



## **XS CARGO INCOME FUND**

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

**For the three and six months ended June 30, 2007**

**Dated August 9, 2007**

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

This management's discussion and analysis ("MD&A") should be read in conjunction with the 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, 2007 and the audited consolidated financial statements and management's discussion and analysis of the Fund for the year ended December 31, 2006. These financial statements, management's discussion and analysis and other documents filed with regulatory authorities can be found on SEDAR at [www.sedar.com](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 9, 2007.

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**

The 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 39 closeout retail stores in Alberta, British Columbia, Manitoba, Saskatchewan, Ontario, Nova Scotia, Newfoundland and New Brunswick.

## **Operating Highlights**

During the quarter, we commenced implementation of JDA® Software Inc.'s Merchandise Management System and Distributed Store System for Windows. This integrated software solution includes: point-of-sale; inventory and distribution management; accounting; and management reporting functions. Retail Process Engineering ("RPE") has been engaged to provide implementation services and has been onsite since April 11, 2007. The system implementation is expected to cost approximately \$2.5 million for hardware, software and implementation services and is expected to be completed by the end of the third quarter. The business process analysis and design has been completed; configuration and testing phase is in progress; and implementation and rollout is on track for completion in September. The new system is designed to allow us to effectively address our inventory allocation issues and to contribute to reductions in freight costs and improved labour efficiencies in our stores, distribution centres and head office.

Although sales performance continues to suffer as we operate with our legacy systems, there were several positive developments during the quarter. Efforts to improve freight efficiencies and reduce freight rates contributed to a reduction in freight costs as a percentage of sales from 9.8% in the first quarter to 9.2% in the second quarter. Since freight costs are allocated to inventory as purchases are made, further reductions are expected in the third quarter as the inventory with lower associated freight costs sells through. The lower freight costs and fewer markdown requirements contributed to a significant improvement in gross margin percentage from 30.5% in the first quarter to 34.3% in the second quarter. Although still lower than the second quarter last year (38%), we are encouraged by the steady improvement throughout the quarter and expect that improvement to continue through the last half of the year. We are also encouraged by stabilization in the wage rate increases in Alberta. During the quarter average wage rates increased by 4% compared to 13% over last nine months.

During the quarter, we opened our 38<sup>th</sup> and 39<sup>th</sup> stores in Belleville and Sarnia, Ontario, respectively. Leases have been signed for Peterborough and Vaughan, Ontario. Both stores are scheduled to open in the third quarter of 2007. Management has announced intentions to focus its resources on the system conversion and ensuring that operations are uninterrupted during this conversion. We therefore do not expect any further store openings in 2007, but plan to aggressively continue our expansion in 2008 after the systems and support personnel are in place.

## SELECTED FINANCIAL INFORMATION AND RESULTS FROM 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, 2007 compared to the three and six month periods ended June 30, 2006. 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</b> (unaudited)	<b>Three Months</b> <b>Ended</b> <b>June 30, 2007</b>	<b>Three Months</b> <b>Ended</b> <b>June 30, 2006</b>	<b>Change Q2 2007</b> <b>from Q2 2006</b>
Sales	29,519,184	27,822,876	1,696,308
Cost of Goods Sold	19,383,595	17,255,921	2,127,674
Gross Margin	10,135,589 34.3%	10,566,955 38.0%	(431,366)
Administrative and Operating Expenses*	8,725,410	6,507,933	2,217,477
Earnings from Operations, as defined*	1,410,179	4,059,022	(2,648,843)

<b>Year-to-Date Operating Results</b> (unaudited)	<b>Six Months</b> <b>Ended</b> <b>June 30, 2007</b>	<b>Six Months</b> <b>Ended</b> <b>June 30, 2006</b>	<b>Change 2007</b> <b>from 2006</b>
Sales	53,176,840	48,494,741	4,682,099
Cost of Goods Sold	35,821,536	30,325,263	5,496,273
Gross Margin	17,355,304 32.6%	18,169,478 37.5%	(814,174)
Administrative and Operating Expenses*	16,721,255	11,951,072	4,770,183
Earnings from Operations, as defined*	634,049	6,218,406	(5,584,357)

\* 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

### Second Quarter

The following table compares sales for the quarter ended June 30, 2007 to the quarter ended June 30, 2006 for new and same stores:

	Sales				Number of Stores as of June 30	
	2007	2006	Change	% change	2007	2006
Same stores	18,691,158	22,167,875	(3,476,717)	(15.7%)	23	23
New stores	10,828,026	5,655,001	5,173,025	91.5%	16	9
Total	29,519,184	27,822,876	1,696,308	6.1%	39	32

Second quarter sales increased by \$1.7 million, from \$27.8 million to \$29.5 million, an increase of 6.1%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$5.2 million in sales. Included in new store sales is revenue from an event sale, which was held in the Greater Toronto Area in May 2007. The offsetting \$3.5 million decrease in total sales represents a 15.7% decrease in same store sales. We anticipated the decrease in same store sales, as a result of issues with the allocation of inventory between stores that resulted in higher than normal stock-outs.

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

Region	June 30, 2007		June 30, 2006	
	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	17	44.9%	15	50.8%
Alberta	8	20.0%	8	21.8%
Saskatchewan and Manitoba	3	8.0%	3	9.2%
British Columbia	8	20.7%	6	18.2%
Atlantic Canada	3	6.4%	-	0.0%
Total	39	100.0%	32	100.0%

### *Year-to-Date*

The following table compares sales for the year-to-date ended June 30, 2007 to the year-to-date ended June 30, 2006 for new and same stores:

	Sales			
	2007	2006	Change	% change
Same stores	34,790,849	40,232,279	(5,441,430)	(13.5%)
New stores	18,385,991	8,262,462	10,123,529	122.5%
Total	53,176,840	48,494,741	4,682,099	9.7%

For the year-to-date, sales increased by \$4.7 million, from \$48.5 million to \$53.2 million, an increase of 9.7%. New stores, defined as stores that have not been open for a full 12 months in the current and prior period, contributed an additional \$10.1 million in sales. The offsetting \$5.4 million decrease represents a 13.5% decrease in same store sales. As discussed above, we anticipated the decrease in same store sales, as a result of problems with the allocation of inventory between stores that resulted in higher than normal stock-outs.

### **Product Replacement Plan Sales**

Sales of two-year product replacement extended warranty plans continue to be strong. During the twenty-one months since implementation, \$4.1 million of Product Replacement Plans (“PRPs”) were sold, with \$2.0 million recognized as revenue since inception, approximately \$0.5 million of which was recognized during the second quarter of 2007 and approximately \$0.9 million for the year-to-date. Revenue from PRP sales is deferred and recognized on a straight-line basis over the two-year terms of the PRPs.

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

#### *Second Quarter*

Cost of goods sold for the quarter increased by \$2.1 million from \$17.3 million to \$19.4 million, an increase of 12.3%, primarily as a result of new store openings.

Gross margin for the quarter decreased by \$0.4 million, from \$10.5 million to \$10.1 million, a decrease of 4.1%. Higher freight costs along with markdowns required to sell-through inventory that was overstocked in certain stores contributed to a gross margin percentage of 34.3% compared to 38.0% in the second quarter of 2006. Freight costs as a percentage of sales were 9.2% compared to 6.7% in the second quarter of 2006 as a result of higher freight rates and efforts to reallocate inventory between stores. The implementation of our new inventory management system by the end of the third quarter of 2007 is expected to alleviate most of the freight inefficiencies we are currently experiencing. We are also working with our third party logistics provider to realize other freight efficiencies and rate reductions through load consolidation and increased use of

inter-modal transport. Those efforts contributed to a reduction of freight costs compared to the first quarter of 2007 from 9.8% to 9.2% of sales. Since freight costs are allocated to inventory as purchases are made, further reductions are expected in the third quarter as the inventory with lower associated freight costs sells through.

*Year-to-Date*

Cost of goods sold for the year-to-date increased by \$5.5 million from \$30.3 million to \$35.8 million, an increase of 18.1%, primarily as a result of new store openings.

Gross margin for the year-to-date decreased by \$0.8 million, from \$18.2 million to \$17.4 million, a decrease of 4.5%. Efforts to reallocate inventory between stores contributed to an increase in freight costs from 6.7% to 9.4% of sales. The increase in freight costs, along with markdowns required to sell-through inventory that was overstocked in certain stores contributed to a reduction in gross margin percentage from 37.5% to 32.6%.

**Administrative and Operating Expenses**

*Second Quarter*

For the quarter, administrative and operating expenses increased by approximately \$2.2 million from \$6.5 million to \$8.7 million. This increase is primarily the result of increases in rent (\$0.4 million increase), 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. The increase in wages was the result of new store openings, wage rate increases and labour inefficiencies in our distributions centres. The components of the wage increases are summarized in the chart below (in \$millions):

	<b>New Stores</b>	<b>Alberta</b>	<b>Other Markets</b>	<b>Total</b>
Wages	0.50	0.36	0.02	0.88
% increase from prior year	100%	33%	2%	34%

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

The average wage rates for our Alberta employees have increased by 17% over the same quarter in 2006, with the remaining increase in wages resulting from the addition of new positions to support our growth, and additional labour hours used in our distribution centres and stores as a result of the inventory allocation issues described above.

*Year-to-Date*

For the year-to-date, administrative and operating expenses increased by approximately \$4.8 million from \$11.9 million to \$16.7 million. This increase is primarily the result of increases in rent (\$0.9 million increase), wages (\$2.0 million increase) and advertising (\$0.8 million increase). The increases in rent and advertising were primarily the result of

new store openings. The increase in wages was the result of new stores openings as well as significant wage rate increases, primarily in Alberta. The components of the wage increases are summarized in the chart below (in \$millions):

	New Stores	Alberta	Other Markets	Total
Wages	1.05	0.73	0.20	1.98
% increase from prior year	100%	36%	9%	42%

## **Earnings from Operations**

### *Second Quarter*

For the quarter, earnings from operations decreased by \$2.6 million, from \$4.0 million to \$1.4 million, a decrease of 65.3%, as a result of the factors discussed previously.

### *Year-to-Date*

For the year-to-date, earnings from operations decreased by \$5.6 million, from \$6.2 million to \$0.6 million, a decrease of 89.8%, as a result of the factors discussed previously.

## **Net (Loss) Earnings**

For the quarter ended June 30, 2007, the Fund had a net loss of \$0.6 million or \$0.09 per unit on a basic and diluted basis. During the quarter, the Fund was required to recognize future income taxes as a result of new tax legislation substantively enacted on June 12, 2007. On initial recognition of the future tax liability, the entire amount was recorded as a charge to earnings during the quarter. See notes 3 and 5 for further details. Prior to the charge to earnings on initial recognition of future income taxes, the Fund had net earnings for the quarter of \$0.1 million or \$0.01 per unit on a basic and diluted basis.

For the year-to-date, the Fund had a net loss of \$1.5 million or \$0.25 per unit on a basic and diluted basis. Prior to the charge on initial recognition of future income taxes in the second quarter, the Fund had a net loss of \$0.9 million or \$0.14 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:

	<b>June 30, 2007</b>	<b>Mar. 31, 2007</b>	<b>Dec. 31, 2006</b>	<b>Dec. 31, 2005</b>
Cash and cash equivalents	-	-	1,017,824	7,442,496
Inventory	22,951,282	25,158,913	22,288,806	15,752,388
Total current assets	29,342,975	29,924,485	31,179,577	28,388,003
Total assets	143,085,432	142,974,262	144,349,830	140,941,626
Total current liabilities excluding term loan	15,155,685	13,446,202	13,859,176	9,085,481
Term loan	21,250,000	21,250,000	17,500,000	15,000,000
Non-controlling interest	54,417,628	55,578,212	57,493,942	59,527,529
Unitholders' equity	50,092,894	51,792,439	54,571,224	56,833,747

## Distributable Cash and Cash Distributions

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

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

Deferred revenue and deferred charges relating to PRPs, net of revenue or costs recognized, are adjusted as the revenue and direct costs related to the PRPs are deferred and recognized over the term of the PRPs. The amounts will be included in net earnings as 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 as they are amortized.

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

The following table summarizes the distributions declared from January 1, 2007 to June 30, 2007:

Record Date	Payment Date	Fund Units		Exchangeable LP Units and Subordinated LP Units		Total	
		Declared \$	Paid \$	Declared \$	Paid \$	Declared \$	Paid \$
Jan. 31, 2007	Feb. 15, 2007	629,681	629,681	359,479	359,479	989,160	989,160
Feb. 28, 2007	March 15, 2007	629,681	629,681	359,479	359,479	989,160	989,160
March 31, 2007	April 15, 2007	572,438	572,438	326,799	326,799	899,237	899,237
April 30, 2007	May 15, 2007	572,438	572,438	326,799	326,799	899,237	899,237
May 31, 2007	June 15, 2007	286,219	286,219	163,725	163,725	449,944	449,944
June 30, 2007	July 15, 2007	286,219	-	163,725	-	449,944	-
		<u>2,976,676</u>	<u>2,690,457</u>	<u>1,700,006</u>	<u>1,536,281</u>	<u>4,676,682</u>	<u>4,226,738</u>

Distributions are paid on Fund Units, XS Cargo LP Exchangeable LP Units and XS Cargo LP Subordinated LP Units. As of June 30, 2007 the following number of units were outstanding:

Fund Units (Note 6)	6,106,000
XS Cargo LP Exchangeable LP Units (Note 7)	3,492,802
XS Cargo LP Subordinated LP Units (Note 7)	<u>2,408,847</u>
	<u>12,007,649</u>

During the three and six month periods ended June 30, 2007, the Fund approved total distributions of \$0.1875 and \$0.4875 per Fund Unit, respectively, to unitholders. It is the Fund's policy to review the monthly distribution amount at least quarterly. For the first two months of 2007, the monthly distribution rate was \$0.103125 per unit. Effective March 2007, the distribution rate was reduced to the monthly level at the time of the IPO of \$0.09375 per unit (from \$0.103125 per unit) for Fund and Exchangeable LP Units. Distributions on Subordinated LP Units were suspended.

The Fund announced a reduction in the monthly distribution rate to \$0.046875 per Fund Unit and Exchangeable LP Unit, beginning with the May 2007 distribution. On an annualized basis, the reduced distribution rate is \$0.5625 per Fund Unit and Exchangeable LP Unit.

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

	<b>Three Months Ended June 30, 2007</b> (unaudited)	<b>Six Months Ended June 30, 2007</b> (unaudited)	<b>Since Inception on May 17, 2005</b> (unaudited)
Cash provided by (used for) operating activities	1,047,482	(4,182,933)	19,526,299
Less: Net change in non-cash working capital	(191,304)	3,885,487	5,757,591
Less: Deferred charges, net of costs recognized	5,322	4,358	336,157
Less: Deferred revenue, net of revenue recognized	25,182	4,598	(2,131,242)
Less: Lease inducements received, net of amortization of lease inducements	(37,125)	(85,933)	(403,908)
Less: Maintenance capital expenditures <sup>1</sup>	(92,064)	(201,429)	(821,678)
<b>Distributable cash<sup>2</sup></b>	<b>757,493</b>	<b>(575,852)</b>	<b>22,263,219</b>
Average Units outstanding during the period	12,001,589	11,998,768	11,990,383
Distributable cash per Unit	0.06	(0.05)	1.86
Distributions declared	1,799,125	4,676,681	27,694,185
Distributions declared per Unit	0.15	0.39	2.31
Ratio of distributions declared to distributable cash (payout ratio)	238%	(912%)	124%

Since inception, the Fund has generated distributable cash per unit of \$1.86 and has declared distributions of \$2.31 per unit. For the second quarter of 2007, the Fund had distributable cash per unit of \$0.06 and declared distributions of \$0.15 per unit. Basic and diluted loss per unit was \$0.09 for the second quarter.

During the three months ended June 30, 2007, distributions declared exceeded 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 as much as 40% of the annual distributable cash being generated in the fourth quarter, it is expected that cash

<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> See discussion under "Non-GAAP Measures" below.

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.

In addition to the seasonal nature of distributable cash, the Fund's lower sales and earnings, as discussed earlier in the "Operating Highlights" section, contributed to a ratio of distributions declared to distributable in excess of 100%. The Fund plans to use credit facilities to finance the shortfall between distributable cash and distributions declared until the fourth quarter of 2007.

### **EBITDA**

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

	<b>Three Months Ended June 30,2007</b>	<b>Six Months Ended June 30, 2007</b>	<b>Since Inception on May 17, 2005</b>
	(unaudited)	(unaudited)	(unaudited)
Net earnings (loss) for the period	(554,670)	(1,501,655)	8,660,909
Add: Non-controlling interest	(536,195)	(1,449,668)	8,339,732
Add: Future income taxes	1,269,160	1,269,160	1,269,160
Add: Interest expense and foreign exchange	560,622	1,008,472	3,077,702
Add: Amortization of property and equipment	313,302	608,280	1,844,306
Add: Amortization of intangible assets	328,100	626,100	2,563,100
<b>EBITDA<sup>3</sup></b>	<b>1,380,319</b>	<b>560,689</b>	<b>25,754,909</b>

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

The following table outlines the Fund Units and non-controlling interest outstanding as of June 30, 2007 and August 9, 2007.

	<b>Units</b>	<b>Issue Costs</b>	<b>Unitholders' Equity</b>	<b>Non- controlling Interest</b>
	#	\$	\$	\$
Fund Units	6,106,000	4,928,124	50,092,894	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	54,417,628

On May 17, 2007, 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 9.

<sup>3</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**

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 15<sup>th</sup> of each month to Unitholders of record on the last business day of the previous month.

During the three and six months ended June 30, 2007, the Fund declared distributions of \$0.1875 and \$0.4875 per Fund Unit, respectively to Unitholders, or \$1,144,876 and \$2,976,676 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 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 fund capital expenditures) and a committed non-revolving term loan to a maximum amount of \$21.25 million.

Interest on the term loan is charged at the lender's Canadian prime rate or U.S. base rate plus 0.25% to 1.25% or the bankers' acceptance rate plus 1.75% to 2.25%, depending on the Fund's senior debt to EBITDA ratio. Interest on the operating loan will vary between the lender's prime rate and the lender's prime rate plus 1.00% depending on the Fund's ratio of senior debt to EBITDA. As of June 30, 2007, \$21.25 million was outstanding on the term loan and \$7.2 million was outstanding on the operating loan. Under the terms of the credit facilities, the term loan is required to be reduced to \$11.25 million by July 31, 2007, which was extended by the lender to August 14, 2007.

On August 9, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by a third party and 50% by a company owned by the President and CEO of the Fund. The principal balance is due after twelve months but is renewable for an additional six months at the option of the Fund. The subordinated loan is collateralized by the second charge on all present and future undertaking and property of the Fund, including an acknowledged assignment of leases and material contracts. Interest on the subordinated loan is charged at 16%, with the Fund's option to capitalize up to 8.0% per annum.

### **Debt Covenants**

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

limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions in excess of distributable cash and other changes in the business without approval of the lender. At June 30, 2007, the Fund was in compliance with the covenants. The limitation on declaring distributions in excess of distributable cash has been waived by the lender until December 31, 2007.

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

### Capital Expenditures

During the quarter, the Fund acquired \$1,328,760 of property and equipment which was financed using the operating loan. Of this, \$297,873 related to new store openings, distribution infrastructure and head office capacity, \$938,823 related to the new point-of-sale and inventory management system and the remaining \$92,064 related to capital expenditures at existing stores and warehouses ("maintenance capital expenditures").

The Belleville, Ontario store opened in May and the Sarnia, Ontario store opened in June. Leases have been finalized for Peterborough and Vaughan, Ontario. Both stores are scheduled to open at the end of the third quarter in 2007. As discussed above, the Fund has credit facilities available to finance these and other growth related capital expenditures planned for the remainder of 2007.

### Interest Rate Risk and Sensitivity

The Fund's long-term debt bears interest with floating rates, thus exposing the Fund to interest rate fluctuations. A 1.0% increase in interest rates would have an impact of \$284,000 annually (\$71,000 during the quarter) on distributable cash based on \$28.4 million of debt outstanding at June 30, 2007.

### Contractual Obligations

The table below sets forth the contractual obligations of the Fund as of June 30, 2007, due in the years indicated which relate to various premises operating leases and the \$21.25 million outstanding on the term loan, with \$10.0 million due on August 13, 2007 and the remainder that matures on May 16, 2008.

(unaudited)	Total	2007	2008	2009	2010	2011	2012 and thereafter
Operating Leases	26,453,621	2,456,412	4,949,907	4,531,237	3,588,672	2,851,136	8,076,257
Term loan	21,250,000	10,000,000	11,250,000	-	-	-	-
Total	47,703,621	12,456,412	16,199,907	4,531,237	3,588,672	2,851,136	8,076,257

## Summary of Quarterly Results (unaudited)

	2007		2006				2005	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Sales	29,519,184	23,657,656	42,339,077	25,960,077	27,822,876	20,671,865	36,436,104	20,775,101
Net (loss) earnings	(554,670)	(946,985)	1,745,044	1,108,744	1,601,832	723,545	3,062,775	1,173,328
Basic and diluted (loss) earnings per unit	(0.09)	(0.16)	0.29	0.18	0.26	0.12	0.50	0.19

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**

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

### **Accounting policy changes**

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

#### *Section 3855: Financial Instruments – Recognition and Measurement*

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

#### *Section 1530: Comprehensive Income*

This Section describes how to report and disclose comprehensive income and its components. Comprehensive income is the change in the Fund's net assets that result from transactions, events or circumstances from sources other than the Fund's Unitholders.

#### *Section 3865: Hedges*

This Section establishes standards for when and how hedge accounting, which is optional, may be applied.

As the Fund does not use hedge accounting, the adoption of these new standards has had no impact on the consolidated financial statements.

**(b) *Section 1506: Accounting Changes***

This standard establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors.

Prior to June 12, 2007, income tax obligations relating to distributions from the Fund were obligations of the Unitholders and, accordingly, no provision for income taxes had been made in respect of the income of the Fund. As described in note 5, the Fund will recognize future income tax in the quarter ended June 30, 2007 as a result of new tax legislation substantively enacted on June 12, 2007, add fully enacted on June 22, 2007. Current income tax will not be recognized until a new tax on the Fund is effective on January 1, 2011 (or earlier if the Fund experiences more than “normal growth” or experiences “undue expansion). Future income tax assets and liabilities are recorded on the difference between the accounting and tax basis of assets and liabilities based on substantively enacted tax laws and rates for those differences that are expected to reverse after January 1, 2011.

The amount of future income tax assets recognized is limited to the amount that is more likely than not to be realized.

*(c) Future Accounting Changes*

In December 2006, the CICA issued three accounting standards: Section 1535, Capital Disclosures, Section 3862, Financial Instruments - Disclosures and Section 3863, Financial Instruments - Presentation. These new standards will be effective for the Fund on January 1, 2008.

*Section 1535: Capital Disclosures*

This new standard established disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund is presently evaluating the impact of this new standard.

*Section 3862: Financial Instruments - Disclosures and Section 3863: Financial Instruments - Presentation*

These new standards replace Section 3861, Financial Instruments - Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. The Fund is presently evaluating the impact of these new standards.

In June 2007, the CICA issued the following accounting standard: 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 retroactive application to prior period financial statements. The Fund is presently evaluating the impact of this new standard.

## **Transactions with Related Parties**

During the three and six month periods ended June 30, 2007, there were no related party transactions.

Subsequent to June 30, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by a third party and 50% by a company owned by the President and CEO of the Fund. See “Credit Facilities” above for further details regarding this agreement.

## **Outlook**

Significant progress has been made on the conversion of our new point-of-sale and inventory management system, with a continued target date of completion by the end of the third quarter. We will continue to experience depressed sales, higher freight expenses, and labour inefficiencies until the new point-of-sale and inventory system is fully functioning. We believe that the new system will not only alleviate the inefficiencies we are currently experiencing, but provide opportunities for further operational enhancements in our stores and distribution centres.

## **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 in accordance with GAAP, 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 Operating Results” and “Year-to-date Operating Results” has been calculated by adding interest expense, foreign exchange loss, amortization of property and equipment and intangible assets, unit-based compensation, future income taxes and non-controlling interest to net earnings for the period. As one of the factors that may be considered relevant by prospective investors is earnings (loss) from operations of the Fund relative to the price of the Units, management

believes that earnings (loss) from operations of the Fund is a useful supplemental measure that may assist prospective investors in assessing an investment in the Fund.

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.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Management of the Fund is responsible for designing internal controls over financial reporting for the Fund as defined under MI 52-109. Management has designed such internal controls over financial reporting, or caused them to be designed under its supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with GAAP. There have been no changes in the Fund's internal controls over financial reporting that occurred during the three month period ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Fund's internal controls over financial reporting.

## **RISK FACTORS**

The Fund's results of operations, business prospects, financial condition, cash distributions to unitholders and the trading price of the Fund's units are subject to a number of risks. These risk factors include: the ability to maintain profitability and manage growth; the ability to expand through new store openings; the ability to source products in adequate quantities and on acceptable terms; changes in trends and consumer tastes; economic conditions and consumer spending; the success of the Fund's marketing efforts and increased marketing expenditures; competition; reliance on centralized distribution centres; freight costs; ability to maintain comparable store sales; seasonality and fluctuations in quarterly results; reliance on management information systems; increase in the cost of, or disruption in the flow of, imported products; successful management of exposure to merchandise returns; foreign exchange fluctuations; costs and availability of insurance coverage; protection of intellectual property; reliance on key personnel; labour matters, including increased labour costs and labour shortages; absence of history as a public company; dependence on external funding sources; environmental regulation; uncertainties arising from world events; property taxes; the Fund's dependence on its operating subsidiaries; the unpredictability and volatility of the market price of the Fund Units; the nature of the Fund Units; the lack of certainty regarding cash distribution levels; cash on cash yield; the structural subordination of the Fund Units; leverage and restrictive covenants; restrictions on potential growth; changes in income tax legislation and other tax

related risks; future sales of Fund Units from treasury; future sales of Fund Units by insiders; the rights of the Vendor in relation to XS Cargo LP; conflicts of interest; unitholder limited liability; the distribution of securities on redemption or termination of the Fund; and the restrictions on certain unitholders and the liquidity of Fund Units. For a discussion of these risks and other risks associated with an investment in Fund Units, see “Risk Factors” detailed in the Fund’s Annual Information Form available at [www.sedar.com](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.