



## **XS CARGO INCOME FUND**

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

**For the quarter and year ended December 31, 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 consolidated financial statements and accompanying notes (the "Financial Statements") of XS Cargo Income Fund (the "Fund") for the year ended December 31, 2008. 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 March 30, 2009.

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

Earnings from operations for the year were \$6.0 million, an increase of \$5.0 million over the previous year. Fourth quarter earnings from operations increased to \$2.15 million compared to a loss of \$1.4 million in the fourth quarter of 2007. Annual sales declined by \$15.0 million or 12%. In the fourth quarter sales declined by \$3.9 million or 9.2% compared to the prior year. Sales in the fourth quarter and the full year were impacted by management's decision to exit certain low margin product categories in particular the television category which alone accounted for nearly 50% of the annual sales decline. \$3.3 million or 84.6% of the fourth quarter decline occurred in the month of December. Lower consumer confidence due to macro economic events reduced store traffic in December and aggressive discounting by competitors narrowed our normal price advantage.

The Fund had an annual 2008 net loss inclusive of a goodwill impairment of \$18.6 million compared to an annual 2007 net loss inclusive of a goodwill impairment of \$37.4 million. Excluding the goodwill impairment, the net loss for the Fund was \$208,063 for 2008 compared to \$4.0 million for 2007.

Gross margin as a percentage of sales for the fourth quarter increased to 30.8% from 24.4% in the fourth quarter of 2007. Gross margin for the full year was 36.9% versus 31.1% in 2007. Gross margin for the full year and the fourth quarter were negatively impacted by adjustments as follows:

Service Inventory	\$628,000
Deposits on Inventory	\$519,000
Foreign Exchange Adjustment	<u>\$654,000</u>
Total	<u>\$1,801,000</u>

Service inventory and deposits on inventory balances were carried over from 2007 based on expected recovery. The adjustments above represent the shortfall between the balance carried over from the prior year and the actual recovery. Based on changes in accounting procedures and inventory handling management believes the adjustments are unanticipated and non-recurring. Within approximately 30 days from September 22, 2008 to October 20, 2008 the Canadian dollar with respect to the foreign exchange adjustment lost 24% of its value versus the US dollar. This coincided with a significant build up of imported inventory for Christmas. Un-hedged purchases resulted in the above foreign exchange adjustment. Although there is no long term correlation between Canada / USD exchange and gross margin, the size and rapidity of the decline resulted in a material adjustment. The normalization of the above adjustments would result in fourth quarter gross margin of 34.3% and 38.5% on an annual basis.

Administrative and operating expenses declined by \$3.27 million in 2008 compared to 2007. This decline did not include \$771,000 of non-recurring and one time items included in the 2008 administrative and operating expenses.

## SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

### Fourth Quarter and Annual Operating Results

The following tables show the unaudited results of the Fund for the quarter and the audited results of the Fund for the year ended December 31, 2008 compared to the quarter and year ended December 31, 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>Fourth Quarter Operating Results</b> (unaudited)	<b>Three Months Ended December 31, 2008</b>	<b>Three Months Ended December 31, 2007</b>	<b>Change Q4 2008 from Q4 2007</b>
Sales	38,713,064	42,653,087	(3,940,023)
Cost of Goods Sold	26,789,605	32,231,166	(5,441,561)
Gross Margin	11,923,459 30.8%	10,421,921 24.4%	1,501,538 6.4%
Administrative and Operating Expenses*	9,769,879	11,860,328	(2,090,449)
Earnings (loss) from Operations, as defined*	2,153,580	(1,438,407)	3,591,987
Net (loss)	(18,203,917)	(36,283,954)	18,080,037

  

<b>Annual Operating Results</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>	<b>Change 2008 over 2007</b>
Sales	110,085,560	125,080,159	(14,994,599)
Cost of Goods Sold	69,442,097	86,128,554	(16,686,457)
Gross Margin	40,643,463 36.9%	38,951,605 31.1%	1,691,858 5.8%
Administrative and Operating Expenses*	34,642,682	37,912,922	(3,270,240)
Earnings from Operations, as defined*	6,000,781	1,038,683	4,962,098
Net (loss)	(18,625,173)	(37,369,629)	18,744,456

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

## Sales

### *Fourth Quarter*

The following table compares sales for the three months ended December 31, 2008 to the three months ended December 31, 2007:

	Sales			
	2008	2007	Change	% change
Sales	38,713,064	42,653,087	(3,940,023)	(9.2)%

Fourth quarter sales decreased by \$3.9 million, from \$42.6 million to \$38.7 million, a decrease of 9.2%. The decrease in sales for the quarter was a result of softer than expected holiday season sales as well as a result of the product mix change in 2008.

### *Annual*

The following table compares sales for the year ended December 31, 2008 to the year ended December 31, 2007:

	Sales			
	2008	2007	Change	% change
Sales	110,085,560	125,080,159	(14,994,599)	(12.0)%

Year over year sales have decreased by \$15.0 million, from \$125.1 million to \$110.1 million, representing a decrease of 12.0%. The decrease in sales for the year was a result of softer than expected holiday season sales as well as a result of the product mix change in 2008.

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

Region	December 31, 2008			December 31, 2007		
	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	47.1%	46.0%	18	46.5%	44.6%
Alberta	8	19.8%	20.1%	8	19.4%	20.4%
British Columbia	8	17.7%	19.0%	8	18.5%	19.9%
Saskatchewan and Manitoba	3	9.3%	9.0%	3	8.7%	8.4%
Atlantic Canada	3	6.1%	5.9%	3	6.9%	6.7%
Total	40	100.0%	100.0%	40	100.0%	100.0%

## Cost of Goods Sold and Gross Margin

### *Fourth Quarter*

Cost of goods sold for the quarter decreased by \$5.4 million from \$32.2 million to \$26.8 million, a decrease of 16.8% compared to the same period in 2007. This decrease resulted from a combination of decrease in sales volume, freight costs, and offsite storage costs.

Gross margin for the quarter increased by \$1.5 million, from \$10.4 million to \$11.9 million, an increase of 14.4% compared to the same period in 2007. This increase is a result of the decrease in cost of goods sold as discussed above. Gross margin percentage increased from 24.4% to 30.8%.

### *Annual*

Cost of goods sold for the year decreased by \$16.7 million, from \$86.1 million to \$69.4 million, a decrease of 19.4% compared to 2007. This was primarily as a result of the factors relating to the fourth quarter as discussed above.

Gross margin for the year increased by \$1.6 million, from \$39.0 million to \$40.6 million, an increase of 4.1% compared to 2007. Gross margin percentage increased from 31.1% to 36.9%.

## **Combined Administrative and Operating Expenses**

### *Fourth Quarter*

For the quarter, administrative and operating expenses decreased by approximately \$2.1 million from \$11.9 million to \$9.8 million as compared to the same period in 2007. This decrease is primarily the result of decreases in wages (\$0.9 million decrease), advertising (\$0.7 million decrease), professional fees (\$0.2 million decrease), travel (\$0.1 million decrease), repairs and maintenance (\$0.1 million decrease), which was offset by rent (\$0.2 million increase). The increase in rent was primarily the result of increases in common area costs. The decreases in administrative and operating costs are a result of continuing focus by the Fund towards better cost management.

### *Annual*

For the year, administrative and operating expenses decreased by \$3.2 million from \$37.9 million to \$34.7 million compared to 2007. This decrease is primarily the result of decreases in wages (\$2.0 million decrease), advertising (\$1.7 million decrease), professional fees (\$0.3 million decrease), which was offset by rent (\$0.8 million increase). The increase in rent was primarily the result of increases in common area costs. Again, the decreases in administrative and operating costs are a result of continuing focus by the Fund towards better cost management.

## **Earnings from Operations**

### *Fourth Quarter*

For the quarter, earnings from operations increased by \$3.6 million, from a loss of \$1.4 million in 2007 to earnings of \$2.2 million, an increase of 257.1%, as a result of the factors discussed previously.

### *Annual*

For the year, earnings from operations increased by \$5.0 million, from \$1.0 million to \$6.0 million, an increase of 500.0%, as a result of the factors discussed previously.

## **Fund Net Earnings**

For the three months ended December 31, 2008, the Fund had a net loss of \$18.2 million or \$2.98 per unit on a basic and diluted basis. This is due to the factors described above, as well as an impairment of goodwill of \$36.2 million. The direct impact on the Fund as a result of the impairment of goodwill and after taking into account the non controlling interest was \$18.5 million.

For the year ended December 31, 2008, the Fund had a net loss of \$18.6 million or \$3.05 per unit on a basic and diluted basis. This represents an improvement from 2007 of \$18.7 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, 2008	Dec 31, 2007
Cash and cash equivalents	-	1,709,959
Inventory	17,677,390	21,144,060
Total current assets	19,691,313	25,914,581
Total assets	27,248,471	71,860,825
Total current liabilities excluding term loan and subordinated loan	10,892,858	15,374,236
Term loan	6,665,444	11,250,000
Subordinated loan	13,199,409	12,162,695
Non-controlling interest	891,083	18,901,771
Unitholders' equity	(5,715,572)	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.

Deferred revenue and deferred charges relating to Product Replace Plans ("PRPs"), net of revenue or costs recognized, are adjusted as the revenue and direct costs related to the PRPs are deferred and recognized over the term of the PRPs. The amounts will be included in net earnings once they are recognized.

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

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

As of December 31, 2008 the following number of units were outstanding:

Fund Units (Note 10)	6,051,000
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>11,952,649</u>

**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, 2008 (unaudited)	Dec. 31, 2007 (unaudited)	Dec. 31, 2008	Dec. 31, 2007
Cash provided by (used for) operating activities	14,038,271	14,151,914	850,036	8,035,959
Less: Net change in non-cash working capital	(12,521,136)	(15,661,662)	2,616,780	(8,554,358)
Less: Deferred charges, net of costs recognized	(5,398)	(83,215)	(139,387)	(64,723)
Less: Deferred revenue, net of revenue recognized	(134,038)	(199,691)	126,034	(206,696)
Less: Lease inducements received, net of amortization of lease inducements	34,394	(168,061)	137,701	(530,552)
Less: Maintenance capital expenditures <sup>1</sup>	(178,763)	(167,787)	(392,376)	(535,062)
Distributable cash <sup>2</sup>	1,233,330	(2,128,502)	3,198,788	(1,855,432)
Average Units outstanding during the period <sup>3</sup>	12,004,649	12,004,649	12,004,649	12,002,489
Distributable cash per Unit	0.10	(0.18)	0.27	(0.15)
Distributions declared	-	899,888	-	6,926,402
Distributions declared per Unit	-	0.07	-	0.58
Ratio of distributions declared to distributable cash (payout ratio)	-	-	-	-

<sup>1</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>2</sup> No distributions have been declared in order to utilize available funds to maintain operations and service the Fund's existing debt.

<sup>3</sup> The average units outstanding during the period (12,004,649) differ from the number of units outstanding at December 31, 2008 (11,952,649) by 52,000 units. The 52,000 units represent units bought by the Fund to cover employment contract obligations.

**EBITDA**

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

	Three months ended		Year ended	
	Dec. 31, 2008 (unaudited)	Dec. 31, 2007 (unaudited)	Dec. 31, 2008	Dec. 31, 2007
Net earnings for the period	(18,203,917)	(36,283,954)	(18,625,173)	(37,369,629)
Add: non-controlling interest	(17,603,331)	(35,482,732)	(18,010,688)	(36,146,900)
Add: Interest expense and foreign exchange	1,238,401	993,367	3,871,690	2,869,905
Add: Impairment of goodwill	36,226,599	65,561,827	36,226,599	65,561,827
Add: Impairment of intangible assets	-	3,385,000	-	3,385,000
Add: Future Income Tax	-	(396,719)	-	-
Add: Amortization of property and equipment	499,889	472,404	1,974,854	1,408,620
Add: Amortization of intangible assets	(13,436)	328,100	541,624	1,256,500
EBITDA	2,144,205	(1,438,407)	5,978,906	965,323

**Unitholders' Equity and Non-controlling Interest**

The following table outlines the Fund Units and non-controlling interest outstanding as of December 31, 2008.

	Units	Issue Costs	Unitholders' Equity	Non-controlling Interest
	#	\$	\$	\$
Fund Units	6,051,000	4,928,124	56,110,332	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	891,083

On December 31, 2008 the Fund acquired 52,000 Fund Units held for unit-based compensation. There have been no changes in the number of Special Voting Units from

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

December 31, 2007 to December 31, 2008. During the fourth quarter the Fund issued 1 million warrants as part of its renewal of the sub debt credit facility.

The Fund has also established an option plan for management and its directors which is subject to approval of its unitholders at its annual general meeting in June 2009. Subsequent to December 31, 2008, the Fund has awarded 300,000 options, subject to the plan being approved, that will vest over 3 years to January 2012.

## **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 2008.

### **Credit Facilities**

The Fund has available under its new amended credit facility agreement which was finalized on September 30, 2008 a \$20,000,000 (\$12,500,000 available from January to July annually each year) demand revolving loan. Under the terms of the credit facility agreement, the operating loan is collateralized by a first charge on all present and after required personal property and an assignment of inventory. Interest on the operating loan is charged at the lender's prime rate plus 2.50%. If funds are withdrawn in U.S. dollars, interest will be charged at the lender's U.S. base rate plus 2.50%. The Fund is also required to pay a standby charge of 0.50% based on the amount equal to the operating facility commitment amount less the aggregate principal amount under the operating facility.

Under the new amended credit facility agreement, the term loan has been extended to April 30, 2009 and consists of a committed non-revolving term loan facility. The maximum available on the term loan facility was \$21,250,000 until July 31, 2007, at which time it was reduced to \$11,250,000. The term loan was permanently reduced by \$4,500,000 on December 31, 2008 and was to be further permanently reduced on March 31, 2009 by an amount equal to 75% multiplied by 2008 excess cash flow as defined in the agreement. Excess cash flow is defined as cash in excess of EBITDA less principal payments, cash interest, cash taxes, permitted distributions to unit holders and unfunded capital expenditures. Management has determined that the Fund did not generate 2008 excess cash flow, as defined, such that no payment will be required. The term loan is collateralized along with the operating loan as described above. Under the new agreement interest on the term loan facility is charged at the lender's Canadian prime rate plus 2.50%.

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by the President and CEO of the Fund. The subordinated loan is collateralized by a second charge on all of

the present and future undertakings and property including an acknowledged assignment of leases and material contracts. The principal balance was due on August 20, 2008; however the subordinated loan was renegotiated on November 5, 2008. The maturity date of the subordinated loan agreements has been extended to June 30, 2009. Interest on the subordinated loan has increased from 16% to 18% effective September 26, 2008, with the Fund's option to capitalize up to 10.0% per annum. As part of the extension, the Fund also issued 1,000,000 fund unit purchase warrants, exercisable at \$0.60 at any time within 36 months of issuance, with a cashless exercise feature at the option of subordinated lenders. The cashless exercise feature allows the subordinated lenders the option of exercising the warrants to acquire units of the fund, without a cash payment, by netting out the difference between the trading price of units at the date of exercise of the warrant and the warrant exercise price of \$0.60 per unit then issuing the proportionately reduced number of fully paid units to the warrant holder.

### **Financial Covenants**

The bank indebtedness, term loan and subordinated loan require the Fund to maintain certain financial covenants, including a maximum senior debt to adjusted EBITDA ratio of 3.5:1.0 until December 31, 2008, at which time the ratio reduces to 2.5:1.0; a minimum current ratio of 1.4:1.0, and a minimum adjusted trailing twelve months EBITDA value of \$8,000,000 as at October 31, 2008 and thereafter. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions and other changes in the business without approval of the lenders.

The subordinated loan agreement also requires the Fund to maintain a total funded debt to adjusted EBITDA ratio of less than 5.0:1.0 until December 31, 2008, at which point the ratio reduces to 3.5:1.0.

As at December 31, 2008, the Fund was not in compliance with its minimum adjusted twelve-month EBITDA covenant. Subsequent to December 31, 2008, the Fund reached an agreement with its lenders and the lenders have provided a waiver covering the breach of the minimum adjusted twelve-month EBITDA covenant. The waiver has been received and is subject to signing by the lender and the Fund.

The Fund was not in compliance with its minimum adjusted twelve-month EBITDA covenant and its senior debt to adjusted twelve-month EBITDA covenant at January 31, 2009 and February 28, 2009. The above noted waiver also covers both of these breaches and is subject to the same conditions.

The Fund anticipates that it will not be in compliance with its financial covenants at March 31, 2009 and will be working with its lenders to negotiate waivers and negotiate its credit renewals.

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

implemented certain operational measures that management believes will return the Fund to profitability for fiscal 2009.

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

### **Capital Expenditures**

During the fourth quarter, the Fund acquired \$178,763 of property and equipment (“maintenance capital expenditures”). Of this, \$109,351 related to distribution infrastructure and head office capacity and the remaining \$69,412 related to capital expenditures at existing stores and warehouses.

For the year ended December 31, 2008, the Fund acquired a total of \$392,376 of property and equipment (“maintenance capital expenditures”). Of this, \$268,109 related to distribution infrastructure and head office capacity and the remaining \$124,267 related to capital expenditures at existing stores and warehouses.

### **Interest Rate Risk and Sensitivity**

The Fund’s term and operating loans bear interest with floating rates based on the bank’s prime rate, thus exposing the Fund to interest rate fluctuations. A 1.0% change in interest rates would have an impact of \$95,263 annually on distributable cash and interest expense based on \$9.53 million of debt outstanding at December 31, 2008.

### **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, 2008, 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, 2008, due in the years indicated which relate to various premises operating leases, the term loan that matures on April 30, 2009, and the subordinated loan due on June 30, 2009.

	<b>Total</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014 and thereafter</b>
Operating Leases	21,001,906	5,031,180	4,074,829	3,316,889	2,598,435	2,156,050	3,824,523

Subordinated								
Loan	13,456,850	13,456,850	-	-	-	-	-	-
Term loan	6,750,000	6,750,000	-	-	-	-	-	-
Total	41,208,756	25,238,030	4,074,829	3,316,889	2,598,435	2,156,050	3,824,523	

As noted above, the Fund's term and subordinated loans mature in 2009.

### Summary of Quarterly Results (unaudited)

	2008				2007			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Sales	38,713,064	24,525,830	25,080,819	21,765,847	42,653,087	29,250,232	29,519,184	23,657,656
Net (loss)	(18,203,917)	(20,378)	248,174	(649,052)	(36,283,954)	415,980	(554,670)	(946,985)
Basic and diluted (loss) earnings per unit	(2.98)	0.00	0.04	(0.11)	(5.95)	0.07	(0.09)	(0.16)

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.

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 \$36,226,599 has been recognized.

The fair value of goodwill is determined using valuation techniques that take into account various factors including projected future cash flows, discount rates and the market value of Fund Units. While careful judgment has been used, the use of different estimates and assumptions in applying the impairment test could materially impact the results.

### *Inventory Valuation*

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

## **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 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 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 consolidated financial statements in note 1.

**(b) Future income taxes – Emerging Issues Committee Abstract EIC-171**

On August 28, 2008, the CICA Emerging Issues Committee (the "Committee") issued guidance on the future income tax consequences of exchangeable interests in an income trust or specified investment flow-through as Abstract EIC-171. The Committee reached a consensus that future income taxes related to the temporary differences associated with the assets and liabilities attributable to the exchangeable interests should not be recorded prior to the conversion of the exchangeable interests. Retrospective application is required to any interim and annual financial statements issued after August 28, 2008, with restatement of prior periods.

The Fund evaluated the impact of this guidance on its financial statements, and concluded that for year ended December 31, 2007, the Fund had recorded those temporary differences associated with the Fund's exchangeable interests or non-controlling interest. As such, for the year ended December 31, 2007 the Fund has decreased future income tax assets and the related valuation allowance by \$391,000. Thus, there was no effect on net loss or loss per unit for December 31, 2007.

**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, and does not anticipate any changes.

### *International Financial Reporting Standards (IFRS)*

The use of IFRS for financial reporting in Canada will become applicable for the year beginning January 1, 2011. To date, the Fund has performed a high-level diagnostic that has identified pertinent differences between IFRS and current accounting policies and procedures that conform to Canadian GAAP. The Fund is in the process of developing a plan for IFRS conversion and the related transition from current standards. Activities under this plan will include, among other things, the identification and documentation of pertinent accounting and reporting differences between IFRS and Canadian GAAP; the choice of IFRS accounting policies, including consideration of elections available under IFRS 1, *First-time Adoption of International Financial Reporting Standards*; determination of the impact of conversion on internal controls, accounting systems and other business solutions and processes; and the development of training to assist appropriate employees in the transition to and ongoing compliance with IFRS. Activities in connection with our IFRS implementation plan will continue throughout 2009, and the Fund will provide the required disclosures regarding the status of this plan.

### **Transactions with Related Parties**

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by Michael McKenna, the President, CEO and a director of XS Cargo GP Inc., the administrator of the Fund. The subordinated loan was renegotiated on November 5, 2008 and the maturity date of the subordinated loan agreements has been extended to June 30, 2009. As part of the extension, the Fund also issued 1,000,000 fund unit purchase warrants, exercisable at \$0.60 at any time within 36 months of issuance, with a cashless exercise feature at the option of subordinated lenders. See "Credit Facilities" above for further details regarding this agreement.

Interest expense totaling \$1,169,765 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, 2008.

Mr. William Gray, a director of the XS Cargo GP Inc, is a partner of Fleming LLP, a law firm which provides legal services to the Fund. Legal fees totaling approximately \$148,000 were charged to the fund by Fleming LLP during the year.

## **Outlook**

The Fund made considerable progress in 2008 toward a return to profitability. Distribution and logistics problems that caused significant disruptions in 2007 have been rectified. Initiatives to reduce costs will continue into 2009 resulting in further reductions of administrative and operating expenses.

Lower fuel prices and reduced economic activity has put considerable downward pressure on freight rates. Slumping retail sales, particularly in the United States will result in increased supply of merchandise from cancelled orders and bankruptcies. As the current Canada / USD exchange rate is fully integrated our normal retail price advantage will be restored.

The current economic environment is creating opportunities for new store expansion. Management anticipates opening three to five major market stores in 2009.

The Fund is subject to a de-listing review with the Toronto Stock Exchange currently scheduled for April 2009. Depending on the results of the review, the Fund if necessary, is prepared to proceed with an orderly transition of the Fund to the Toronto Stock Venture Exchange to ensure that units of the Fund will continue to trade on the public markets.

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

Earnings from operations disclosure under "Fourth Quarter and Annual 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, 2008	Three Months Ended December 31, 2007
Net (loss)	(18,203,917)	(36,283,954)
Add:		
Non-controlling interest	(17,603,331)	(35,482,732)
Future income taxes	-	(396,719)
Impairment of Goodwill	36,226,599	65,561,827
Impairment of intangible assets	-	3,385,000
Foreign exchange (gain) loss	(3,062)	(30,706)
Interest on term and subordinated loans	1,042,579	670,429
Interest on operating loan	198,884	353,644
Amortization of intangible assets	(13,436)	328,100
Amortization of property and equipment	499,889	472,404
Unit based compensation expense	9,375	(15,700)
Earnings (loss) from Operations, as defined	2,153,580	(1,438,407)

<b>Annual</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
Net (loss)	(18,625,173)	(37,369,629)
Add:		
Non-controlling interest	(18,010,688)	(36,146,900)
Impairment of Goodwill	36,226,599	65,561,827
Impairment of intangible assets	-	3,385,000
Foreign exchange loss	(120,274)	215,470
Interest on term and subordinated loans	3,447,185	2,071,349
Interest on operating loan	544,779	583,086
Amortization of intangible assets	541,624	1,256,500
Amortization of property and equipment	1,974,854	1,408,620
Unit based compensation expense	21,875	73,360
Earnings from Operations, as defined	<u>6,000,781</u>	<u>1,038,683</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 National Instrument 52-109 ("NI 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, 2008, 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 NI 52-109. The Certifying Officers directed the assessment of the design and operating effectiveness of the Fund's internal control over financial reporting as at December 31, 2008 and based on that assessment determined that the Fund's internal control over financial reporting was, in all material respects, appropriately designed and operating effectively.

## **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](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.