007	Year Ended December 31, 2006
Net Earnings (loss)	(37,369,629)	5,179,165
Add:		
Non-controlling interest	(36,146,900)	4,991,919
Impairment of Goodwill	65,561,827	-
Impairment of intangible assets	3,385,000	-
Foreign exchange loss	215,470	194,091
Interest on term and subordinated loans	2,071,349	1,042,066
Interest on operating loan	583,086	291,060
Amortization of intangible assets	1,256,500	1,192,000
Amortization of property and equipment	1,408,620	898,878
Unit based compensation expense	73,360	147,000
Earnings (loss) from Operations, as defined	<u>1,038,683</u>	<u>13,936,179</u>

Gross margin before non-recurring expenses has been calculated as outlined in the selected financial information and results from operations as gross margin plus non-recurring expenses included in cost of goods sold.

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.

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 "Certifying Officers"), 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.

The Certifying Officers of the Fund have evaluated the effectiveness of the Fund's disclosure controls and procedures as of December 31, 2007, and have 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 the Certifying Officers on a timely basis to ensure adequate disclosure.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Certifying Officers of the Fund are responsible for designing internal controls over financial reporting for the Fund as defined under MI 52-109. The Certifying Officers have designed such internal controls over financial reporting, or caused them to be designed under their 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. However, during the Certifying Officers' assessment of the design of internal control over financial reporting as at December 31, 2007, certain weaknesses in internal controls over financial reporting were identified as follows:

- The Fund's accounting and finance departments were substantially impacted by the departure of the Chief Financial Officer effective January 22, 2008 who has not yet been replaced, and the departure of the Fund's Controller in December 2007 who was replaced in February 2008
- Deposits on inventory balances were not followed up and reconciled on a timely basis, resulting in an allowance of \$1.2 million in the fourth quarter of 2007

These weaknesses in the Fund's internal control over financial reporting, noted above, result in a more than remote likelihood that a material misstatement may not be prevented or detected on a timely basis.

In order to address these weaknesses, the Fund has hired a new Controller, and has retained the services of an external chartered accountant to assist with the CFO function while carrying on its search for the hiring of a new CFO. The Fund has additionally instituted new reporting systems to ensure that there is appropriate and regular follow up on inventory balance deposits and that these balances are reconciled on a monthly basis. The Certifying Officers continue to work to mitigate the risk of a material misstatement in financial reporting.

Other than the weaknesses identified above, there have been no changes in the Fund's internal control over financial reporting that occurred during the Fund's most recent interim period that has materially affected, or is reasonably likely to materially affect, the Fund's internal control over financial reporting

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.