



## **XS CARGO INCOME FUND**

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

**For the three and six months ended June 30, 2008**

## **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 interim consolidated financial statements and accompanying notes (the "Financial Statements") of XS Cargo Income Fund (the "Fund") for the three and six months ended June 30, 2008, and the audited consolidated financial statements and management's discussion and analysis of 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](http://www.sedar.com). Results are reported in Canadian dollars unless otherwise stated and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Certain dollar amounts have been rounded to the nearest thousand dollars, while other amounts have been rounded to the nearest hundred thousand dollars. References to notes are to the notes to the Financial Statements of the Fund unless otherwise stated.

This MD&A is dated August 6, 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

We continue to rationalize our product mix in response to the high cost of transportation. This has resulted in reduced sales, however gross margins have increased significantly, from 34.3% in the second quarter of 2007 to 41.9% in the second quarter of 2008, more than offsetting the impact of the sales decline. In addition, the Fund's EBITDA<sup>1</sup> has increased from \$1.4 million for the 2007 second quarter to \$2.1 million for the second quarter of 2008.

The second quarter saw continued improvement in all aspects of our supply chain management. Freight management efforts have resulted in a decrease in freight as a percentage of sales from 9.2% in the second quarter of 2007 to 8.0% in the second quarter of 2008 despite much higher fuel costs.

Continued improvements in our merchandise management system have contributed to increased labor efficiencies and lower wage expense in both distribution centers. Management is confident that system problems which seriously impacted 2007 results are rectified. We believe the necessary procedures are in place to handle the increased volumes in the fourth quarter of 2008.

## SELECTED FINANCIAL INFORMATION AND RESULTS OF OPERATIONS

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

The following tables show the unaudited results of the Fund for the three and six month periods ended June 30, 2008 compared to the three and six month periods ended June 30, 2007. The results of operations for these periods are not necessarily indicative of the results of operations to be expected in any given period.

<b>Second Quarter Operating Results (unaudited)</b>	<b>Three Months Ended June 30, 2008</b>	<b>Three Months Ended June 30, 2007</b>	<b>Change Q2 2008 from Q2 2007</b>
Sales	25,080,819	29,519,184	(4,438,365)
Cost of Goods Sold	14,564,138	19,383,595	(4,819,457)
Gross Margin	10,516,681 41.9%	10,135,589 34.3%	381,092
Administrative and Operating Expenses*	8,401,979	8,725,410	(323,431)
Earnings from Operations, as defined*	2,114,702	1,410,179	704,523
Net Earnings (Loss)	248,174	(554,670)	802,844

<sup>1</sup> EBITDA refers to earnings before interest, taxes, depreciation and amortization. See discussion under "Non-GAAP Measures" below.

<b>Year-to-date Operating Results</b> (unaudited)	<b>Six Months Ended June 30, 2008</b>	<b>Six Months Ended June 30, 2007</b>	<b>Change 2008 from 2007</b>
Sales	46,846,666	53,176,840	(6,330,174)
Cost of Goods Sold	27,562,178	35,821,536	(8,259,358)
Gross Margin	19,284,488 41.2%	17,355,304 32.6%	1,929,184
Administrative and Operating Expenses*	16,733,607	16,721,255	12,352
Earnings from Operations, as defined*	2,550,881	634,049	1,916,832
Net Loss	(400,878)	(1,501,655)	1,100,777

\* 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”.

## Store Sales

### *Second Quarter*

The following table compares store sales for the three months ended June 30, 2008 to the three months ended June 30, 2007 for new and same stores:

	Sales				Number of Stores as of June 30	
	2008	2007	Change	% change	2008	2007
Same stores	21,073,413	24,174,565	(3,101,152)	(12.8%)	32	32
New stores	3,996,613	4,049,482	(52,869)	(1.3%)	8	7
Subtotal	25,070,027	28,224,047	(3,154,020)	(11.2%)	40	39
Non-store sales**	10,792	1,295,137	(1,284,345)	(99.2%)		
Total sales	25,080,819	29,519,184	(4,438,365)	(15.0%)	40	39

Second quarter store sales decreased by \$3.2 million, from \$28.2 million to \$25.1 million, a decrease of 11.2%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, experienced a second quarter decrease of \$53 thousand representing a sales decrease of 1.3%. Same stores experienced a second quarter decrease of \$3.1 million representing a sales decrease of 12.8%. The stores sales decrease is primarily due to a decrease in television sales which are down by \$1.9 million from the same quarter in 2007.

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

<b>Region</b>	<b>June 30, 2008</b>		<b>June 30, 2007</b>	
	Number of stores, end of quarter	Percentage of sales during the quarter	Number of stores, end of quarter	Percentage of sales during the quarter
Ontario	18	46.5%	17	43.6%
Alberta	8	19.5%	8	20.5%
British Columbia	8	19.5%	8	20.5%
Saskatchewan and Manitoba	3	8.7%	3	7.7%
Atlantic Canada	3	5.8%	3	7.7%
<b>Total</b>	<b>40</b>	<b>100.0%</b>	<b>39</b>	<b>100.0%</b>

#### *Year-to-Date*

The following table compares store sales for the six months ended June 30, 2008 to the six months ended June 30, 2007 for new and same stores:

	Sales			
	2008	2007	Change	% change
Same stores	40,841,193	46,852,018	(6,010,825)	(12.8%)
New stores	5,964,010	4,835,006	1,129,004	23.4%
Subtotal	46,805,204	51,687,024	(4,881,820)	(9.4%)
Non-store sales**	41,462	1,489,816	(1,448,354)	(97.2%)
	46,846,666	53,176,840	(6,330,174)	(11.9%)

\*\* Non-store sales include off-site sales, web store sales, and other.

For the year-to-date, store sales decreased by \$4.9 million, from \$51.7 million to \$46.8 million, a decrease of 9.4%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$1.1 million in sales. The same store sales decreased by \$6.0 million, a decrease of 12.8%. The stores sales decrease is primarily due to a decrease in television sales which are down by \$4.0 million from the period in 2007.

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

### *Second Quarter*

Cost of goods sold for the quarter decreased by \$4.8 million from \$19.4 million to \$14.6 million, a decrease of 24.7%. This decrease is based on a 26.2% decrease in freight costs coupled with a 24.8% decrease in product costs for the quarter. The product cost changes are due to a continued rationalization in the merchandise mix during the quarter in response to the high cost of transportation.

Gross margin for the quarter increased by \$0.4 million, from \$10.1 million to \$10.5 million, an increase of 3.8%. This increase is a result of the decrease in cost of goods sold as discussed above. Gross margin percentage increased from 34.3% to 41.9%.

### *Year-to-Date*

Cost of goods sold for the year-to-date decreased by \$8.2 million from \$35.8 million to \$27.6 million, a decrease of 23.1%. This decrease is based on a 17.6% decrease in freight costs coupled with a 24.2% decrease in product costs year to date. The product cost changes are due to a continued rationalization in the merchandise mix year to date in response to the high cost of transportation.

Gross margin for the year-to-date increased by \$1.9 million, from \$17.4 million to \$19.3 million, an increase of 11.1%. This increase is a result of the decrease in cost of goods sold as discussed above. Gross margin percentage increased from 32.6% to 41.2%.

## **Combined Administrative and Operating Expenses**

### *Second Quarter*

For the quarter, administrative and operating expenses decreased by approximately \$0.3 million from \$8.7 million to \$8.4 million. This decrease is primarily the result of decreases in wages (\$0.4 million decrease) and advertising (\$0.4 million decrease), offset by increases in professional fees (\$0.2 million increase), rent (\$0.2 million increase) and office supplies (\$0.1 million increase). The increase in rent was primarily the result of new store openings and increases in common area costs. The increase in professional fees is due to the continued use of an external accountant as interim CFO as well as additional costs associated with renegotiating our credit facilities. The decreases are as a result of continuing focus by the Fund to reduce administrative and operating costs.

### *Year-to-Date*

For the year-to-date, administrative and operating expenses remained flat at \$16.7 million. This is primarily the result of increases in professional fees (\$0.5 million increase) and rent (\$0.6 million increase), offset by decreases in advertising (\$0.5 million decrease), wages (\$0.3 million decrease) and consulting (\$0.3 million decrease). The increase in rent was primarily the result of new store openings, increases in common area costs and lease renewals. The increase in professional fees is due to the continued use of an external accountant as interim CFO as well as additional costs associated with renegotiating our credit facilities. The decreases are as a result of continuing focus made by the Fund to reduce administrative and operating costs.

### **Earnings from Operations**

#### *Second Quarter*

For the quarter, earnings from operations increased by \$0.7 million, from \$1.4 million to \$2.1 million, an increase of 50.0% as a result of the factors discussed previously.

#### *Year-to-Date*

For the year-to-date, earnings from operations increased by \$1.9 million, \$0.6 million to earnings of \$2.5 million, an increase of 302.3% as a result of the factors discussed previously.

### **Fund Net Earnings**

For the three months ended June 30, 2008, the Fund had net earnings of \$0.2 million or \$0.04 per unit on a basic and diluted basis. This compares with the prior year's net loss of \$0.6 million or \$0.09 per unit on a basic and diluted basis. This improvement is due to the factors described previously, offset by an increase in interest expense resulting from the subordinated loans that were drawn in August 2007, net of adjustments for non-controlling interest.

For the year-to-date, the Fund had a net loss of \$0.4 million or \$0.07 per unit on a basic and diluted basis. This compares with the prior year's net loss of \$1.5 million or \$0.25 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:

	June 30, 2008	Mar 31, 2008	Dec 31, 2007
Cash and cash equivalents	-	-	1,709,959
Inventory	20,050,500	19,095,062	21,144,060
Total current assets	24,365,398	24,027,281	25,914,581
Total assets	69,017,101	69,301,445	71,860,825
Total current liabilities excluding term loan and subordinated loan	12,848,326	13,874,944	15,374,236
Term loan	11,250,000	11,250,000	11,250,000
Subordinated loan	12,828,139	12,492,465	12,162,695
Non-controlling interest	18,514,119	18,274,132	18,901,771
Unitholders' equity	12,387,167	12,135,868	12,784,920

## Distributable Cash and Cash Distributions

On December 17, 2007, the Fund announced that it was suspending monthly cash distributions on Fund Units and Exchangeable LP Units beginning with the December 2007 distribution.

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.

No distributions were paid on Fund Units, Exchangeable LP Units or Subordinated LP Units during the quarter.

As at June 30, 2008 and August 6, 2008 the following number of units were outstanding:

Fund Units (Note 5)	6,103,000
XS Cargo LP Exchangeable LP Units (Note 6)	3,492,802
XS Cargo LP Subordinated LP Units (Note 6)	<u>2,408,847</u>
	<u>12,004,649</u>

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

	Three months ended		Six months ended	
	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)
Cash provided by (used for) operating activities	(953,462)	1,047,482	(8,339,951)	(4,182,933)
Less: Net change in non-cash working capital	2,270,428	(191,304)	9,562,365	3,885,487
Less: Deferred charges, net of costs recognized	(19,299)	5,322	(90,980)	4,358
Less: Deferred revenue, net of revenue recognized	171,411	25,182	137,408	4,598
Less: Lease inducements received, net of amortization of lease inducements	35,298	(37,125)	68,010	(85,933)
Less: Maintenance capital expenditures <sup>2</sup>	(18,553)	(92,064)	(175,955)	(201,429)
Distributable cash <sup>3</sup>	1,485,823	757,493	1,160,897	(575,852)
Average Units outstanding during the period	12,004,649	12,001,589	12,004,649	11,998,768
Distributable cash per Unit	0.12	0.06	0.10	(0.05)
Distributions declared	-	1,799,125	-	4,676,681
Distributions declared per Unit	-	0.15	-	0.39
Ratio of distributions declared to distributable cash (payout ratio)	-	238%	-	(912%)

<sup>2</sup> Maintenance capital expenditures refer to acquisitions of property and equipment to replace or upgrade equipment and information systems at existing stores and distribution centres. See discussion under “Capital Expenditures” below.

<sup>3</sup> No distributions have been declared in order to utilize available funds to maintain operations and service the Fund’s existing debt.

## EBITDA

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

	Three months ended		Six months ended	
	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)
Net earnings (loss) for the period	248,174	(554,670)	(400,878)	(1,501,655)
Add: Non-controlling interest	239,987	(536,195)	(387,652)	(1,449,668)
Add: Future income taxes	-	1,269,160	-	1,269,160
Add: Interest expense and foreign exchange	946,000	560,622	1,879,473	1,008,472
Add: Amortization of property and equipment	492,396	313,302	980,523	608,280
Add: Amortization of intangible assets	185,020	328,100	476,290	626,100
EBITDA	2,111,577	1,380,319	2,547,756	560,689

## Unitholders' Equity and Non-controlling Interest

The following table outlines the Fund Units and non-controlling interest outstanding as of June 30, 2008.

	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	-	-	18,514,119

There have been no changes in the number of Fund Units or Special Voting Units from June 30, 2008 to August 6, 2008.

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

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Distributable Cash and Cash Distributions**

On December 17, 2007, the Fund announced that it was suspending monthly cash distributions on Fund Units and Exchangeable LP Units beginning with the December 2007 distribution.

The Fund declared no distributions in the first or second quarter of 2008.

### **Credit Facilities**

The Fund has credit facilities with a Canadian chartered bank that consist of a \$12.5 million demand revolving operating loan (which is increased to \$20.0 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 \$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 2.75%, depending on the Fund's senior debt to EBITDA ratio. The term loan is collateralized by a first charge on all present and after acquired personal property and an assignment of inventory. Interest on the operating loan varies 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 June 30, 2008, \$11.25 million was outstanding on the term loan and \$6.84 was outstanding on the operating loan. The term loan was due on May 16, 2008, no repayment has been demanded and refinancing negotiations are ongoing.

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 administrator of the Fund. The principal balance is due after twelve months but is renewable for an additional six months at the request of the Fund, conditional upon the Fund's compliance with the agreements and the lenders' approval. 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 June 30, 2008, \$12.0 million was outstanding on the loan, with \$0.9 million of interest capitalized as part of the outstanding principal balance.

## **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 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. 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 subordinated loan requires the Fund to maintain certain financial covenants, including a total funded debt to EBITDA ratio of less than 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 June 30, 2008, the Fund was not in compliance with its senior debt to EBITDA covenant, fixed charge coverage ratio covenant, total debt to EBITDA covenant and the minimum twelve-month EBITDA covenant giving the lenders the right to demand payment. All loans are presented as current liabilities. The Fund continues to work with its lenders to remedy the breaches and negotiate mutually acceptable terms as quickly as possible.

In addition to the lenders' rights to demand repayment as result of the above defaults, the Fund's term loan matured on May 16, 2008 and the subordinated loans mature on August 20, 2008. The Fund is presently evaluating its options with respect to the repayment and possible renegotiation of these loans.

## **Capital Expenditures**

During the second quarter, the Fund acquired \$34,889 of property and equipment. Of this, \$16,336 related to distribution infrastructure and head office capacity and the remaining \$18,553 related to capital expenditures at existing stores and warehouses ("maintenance capital expenditures").

## **Interest Rate Risk and Sensitivity**

The Fund's term and operating loans bear interest with floating rates based on the bank's prime rate, thus exposing the Fund to interest rate fluctuations. A 1.0% increase in interest rates would have an impact of \$181,000 annually (\$45,250 for a quarter) on distributable cash and interest expense based on \$18.1 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 June 30, 2008, due in the years indicated, which relate to various premises operating leases, the \$11.25 million outstanding on the term loan that matured on May 16, 2008, and was not repaid and the subordinated loan due on August 20, 2008, both of which are currently in default and subject to repayment demand at any time at the lenders' option.

	<b>Total</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013 and thereafter</b>
Operating							
Leases	22,720,624	2,571,000	4,863,981	3,962,401	3,197,189	2,418,440	5,707,613
Subordinated							
Loan	12,000,000	12,000,000	-	-	-	-	-
Term loan	11,250,000	11,250,000	-	-	-	-	-
<b>Total</b>	<b>45,970,624</b>	<b>25,821,000</b>	<b>4,863,981</b>	<b>3,962,401</b>	<b>3,197,189</b>	<b>2,418,440</b>	<b>5,707,613</b>

As noted above, the Fund's term loan was due on May 16, 2008 and subordinated loans mature in August 2008. The Fund is presently evaluating its options with respect to the repayment and possible renegotiation of these loans.

Summary of Quarterly Results (unaudited)

	2008		2007				2006	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Sales	25,080,819	21,765,847	42,653,087	29,250,232	29,519,184	23,657,656	42,339,077	25,960,077
Net earnings (loss)	248,174	(649,052)	(36,283,954)	415,980	(554,670)	(946,985)	1,745,044	1,108,744
Basic and diluted earnings (loss) per unit	0.04	(0.11)	(5.95)	0.07	(0.09)	(0.16)	0.29	0.18

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

**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**

**(a) On January 1, 2008, the Fund adopted the following recommendations of the Canadian Institute of Chartered Accountants ("CICA") Handbook:**

### *Section 1535: Capital Disclosures*

This new standard established disclosure requirements concerning capital such as: qualitative information about the Fund's objectives, policies and processes for managing capital; quantitative data about what the Fund regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund has included the required disclosures as part of the interim consolidated financial statements.

*Section 3031: Inventories*

This new standard 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. This section did not have a significant impact on the Fund's interim consolidated financial statements.

*Section 1400: General Standards of Financial Statement Presentation*

This section was amended to include requirements for management to assess and disclose the Fund's 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, and have been incorporated into the Fund's interim consolidated financial statements in note 1.

**Future accounting changes**

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

*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 for the quarter totaling \$282,280 (YTD \$563,242) was recorded on the portion of the loan outstanding to the related party during the quarter. There were no other related party transactions during the three month period ended June 30, 2008.

**Outlook**

Substantial progress has been made to return the Fund to its historical level of profitability. Significant problems arising from the implementation of a new merchandising management system have been rectified. As a result, the risk of a recurrence of the supply chain problems encountered in 2007 is greatly reduced.

Although sales have declined it is largely due to a voluntary exit from unprofitable product categories. The result has been a significant increase in gross margins. The Fund's merchandising group is working to replace sales lost due to discontinued product categories. We continue to leverage our ability to source quality merchandise from close-outs, cancelled orders, bankruptcies and other opportunities. Our efforts have been aided by adverse conditions in the retail industry caused by the weakened U.S. economy.

## Additional Information

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

## Non-GAAP Measures

References to "EBITDA" are to earnings before interest, 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 "Second Quarter and Year to date 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:

<b>Second Quarter (unaudited)</b>	<b>Three Months Ended June 30, 2008</b>	<b>Three Months Ended June 30, 2007</b>	<b>Six Months Ended June 30, 2008</b>	<b>Six Months Ended June 30, 2007</b>
Net Earnings (Loss)	248,174	(554,670)	(400,878)	(1,501,655)
Add:				
Non-controlling interest	239,987	(536,195)	(387,652)	(1,449,668)
Future income taxes	-	1,269,160	-	1,269,160
Foreign exchange (gain) loss	(31,939)	113,481	45,128	130,960
Interest on term and subordinated loans	845,881	359,155	1,627,105	702,097
Interest on operating loan	132,058	87,986	207,240	175,415
Amortization of intangible assets	185,020	328,100	476,290	626,100
Amortization of property and equipment	492,396	313,302	980,523	608,280
Unit based compensation expense	3,125	29,860	3,125	73,360
Earnings (loss) from Operations, as defined	2,114,702	1,410,179	2,550,881	634,049

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 "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.

## **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 June 30, 2008, certain weaknesses in internal controls over financial reporting were identified as follows:

- The departure of the Chief Financial Officer effective January 22, 2008, and the departure of the Fund's Controller in December 2007
- 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, discussed below, 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 in the first quarter and has hired a new Chief Financial Officer at the end of the second quarter. The Fund has additionally instituted new reporting systems and controls 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 of the Fund to continue as a going concern; the ability of the Fund to successfully remedy the breaches of its credit facilities and subordinated loan and to renegotiate the terms of or obtain alternate financing to replace these facilities and loans; 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; 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](http://www.sedar.com).

## **FORWARD LOOKING STATEMENTS**

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

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

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

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