



XS CARGO INCOME FUND

Management's Discussion of Financial Condition and Results of Operations

For the three and nine months ended September 30, 2006

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

This management's discussion and analysis ("MD&A") should be read in conjunction with the interim consolidated financial statements and accompanying notes (the "Financial Statements") of XS Cargo Income Fund (the "Fund") for the three and nine months ended September 30, 2006 and the audited consolidated financial statements and management's discussion and analysis of the Fund for the period ended December 31, 2005. 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 November 9, 2006.

OVERVIEW OF THE FUND

Issuance of Fund Units and Acquisition

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

The Fund commenced business operations on May 17, 2005, when it completed an initial public offering (the "IPO") of 6,106,000 trust units ("Fund Units"), at a price of \$10 per unit, for aggregate gross proceeds of \$61,060,000. Concurrent with the closing of the IPO, the Fund acquired a 51% indirect interest in XS Cargo LP (note 3) and XS Cargo LP acquired the net assets (the "Acquired Business") of Famous Brands (Edmonton) Inc. (the "Vendor").

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

Basis of Management's Discussion and Analysis

To provide more meaningful information, the following MD&A compares the operating results of the Fund for the nine months ended September 30, 2006 to those of the combined results for the Vendor and Fund for the nine months ended September 30, 2005. (See "Non-GAAP Measures"). The Fund commenced operations on May 17, 2005, therefore the Fund results are only available for the period from May 17, 2005 to September 30, 2005 for comparatives purposes.

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

The Business of the Fund

XS Cargo LP operates 35 closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Nova Scotia and Newfoundland.

Operating Highlights

Our third quarter showed revenue growth of 25% from the previous year and substantial progress was made to allow us to continue our expansion in the fourth quarter and into 2007. New stores were opened in Vancouver, Halifax and St. John's on October 26, 2006. All three stores experienced successful grand openings. In particular, we expect demand to be strong in the Maritimes and we plan to continue to aggressively build out stores in the Atlantic Provinces.

Significant management resources during the quarter were invested in our internet-based sales strategy. Our new website will be launched in mid-November, 2006 allowing customers to shop online. We believe that the internet provides a significant opportunity to expand our customer base and increase sales. We have partnered with Ingram Micro Logistics to handle the fulfillment of online orders. This strategy will enable us to grow internet sales with minimal additional infrastructure development.

During the quarter we completed a major upgrade to our point-of-sale and distribution system. Our existing system, which has been in place since 2000, is a cost-efficient custom designed application. The rate of our growth over the past two years necessitated a major upgrade to enhance the effectiveness of our inventory distribution. At the time of the upgrade, certain distribution functions were not operating to full design specifications resulting in sub-optimal allocation of inventory to individual stores. This had a negative impact on sales and contributed to higher freight costs during the quarter.

The logistics and systems problems described above are temporary in nature and have been addressed. The core of our business, our ability to source high-demand, quality merchandise at substantial discounts to regular wholesale prices remains strong. We are pleased with the quality and quantity of our inventory going into the holiday shopping season and remain optimistic about our performance in the fourth quarter.

With revenue growth of 25% and gross margin percentages holding steady, the only restraint on EBITDA¹ growth was significant upward wage pressures. Excluding new stores we experienced a 32% increase in wage expense. The majority of the wage increases

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

were in Alberta where we have our corporate head office, one distribution centre and eight stores. Wages in Alberta represent over 45% of our total wage expense and were up 45% compared to the third quarter of last year. Further wage increases will be mitigated by our expansion outside of Alberta, including the three stores that opened in the fourth quarter.

SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

Third Quarter and Year-to-Date Operating Results

The following tables show the unaudited results of the Fund for the year-to-date of 2006 compared to the combined results of the Fund and the Vendor for the year-to-date of 2005. The results of operations for these periods are not necessarily indicative of the results of operations to be expected in any given period.

Third Quarter Results (unaudited)	Fund July 1 to Sept. 30, 2006	Fund July 1 to Sept. 30, 2005	Change Q3 2006 from 2005
Sales	25,960,077	20,775,101	5,184,976
Cost of Sales	16,218,470	12,968,554	3,249,916
Gross Margin	9,741,607 37.5%	7,806,547 37.6%	1,935,060
Administrative and Operating Expenses*	6,646,153	4,848,017	1,798,136
Earnings from Operations, as defined*	3,095,454	2,958,530	136,924
Year-to-Date Results (unaudited)	Fund January 1 to Sept. 30, 2006	Combined Vendors and Fund January 1 to Sept. 30, 2005	Change 2006 over 2005
Sales	74,454,818	60,931,130	13,523,688
Cost of Sales	46,543,733	38,677,601	7,866,132
Gross Margin	27,911,085 37.5%	22,253,529 36.5%	5,657,556
Administrative and Operating Expenses*	18,597,225	13,626,894	4,970,331
Earnings from Operations, as defined*	9,313,860	8,626,635	687,225
Non-recurring operating expenses**	170,000	-	170,000
Earnings from Operations before non-recurring expenses	9,483,860	8,621,726	857,225

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

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

Sales

Quarter

The following table compares sales for the three months ended September 30, 2006 to the three months ended September 30, 2005 for new and same stores:

	Sales				Number of Stores as of September 30	
	2006	2005	Change	% change	2006	2005
Same stores	16,104,551	16,234,251	(129,700)	(1.0%)	18	18
New stores	9,855,526	4,540,850	5,314,676	117.0%	14	7
Total	25,960,077	20,775,101	5,184,976	25.0%	32	25

Third quarter sales increased by \$5.2 million, from \$20.8 million to \$26.0 million, an increase of 25.0%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$5.3 million in sales. The remaining \$0.1 million decrease represents a 1.0% decrease in same store sales. Excluding three stores that experienced cannibalization from new stores opening in overlapping trading areas, same store sales for the period were 1.3% higher than the third quarter of 2005.

Year-to-date

For the year-to-date, sales have increased by \$13.5 million from \$60.9 million to \$74.4 million, representing an increase of 22.2%. Year-to-date same store sales were up 2.3%, excluding three stores that experienced cannibalization from new stores opening in overlapping trading areas.

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

Region	September 30, 2006		September 30, 2005	
	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	15	49.7%	12	49.4%
Alberta	8	23.2%	6	22.7%
Saskatchewan and Manitoba	3	9.3%	3	14.2%
British Columbia	6	17.8%	4	13.7%
Total	32	100.0%	25	100.0%

Product Replacement Plan Sales

Sales of two-year product replacement extended warranty plans continue to be strong. During the twelve months since implementation, \$2.4 million of Product Replacement Plans (“PRPs”) were sold, however only \$0.7 million has been recognized as revenue to date and approximately \$0.3 million was recognized during the quarter. Revenue from PRP sales is deferred and recognized on a straight-line basis over the two-year terms of the PRPs.

Cost of Sales and Gross Margin

Quarter

Cost of sales for the quarter increased by \$3.2 million from \$13.0 million to \$16.2 million, an increase of 25.1%, primarily as a result of new store openings.

Gross margin for the quarter increased by \$1.9 million, from \$7.8 million to \$9.7 million, an increase of 24.8%. This increase is a result of net increases in sales volumes from new store development.

Year-to-date

Cost of sales for the year-to-date increased by \$7.8 million, from \$38.7 million to \$46.5 million, an increase of 20.3%, primarily as a result of new store openings.

Gross margin for the year-to-date increased by \$5.6 million, from \$22.3 million to \$27.9, an increase of 25.4%. \$0.6 million of the increase was the result of an increase in gross margin percentage from 36.5% to 37.5% and the remaining \$5.0 million increase is the result in net increases in sales volumes from new store development.

Combined Administrative and Operating Expenses

Quarter

For the quarter, administrative and operating expenses increased by approximately \$1.8 million from \$4.8 million to \$6.6 million. This increase is primarily the result of increases in rent (\$0.3 million), wages (\$0.9 million increase) and advertising (\$0.4 million increase). The increases in rent and advertising were primarily the result of new store openings and these costs remain consistent as a percentage of sales to the prior year. The increase in wages was the result of new stores openings as well as significant wage rate increases, primarily in Alberta. The components of the wage increases are summarized in the chart below (in \$millions):

	<u>New Stores</u>	<u>Alberta</u>	<u>Other Markets</u>	<u>Total</u>
Wages	0.4	0.4	0.1	0.9
% increase from prior year	100%	45%	15%	52%

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

Year-to-date

For the year-to-date, administrative and operating expenses increased by \$5.0 million from \$13.6 million to \$18.6 million. This increase is primarily the result of increases in rent (\$1.3 million increase), wages (\$2.1 million increase) and advertising (\$0.8 million increase). The increase in rent is the result of new store growth as well as the new distribution centre that opened in Mississauga, Ontario in May 2005 (\$0.8 million). The increase in advertising expense is entirely due to new store growth. The increase in wage expense is the result of new store growth, the new distribution centre as well as significant upward wage pressures, particularly in Alberta. In addition, incremental public company administrative expenses accounted for \$0.3 million of the increase. Included in year-to-date administrative and operating costs are \$0.2 million non-recurring expenses relating to the consolidation of the Edmonton distribution facilities that were incurred in the first quarter.

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

	New Stores	Alberta	Other Markets	Total
Wages	0.9	0.9	0.3	2.1
% increase from prior year	100%	36%	8%	37%

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

Earnings from Operations

Quarter

For the quarter, earnings from operations increased by \$0.1 million, from \$3.0 million to \$3.1 million, an increase of 3.8%.

Year-to-date

For the year-to-date, earnings from operations increased by \$0.7 million, from \$8.6 million to \$9.3 million, an increase of 8.0%. Excluding the non-recurring expenses related to the consolidation of the Edmonton distribution facilities that were incurred in the first quarter, earnings from operations increased by \$0.9 million, or 9.9%.

Fund Net Earnings

For the three months ended September 30, 2006, the Fund had net earnings of \$1.1 million or \$0.182 per unit on a basic and diluted basis.

For the nine months ended September 30, 2006, the Fund had net earnings of \$3.4 million or \$0.562 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:

	Sept. 30, 2006 (unaudited)	Dec. 31, 2005
Cash	-	7,442,496
Inventory	22,260,785	15,752,388
Total current assets	29,553,428	28,388,003
Total assets	142,413,434	140,941,626
Bank indebtedness	4,586,592	-
Total current liabilities excluding term loan	11,887,978	9,085,481
Term loan	17,500,000	15,000,000
Non-controlling interest	57,589,346	59,527,529
Unitholders' equity	54,715,224	56,833,747

Distributable Cash and Cash Distributions

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

As the Fund will distribute as approximately 90% of its cash on an ongoing basis, management believes that EBITDA is the most useful measure in evaluating the performance of the Fund, and thus determining distributable cash. The Fund uses cash provided by operating activities, excluding changes in non-cash working capital, as its basis to calculate EBITDA. 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.

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

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

The following table summarizes the distributions from January 1, 2006 to September 30, 2006:

Record Date	Payment Date	Fund Units		Exchangeable LP Units and Subordinated LP Units		Total	
		Declared	Paid	Declared	Paid	Declared	Paid
		\$	\$	\$	\$	\$	\$
January 31, 2006	February 15, 2006	572,438	572,438	326,148	326,148	898,586	898,586
February 28, 2006	March 15, 2006	572,437	572,437	326,148	326,148	898,585	898,585
March 31, 2006	April 15, 2006	629,681	629,681	1,056,051	1,056,051	1,685,732	1,685,732
April 30, 2006	May 15, 2006	629,682	629,682	358,763	358,763	988,445	988,445
May 31, 2006	June 15, 2006	629,681	629,681	358,763	358,763	988,444	988,444
June 30, 2006	July 15, 2006	629,681	629,681	1,102,247	1,102,247	1,731,928	1,731,928
July 31, 2006	August 15, 2006	629,681	629,681	359,479	359,479	989,160	989,160
August 31, 2006	Sept. 15, 2006	629,681	629,681	359,479	359,479	989,160	989,160
Sept. 30, 2006	October 15, 2006	629,681	-	1,103,235	-	1,732,916	-
		<u>5,552,643</u>	<u>4,922,962</u>	<u>5,350,313</u>	<u>4,247,078</u>	<u>10,902,956</u>	<u>9,170,040</u>

Distributions are paid on Fund Units, XS Cargo LP Exchangeable LP Units and XS Cargo LP Subordinated LP Units. As of September 30, 2006 the following number of units were outstanding:

Fund Units (Note 5)	6,106,000
XS Cargo LP Exchangeable LP Units (Note 6)	3,485,858
XS Cargo LP Subordinated LP Units (Note 6)	<u>2,404,058</u>
	<u>11,995,916</u>

During the three months ended September 30, 2006, the Fund approved distributions of an aggregate of \$0.309375 per Fund Unit to unitholders. It is the Fund's policy to review the monthly distribution amount at least quarterly. Our monthly distribution rate at the time of our initial public offering was \$0.09375 per unit. The monthly distribution rate was increased to \$0.103125 per unit in March 2006.

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

	July 1 to Sept. 30, 2006	January 1 to Sept. 30, 2006	Since Inception on May 17, 2005
	(unaudited)	(unaudited)	(unaudited)
Cash provided by (used for) operating activities	(246,039)	(2,054,952)	13,624,171
Less: Net change in non-cash working capital	3,065,687	10,508,974	6,022,325
Add: Interest expense	314,847	905,155	1,410,077
Less: Unit based compensation	(43,500)	(103,500)	(290,830)
Less: Lease inducements received, net of amortization of lease inducements	(62,677)	(88,874)	(230,990)
EBITDA²	3,028,318	9,166,803	20,534,753
Add: Unit based compensation	43,500	103,500	290,830
Less: Interest paid	(314,847)	(905,155)	(1,410,077)
Less: Maintenance capital expenditures ³	(67,608)	(233,814)	(428,819)
Distributable cash⁴	2,689,363	8,131,334	18,986,687
Average Units outstanding during the period	11,995,916	11,988,137	11,986,333
Distributable cash per Unit	0.22	0.68	1.58
Distributions declared	3,711,236	10,901,745	19,305,055
Distributions declared per Unit	0.31	0.91	1.61
Ratio of distributions declared to distributable cash (payout ratio)	138%	134%	102%

² EBITDA refers to earnings before interest, taxes, depreciation and amortization. See discussion under "Non-GAAP Measures" below.

³ 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.

⁴ See discussion under "Non-GAAP Measures" below.

Since inception, the Fund has had distributable cash per unit of \$1.58 and has declared distributions of \$1.61 per unit. For the third quarter, the Fund had distributable cash per unit of \$0.22 and declared distributions of \$0.31 per unit. Basic and diluted earnings per unit were \$0.18 for the third quarter.

During the three months ended September 30, 2006, cash distributions were higher than distributable cash. The monthly cash distributions are based on management's estimate of distributable cash for the year. Since the Fund's business is seasonal in nature, with approximately 40% 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.

Unitholders' Equity and Non-controlling Interest

The following table outlines the Fund Units and non-controlling interest outstanding as of September 30, 2006.

	Units	Issue Costs	Unitholders' Equity	Non-controlling Interest
	#	\$	\$	\$
Fund Units	6,106,000	4,928,124	56,131,876	-
Special Voting Units	5,889,916	-	-	-
Non-controlling Interest	5,889,916	-	-	57,589,346

On June 30, 2006, 6,944 Exchangeable Units, 4,789 Subordinated Units and 11,733 Special Voting Units were issued to the Chief Financial Officer as described in Note 8.

LIQUIDITY AND CAPITAL RESOURCES

Distributable Cash and Cash Distributions

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

During the three and nine months ended September 30, 2006, the Fund declared distributions of \$0.309375 and \$0.909375 per Fund Unit respectively to Unitholders, or \$1,889,043 and \$5,552,643 in total.

Credit Facilities

The Fund has established credit facilities with a Canadian chartered bank. These credit facilities consist of a \$12.5 million demand revolving operating loan (which is increased from \$10.0 million between the months of August and December, to facilitate the build up of inventories for the fourth quarter holiday shopping season) and a committed non-revolving term loan to a maximum amount of \$17.5 million. On May 17, 2005 the Fund drew \$15.0 million on the term loan in connection with the acquisition described on page 1. During August 2006, the additional \$2.5 million was drawn on the term loan. As at September 30, 2006, \$17.5 million remains outstanding on the term loan and \$4.6 million was outstanding on the operating loan.

The term loan is due on May 17, 2007 and may be extended for an additional year based on approval by the lender to May 17, 2008.

Capital Expenditures

During the quarter, the Fund acquired \$263,988 of property and equipment financed using the term loan. The Fund drew additional amounts available on the term loan in the third quarter in order to finance the capital expenditures for new store growth as well as capital expenditures that were previously financed using cash flow from operations. Of the \$263,988 of capital expenditures, \$196,380 related to new store openings, distribution infrastructure and head office capacity and the remaining \$67,608 related to capital expenditures at existing stores and warehouses (“maintenance capital expenditures”).

Subsequent to September 30, 2006, the Fund opened new stores in Vancouver, British Columbia; Halifax, Nova Scotia; and St. John’s, Newfoundland. The new stores will require capital expenditures of approximately \$360,000 in the fourth quarter of 2006. As discussed above, the Fund has credit facilities available to finance these and other growth related capital expenditures in the remainder of 2006.

Interest Rate Risk and Sensitivity

The Fund is not significantly impacted by interest rate changes. The Fund’s long-term debt bears interest with floating rates based on the bank’s prime rate, thus exposing the Fund to interest rate fluctuations. A 1.0% increase in interest rates would have an impact of \$221,000 annually (\$55,250 during the quarter) on distributable cash based on \$22.1 million of debt outstanding.

Contractual Obligations

The table below sets forth the contractual obligations of the Fund as of September 30, 2006, due in the years indicated, which relate to various premises operating leases and the \$17.5 million outstanding on the term loan that matures on May 17, 2007, but may be extended with approval of the lender until 2008.

(unaudited)	Total	2006	2007	2008	2009	2010	2011 and thereafter
Operating Leases	22,620,614	1,082,802	4,011,318	3,816,684	3,550,395	2,131,658	8,027,757
Term loan	17,500,000	-	17,500,000	-	-	-	-
Total	40,120,614	1,082,802	21,511,318	3,816,684	3,550,395	2,131,658	8,027,757

Summary of Quarterly Results (unaudited)

	July 1 to Sept. 30, 2006	April 1 to June 30, 2006	January 1 to March 31, 2006	October 1 to December 31, 2005	July 1 to Sept. 30, 2005	May 17 to June 30, 2005
Sales	25,960,077	27,822,876	20,671,865	36,436,104	20,775,101	11,755,952
Net earnings	1,108,744	1,601,832	723,545	3,062,775	1,173,328	747,296
Basic and diluted earnings per unit	0.182	0.262	0.119	0.502	0.192	0.122

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

Off-Balance Sheet Arrangements

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

Critical Accounting Estimates

Goodwill

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

Inventory Valuation

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

Changes in Accounting Policies Including Initial Adoptions

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

Financial Instruments

Due to the nature of its business, the Fund does not engage in activities or hold assets that would require the Fund to acquire financial instruments for hedging or speculative purposes. The financial instruments that are held by the Fund are held in the normal course of operations and as a result no significant accounting policies need to be adopted or assumptions made in reporting the Fund's financial instruments.

Transactions with Related Parties

Transactions with related parties include XS Cargo LP's purchase of the assets of the business from the Vendor on May 17, 2005. During the three and nine months ended September 30, 2006, there were no related party transactions.

Outlook

Management believes that operating results will continue to improve in the upcoming year due to new store openings, the realization of freight savings from the new distribution centre in Ontario, the realization of efficiencies from consolidation of the Edmonton distribution and warehousing operations and the introduction of new revenue streams. XS Cargo opened new stores in Vancouver, British Columbia; Halifax, Nova Scotia; and St. John's, Newfoundland during the fourth quarter of 2006.

Additional Information

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

Non-GAAP Measures

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

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

EBITDA, distributable cash and earnings from operations are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP. Investors are cautioned that EBITDA, distributable cash and earnings from operations should not replace net income or loss (as determined in accordance with GAAP) as an indicator of the Fund's performance, of its cash flows from operating, investing and financing activities or as a measure of its liquidity and cash flows. The Fund's methods of calculating EBITDA, distributable cash and earnings from operations may differ from the

methods used by other issuers and may not be comparable to similar measures presented by other issuers.

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 final prospectus dated May 6, 2005 and the Fund's Annual Information Form available at www.sedar.com.

The Honourable Jim Flaherty, Canadian Minister of Finance, made an announcement on October 31, 2006 outlining proposed changes to the taxation of income trusts. In his announcement, Mr. Flaherty included a proposed tax on distributions paid on publicly traded income trusts and limited partnerships. As the Fund is an existing, publicly traded income trust these proposed changes would not affect the Fund until 2011. The Fund will continue to pay close attention to the government's stance on taxing distributions from income trusts and any potential impact this may have on the Fund and its stakeholders.

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.