



## **XS CARGO INCOME FUND**

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

**For the three and nine months ended September 30, 2008**

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

This management's discussion and analysis ("MD&A") should be read in conjunction with the interim consolidated financial statements and accompanying notes (the "Financial Statements") of XS Cargo Income Fund (the "Fund") for the three and nine months ended September 30, 2008, and the audited consolidated financial statements and management's discussion and analysis of the Fund for the year ended December 31, 2007. These financial statements, management's discussion and analysis and other documents filed with regulatory authorities can be found on SEDAR at [www.sedar.com](http://www.sedar.com). Results are reported in Canadian dollars unless otherwise stated and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Certain dollar amounts have been rounded to the nearest thousand dollars, while other amounts have been rounded to the nearest hundred thousand dollars. References to notes are to the notes to the Financial Statements of the Fund unless otherwise stated.

This MD&A is dated November 12, 2008.

Readers are referred to the advisories regarding forward-looking information and non-GAAP measures in the "Forward Looking Statements" and "Non-GAAP Measures" sections of this MD&A.

### **OVERVIEW OF THE FUND**

#### **Issuance of Fund Units and Acquisition**

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

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

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

#### **The Business of the Fund**

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

## Operating Highlights

Sales from continuing operations have declined by \$4.6 million or 15.8% in the third quarter. Year to date, sales from continuing operations declined by \$9.4 million or 11.7%. Earnings from operations in the third quarter declined to \$1.3 million from \$1.9 million in 2007. Year to date earnings from operations were \$3.8 million, an increase of \$1.3 million over the same period last year. The Fund had a net loss of \$20,000 for the quarter. Year to date, the Fund narrowed its net loss from \$1.1 million in 2007 to \$400,000 in 2008 despite a \$1.1 million increase in interest expense.

During the third quarter the Fund saw improvements in all aspects of its supply chain management resulting in a decrease in freight, as a percentage of sales, from 9.3% in the third quarter of 2007 to 8.6% in the third quarter of 2008. Merchandise management system improvements continue to drive labor efficiencies and result in lower wage expense in both distribution centres. Management is confident that system problems that impacted 2007 results are rectified.

During the third quarter, the Fund entered into a new agreement with its term and operating loan lender which resulted in the Fund being in compliance with the amended financial covenants as at the end of the third quarter. Subsequent to September 30, 2008, the Fund also reached an agreement with its subordinated loan lenders and those lenders have provided a waiver covering the past breach of all financial covenants.

## SELECTED FINANCIAL INFORMATION AND RESULTS OF OPERATIONS

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

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

<b>Third Quarter Operating Results</b> (unaudited)	<b>Three Months</b> <b>Ended</b> <b>September 30, 2008</b>	<b>Three Months</b> <b>Ended</b> <b>September 30, 2007</b>	<b>Change Q3 2008</b> <b>from Q3 2007</b>
Sales	24,525,830	29,250,232	(4,724,402)
Cost of Goods Sold	15,090,314	18,075,852	(2,985,538)
Gross Margin	9,435,516 38.5%	11,174,380 38.2%	(1,738,864)
Administrative and Operating Expenses*	8,139,197	9,305,539	(1,166,342)
Earnings from Operations, as defined*	1,296,319	1,868,841	(572,522)
Net Earnings (Loss)	(20,378)	415,980	(436,358)

<b>Year-to-date Operating Results</b> (unaudited)	<b>Nine Months Ended</b> <b>September 30, 2008</b>	<b>Nine Months Ended</b> <b>September 30, 2007</b>	<b>Change 2008</b> <b>from 2007</b>
Sales	71,372,496	82,427,072	(11,054,576)
Cost of Goods Sold	42,652,492	53,897,388	(11,244,896)
Gross Margin	28,720,004 40.2%	28,529,684 34.6%	190,320
Administrative and Operating Expenses*	24,872,804	26,026,794	(1,153,990)
Earnings from Operations, as defined*	3,847,200	2,502,890	1,344,310
Net Loss	(421,256)	(1,085,675)	664,419

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

## Store Sales

### *Third Quarter*

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

	Sales				Number of Stores as of September 30	
	2008	2007	Change	% change	2008	2007
Same stores	20,394,063	24,145,497	(3,751,434)	-15.5%	32	32
New stores	4,129,620	4,969,509	(839,889)	-16.9%	8	8
Subtotal	24,523,683	29,115,006	(4,591,323)	-15.8%	40	40
Non-store sales**	2,147	135,226	(133,079)	-98.4%		
Total sales	24,525,830	29,250,232	(4,724,402)	-16.2%	40	40

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

For the third quarter, overall sales decreased by \$4.7 million, from \$29.2 million to \$24.5 million, a decrease of 16.2%. Store sales declined by \$4.6 million or 15.8%. Same store sales, defined as sales from stores that have been open for a full 12 months in the current and prior period, decreased by \$3.8 million, or 15.5%. New store sales showed a decrease of \$0.8 million or 16.9%.

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

Region	September 30, 2008		September 30, 2007	
	Number of stores, end of quarter	Percentage of sales during the quarter	Number of stores, end of quarter	Percentage of sales during the quarter
Ontario	18	45.49%	18	44.68%
Alberta	8	20.14%	8	20.42%
British Columbia	8	19.59%	8	20.07%
Saskatchewan and Manitoba	3	8.48%	3	7.97%
Atlantic Canada	3	6.30%	3	6.86%
<b>Total</b>	<b>40</b>	<b>100.00%</b>	<b>40</b>	<b>100.00%</b>

#### *Year-to-Date*

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

	Sales			
	2008	2007	Change	% change
Same stores	59,766,099	69,312,184	(9,546,085)	-13.8%
New stores	11,562,789	11,489,845	72,944	0.6%
Subtotal	71,328,888	80,802,029	(9,473,141)	-11.7%
Non-store sales**	43,608	1,625,043	(1,581,435)	-97.3%
	71,372,496	82,427,072	(11,054,576)	-13.4%

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

For the year-to-date, overall sales decreased by \$11.0 million, from \$82.4 million to \$71.4 million, a decrease of 13.4%. Web site sales and off-site sales were discontinued in 2008 resulting in a \$1.6 million decline. Store sales declined by \$9.4 million or 11.7%. Same store sales, defined as sales from stores that have been open for a full 12 months in the current and prior period, decreased by \$9.5 million, or 13.8%. New store sales showed an increase of \$0.1 million or 0.6%.

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

### *Third Quarter*

Cost of goods sold for the quarter decreased by \$3.0 million from \$18.1 million to \$15.1 million, a decrease of 16.5%. This decrease is directly related to the 16.2% decrease in Sales.

Gross margin for the quarter decreased by \$1.7 million, from \$11.1 million to \$9.4 million, a decrease of 15.6%. This decrease is a result of the 16.2% decrease in Sales. Gross margin percentage increased from 38.2% to 38.5%.

### *Year-to-Date*

Cost of goods sold for the year-to-date decreased by \$11.2 million from \$53.9 million to \$42.7 million, a decrease of 20.9%. This decrease is a result of a 13.4% decline in sales, lower freight expense and increased product margins.

Gross margin for the year-to-date increased by \$0.2 million, from \$28.5 million to \$28.7 million, an increase of 0.7%. This is a result of an increase in gross margin percentage from 34.6% to 40.2%.

## **Combined Administrative and Operating Expenses**

### *Third Quarter*

For the quarter, administrative and operating expenses decreased by approximately \$1.2 million from \$9.3 million to \$8.1 million. This decrease is primarily the result of decreases in wages (\$0.7 million decrease) and advertising (\$0.5 million decrease), and office supplies (\$0.2 million decrease), offset by rent (\$0.2 million increase). The increase in rent was primarily the result of increases in common area costs. The decreases are as a result of continuing focus by the Fund to reduce administrative and operating costs.

### *Year-to-Date*

For the year-to-date, administrative and operating expenses decreased by approximately \$1.2 million from \$26.1 million to \$24.9 million. This is primarily the result of decreases in advertising (\$1.0 million decrease), wages (\$0.9 million decrease) and office supplies (\$0.4 million decrease), offset by professional fees (\$0.4 million increase) and rent (\$0.7 million increase). The increase in rent was primarily the result of new store openings, increases in common area costs and lease renewals. The increase in professional fees are due to the use of an external accountant as interim CFO until June 2008 and one time costs associated with renegotiating our credit facilities. The decreases are as a result of the continuing focus made by the Fund to reduce administrative and operating costs.

### **Earnings from Operations**

#### *Third Quarter*

For the quarter, earnings from operations decreased by \$0.6 million, from \$1.9 million to \$1.3 million, a decrease of 30.6% as a result of the factors discussed previously.

#### *Year-to-Date*

For the year-to-date, earnings from operations increased by \$1.3 million, from \$2.5 million to \$3.8 million, an increase of 53.7% as a result of the factors discussed previously.

### **Fund Net Earnings**

For the three months ended September 30, 2008, the Fund had a net loss of \$20 thousand. This compares with the prior year's net earnings of \$0.4 million or \$0.07 per unit on a basic and diluted basis.

For the year-to-date, the Fund had a net loss of \$0.4 million or \$0.07 per unit on a basic and diluted basis. This compares with the prior year's net loss of \$1.1 million or \$0.18 per unit on a basic and diluted basis.

Interest expense increased by \$163,306 and \$1,120,139 during the three months and nine months ended September 30, 2008.

## Financial Position

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

	Sept 30, 2008	June 30, 2008	Mar 31, 2008	Dec 31, 2007
Cash and cash equivalents	-	-	-	1,709,959
Inventory	23,308,097	20,050,500	19,095,062	21,144,060
Total current assets	30,785,420	24,365,398	24,027,281	25,914,581
Total assets	74,853,029	69,017,101	69,301,445	71,860,825
Total current liabilities excluding term loan and subordinated loan	18,552,157	12,848,326	13,874,944	15,374,236
Term loan	11,097,799	11,250,000	11,250,000	11,250,000
Subordinated loan	13,082,856	12,828,139	12,492,465	12,162,695
Non-controlling interest	18,494,413	18,514,119	18,274,132	18,901,771
Unitholders' equity	12,376,164	12,387,167	12,135,868	12,784,920

## Distributable Cash and Cash Distributions

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

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

Deferred revenue and deferred charges relating to Product Replacement 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 the quarter.

As at September 30, 2008 and November **12**, 2008 the following number of units were outstanding:

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

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

	Three months ended		Nine months ended	
	September 30, 2008 (unaudited)	September 30, 2007 (unaudited)	September 30, 2008 (unaudited)	September 30, 2007 (unaudited)
Cash provided by (used for) operating activities	(4,848,284)	(1,933,022)	(13,188,235)	(6,115,955)
Less: Net change in non-cash working capital	5,557,551	3,221,818	15,137,916	7,107,304
Less: Deferred charges, net of costs recognized	(43,009)	14,134	(133,989)	18,492
Less: Deferred revenue, net of revenue recognized	122,664	(11,604)	260,072	(7,005)
Less: Lease inducements received, net of amortization of lease inducements	35,297	(276,558)	103,307	(362,491)
Less: Maintenance capital expenditures <sup>1</sup>	(37,657)	(165,846)	(213,613)	(367,275)
Distributable cash <sup>2</sup>	804,562	848,922	1,965,458	273,070
Average Units outstanding during the period	12,004,649	12,001,589	12,004,649	11,998,768
Distributable cash per Unit	0.07	0.07	0.16	0.02
Distributions declared	-	1,349,833	-	6,026,514
Distributions declared per Unit	-	0.11	-	0.5
Ratio of distributions declared to distributable cash (payout ratio)	-	159%	-	2,207%

<sup>1</sup> Maintenance capital expenditures refer to acquisitions of property and equipment to replace or upgrade equipment and information systems at existing stores, distribution centres, and head office. 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.

## EBITDA

Management believes that EBITDA<sup>3</sup> is a useful measure in evaluating the performance of the Fund. The following table reconciles EBITDA to net earnings for the periods indicated.

	Three months ended		Nine months ended	
	September 30, 2008 (unaudited)	September 30, 2007 (unaudited) restated <sup>5</sup>	September 30, 2008 (unaudited)	September 30, 2007 (unaudited) restated <sup>5</sup>
Net earnings	(20,378)	415,980	(421,256)	(1,085,675)
Add: Non-controlling interest	(19,706)	161,720	(407,358)	(664,168)
Add: Interest expense and foreign exchange	753,816	868,066	2,633,289	1,876,538
Add: Future income taxes	-	(248,661)	-	396,719
Add: Amortization of PPE	494,442	327,936	1,474,965	936,216
Add: Amortization of Intangible	78,770	328,100	555,060	954,200
EBITDA	1,286,944	1,853,141	3,834,700	2,413,830

## Unitholders' Equity and Non-controlling Interest

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

	Units	Issue Costs	Unitholders' Equity	Non- controlling Interest
	#	\$	\$	\$
Fund Units	6,103,000	4,928,124	56,116,612	-
Special Voting Units	5,901,649	-	-	-
Non-controlling Interest	5,901,649	-	-	18,494,413

There have been no changes in the number of Fund Units or Special Voting Units from September 30, 2008 to November 12, 2008.

<sup>3</sup> EBITDA refers to earnings before interest, taxes, depreciation and amortization. See discussion under "Non-GAAP Measures" below.

<sup>5</sup> The Fund has restated the figures as at September 30, 2007 in accordance with EIC-171. See note (b) future income taxes – emerging issues committee abstract EIC-171 on page 16 of the MD&A

## **LIQUIDITY AND CAPITAL RESOURCES**

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

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

The Fund declared no distributions in the first, second and third quarter of 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) 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 will be permanently reduced by \$4,500,000 on or by December 31, 2008 and further permanently reduced on March 31, 2009 by an amount equal to 75% multiplied by 2008 excess cash flow as defined in the agreement. 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 subsequent to September 30, 2008. On November 5, 2008, the Fund reached an agreement with its subordinated loan lenders. 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%, with the Fund's option to capitalize up to 10.0% per annum. The subordinated loan lenders were each issued warrants to purchase up to 500,000 Fund units each at \$0.60 per unit at any time within 36 months of issuance, with a cashless exercise feature if the subordinated lender so desires.

### **Debt Covenants**

Both the term loan and operating 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 month (TTM) EBITDA value of \$8,000,000 for the month ending October 31, 2008 and thereafter. Additionally, the covenants limit the Fund's ability to undertake mergers, acquisitions, incur new indebtedness, declare distributions and undertake other changes in the business without approval of the lender. At September 30, 2008 the Fund reached an agreement with its term and operating loan lender, resulting in compliance with the amended financial covenants as at the end of the third quarter.

The subordinated loan agreement requires 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 TTM EBITDA value of \$8,000,000 for the month ending October 31, 2008 and thereafter, and a total funded debt to adjusted EBITDA ratio of less than 5.0:1.0 until December 30, 2008, at which point the ratio reduces to 3.5:1.0. There are additional restrictive covenants that limit the Fund's ability to undertake mergers, acquisitions, new indebtedness, declare distributions and other changes in the business without approval of the lenders. Subsequent to September 30, 2008, the Fund reached an agreement with its subordinated lender and the lender has provided a waiver covering the breach of all financial covenants.

### **Capital Expenditures**

During the third quarter, the Fund acquired \$37,657 of property and equipment ("maintenance capital expenditures"). Of this, \$11,205 related to distribution infrastructure and head office capacity and the remaining \$26,453 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 \$230,000 annually (\$57,500 for a quarter) on distributable cash and interest expense based on \$23.0 million of debt outstanding.

### **XS Cargo LP Subordinated LP Units**

The Subordinated LP Units will be automatically exchanged for Exchangeable LP Units on a one-for-one basis and the subordination provisions will apply until the end of any fiscal year ending on or after December 31, 2006 if, for that fiscal year the Fund has earned EBITDA (earnings before interest, taxes, depreciation and amortization) of at least \$14.432 million and the Fund has paid distributions of at least \$1.125 per Fund Unit for such fiscal year. For the year ended December 31, 2007, the criteria were not met for the automatic exchange to occur.

### **Contractual Obligations**

The table below sets forth the contractual obligations of the Fund as of September 30, 2008, due in the years indicated, which relate to various premises operating leases, the \$11.25 million outstanding on the term loan that matured on May 16, 2008, and was not repaid and the subordinated loan due on August 20, 2008 and was not repaid.

	<b>Total</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013 and thereafter</b>
Operating							
Leases	21,432,436	1,282,812	4,863,981	3,962,401	3,197,189	2,418,440	5,707,613
Subordinated							
Loan	12,000,000	-	12,000,000	-	-	-	-
Term loan	11,250,000	4,500,000	6,750,000	-	-	-	-
<b>Total</b>	<b>44,682,436</b>	<b>5,782,812</b>	<b>23,613,981</b>	<b>3,962,401</b>	<b>3,197,189</b>	<b>2,418,440</b>	<b>5,707,613</b>

As noted above, the Fund's term loan was due on May 16, 2008 and subordinated loan was due on August 20, 2008. Under the new credit agreement signed September 30, 2008, the term loan has been extended to April 20, 2009 and is to be permanently reduced by \$4,500,000 on or by December 31, 2008. Subsequent to September 30, 2008, a new credit agreement was signed and the subordinated loan maturity date has been extended to June 30, 2009.

## Summary of Quarterly Results (unaudited)

	2008			2007				2006
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Sales	24,525,830	25,080,819	21,765,847	42,653,087	29,250,232	29,519,184	23,657,656	42,339,077
Net (loss) earnings	(20,378)	248,174	(649,052)	(36,283,954)	415,980	(554,670)	(946,985)	1,745,044
Basic and diluted (loss) earnings per unit	(0.00)	0.04	(0.11)	(5.95)	0.07	(0.09)	(0.16)	0.29

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. Management believes that the estimates, assumptions and allocation methods are reasonable in the circumstances. It is possible that materially different results would be reported using different assumptions or allocation methods.

## **Changes in Accounting Policies Including Initial Adoptions**

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

### *Section 1535: Capital Disclosures*

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

*Section 3031: Inventories*

This new standard provides guidance in determining the cost of inventory and its subsequent recognition as an expense. The standard is effective for fiscal periods beginning on or after January 1, 2008 and requires the retrospective application to prior period financial statements. This section did not have a significant impact on the Fund's interim consolidated financial statements.

*Section 1400: General Standards of Financial Statement Presentation*

This section was amended to include requirements for management to assess and disclose the Fund's ability to continue as a going concern. These requirements are effective for interim and annual financial statements for years beginning on or after January 1, 2008, and have been incorporated into the Fund's interim consolidated financial statements in note 1.

**(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 the periods ending June 30, 2007, September 30, 2007 and December 31, 2007, the Fund had recorded those temporary differences associated with the Fund's exchangeable interests or non-controlling interest. As such, the Fund has recorded a reduction in future income tax expense for the nine months ended September 30, 2007 of \$383,441, and a reduction in the future income tax recovery for the three months ended September 30, 2007 of \$240,339. As this also results in an offsetting change in non-controlling interest, there was no effect on net income or earnings per unit for the periods. For the quarters ended March 31, 2008 and June 30, 2008, there has been no change due to the valuation allowance for the future income tax assets as described in note 10. No periods other than those indicated above are affected.

**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.

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

The use of IFRS for financial reporting in Canada will become applicable for the year beginning January 1, 2011. The Fund is currently in the process of developing an implementation strategy to establish timelines and identify significant differences between Canadian GAAP and IFRS. The impacts on the consolidated financial statements of converting to IFRS are unknown at this time.

### **Transactions with Related Parties**

On August 20, 2007, the Fund entered into a subordinated loan agreement for \$12,000,000, funded 50% by an independent third party and 50% by a company owned by Michael McKenna, the President, CEO and a director of XS Cargo GP Inc., the administrator of the Fund. See "Credit Facilities" above for further details regarding this agreement.

Interest expense for the quarter totaling \$260,255 (YTD \$823,497) was recorded on the portion of the loan outstanding to the related party during the quarter. There were no other related party transactions during the three and nine months ended September 30, 2008.

On September 26, 2008 the Fund reached agreement in principle as to the terms of revised financing agreements with the lenders of the subordinated loans. This agreement was closed on November 7, 2008. The terms of the new agreement for the subordinated loan which is funded 50% by an independent third party and 50% by a company owned by Michael McKenna, include:

- The expiry date of the subordinated debt facilities has been extended to June 30, 2009.
- The interest rate is increased from 16% to 18%, with the cash pay interest remaining at 8% and the remaining 10% interest being capitalized.
- Each party received warrants to purchase 500,000 trust units of the Fund at an exercise price of \$0.60 per unit at any time over the next 3 years.
- An amendment fee of \$150,000 (\$75,000 to each lender) was paid.

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 \$26,000 and \$120,000 were charged to the fund by Fleming LLP during the three and nine months ended September 30, 2008.

## Outlook

Problems arising from the implementation of a new merchandise management system severely impacted results in the fourth quarter of 2007. Management is confident the problems are rectified and sees little risk of a recurrence in Q4 2008.

Year to date the Fund has experienced a significant decline in sales. This is due in large part to a rationalization of our product mix which resulted in a decision to exit certain product categories most notably the television category. Additionally, the Fund discontinued both website sales and off-site sales in 2008. These changes accounted for \$7.0 million of the \$11.0 million year to date sales decline. Other miscellaneous products were discontinued in 2008 based on prohibitive freight costs which further contributed to the decline. Year to date reduced administrative and operating expenses and increased gross margins, as a percentage of sales, more than offset the earnings loss resulting from the sales decline compared to 2007.

Our merchandise group has been and continues to work at replacing the loss of sales due to discontinued product categories. As a result of the efforts made to date, management believes that the comparable year to year decline in sales for the first 9 months of 2008 will be significantly reduced in the fourth quarter of 2008 and into 2009.

Management believes a weakening economy will ultimately benefit XS Cargo, relative to the regular retail channel, due to increased product opportunities from cancelled orders and bankruptcies.

Recent weakness in the Canadian dollar presents a short term challenge as approximately 75% of product purchases are made outside Canada in U.S. dollars. As a direct importer XS Cargo is immediately impacted by large moves in the currency. The currency playing field will level as wholesale distributors are forced to increase prices. Management believes it has the necessary pricing power to mitigate the short term effects of the decline in the Canadian dollar.

The Fund has recently finalized new financing agreements with its senior and subordinated lenders. The Fund plans to repay at minimum \$4.5 million of senior debt from earnings at year end, in turn reducing interest expense in 2009.

## Additional Information

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

## Non-GAAP Measures

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

Earnings from operations disclosure under "Third Quarter and Year to date Operating Results" has been calculated as described below. Earnings from operations have been derived by adding interest expense, amortization of property and equipment and intangible assets, unit-based compensation, future income taxes, foreign exchange and non-controlling interest to net earnings for the period. The following table details the reconciliation from net earnings:

<b>Third Quarter (unaudited)</b>	<b>Three Months Ended September 30, 2008</b>	<b>Three Months Ended September 30, 2007</b>	<b>Nine Months Ended September 30, 2008</b>	<b>Nine Months Ended September 30, 2007</b>
Net Earnings (Loss)	(20,378)	415,980	(421,256)	(1,085,675)
Add:		restated		restated
Non-controlling interest	(19,706)	161,720	(407,358)	(664,168)
Future income taxes	-	(248,661)	-	396,719
Foreign exchange (gain) loss	(162,340)	115,216	(117,212)	246,176
Interest on term and subordinated loans	771,207	698,823	2,398,312	1,400,920
Interest on operating loan	144,949	54,027	352,189	229,442
Amortization of intangible assets	78,770	328,100	555,060	954,200
Amortization of property and equipment	494,442	327,936	1,474,965	936,216
Unit based compensation expense	9,375	15,700	12,500	89,060
Earnings (loss) from Operations, as defined	1,296,319	1,868,841	3,847,200	2,502,890

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

## **DISCLOSURE CONTROLS AND PROCEDURES**

The Fund's disclosure controls and procedures (as defined under Multilateral Instrument 52-109 ("MI 52-109") of the Canadian Securities Administrators) have been designed to provide reasonable assurance that material information relating to the Fund, including its consolidated subsidiaries, is made known to the Chief Executive Officer and the Chief Financial Officer of the GP (the "Certifying Officers"), the administrator of the Fund and the general partner of XS Cargo LP, by others within those entities, particularly during the period in which the annual filings are being prepared.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

The Certifying Officers of the Fund are responsible for designing internal controls over financial reporting for the Fund as defined under MI 52-109. The Certifying Officers have designed such internal controls over financial reporting, or caused them to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with GAAP. However, during the Certifying Officers' assessment of the design of internal control over financial reporting as at September 30, 2008, certain weaknesses in internal controls over financial reporting were identified as follows:

- The departure of the Chief Financial Officer effective January 22, 2008, and the departure of the Fund's Controller in December 2007
- Deposits on inventory balances were not followed up and reconciled on a timely basis, resulting in an allowance of \$1.2 million in the fourth quarter of 2007

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

In order to address these weaknesses, the Fund hired a new Controller in the first quarter and hired a new Chief Financial Officer at the end of the second quarter. During the third quarter the Fund has instituted additional reporting steps and re-evaluated its controls to ensure that there is appropriate and regular follow up on inventory deposit balances and that these balances are reconciled on a monthly basis. The Certifying Officers believe that

they have mitigated the risk of a material misstatement in financial reporting during the third quarter.

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

## **RISK FACTORS**

The Fund's results of operations, business prospects, financial condition, cash distributions to unitholders and the trading price of the Fund's units are subject to a number of risks. These risk factors include: the ability of the Fund to continue as a going concern; the ability to maintain profitability and manage growth; the ability to expand through new store openings; the ability to source products in adequate quantities and on acceptable terms; changes in trends and consumer tastes; economic conditions and consumer spending; the success of the Fund's marketing efforts and increased marketing expenditures; competition; reliance on centralized distribution centres; freight costs; ability to maintain comparable store sales; seasonality and fluctuations in quarterly results; reliance on management information systems; increase in the cost of, or disruption in the flow of, imported products; successful management of exposure to merchandise returns; foreign exchange fluctuations; costs and availability of insurance coverage; protection of intellectual property; reliance on key personnel; labour matters, including increased labour costs and labour shortages; dependence on external funding sources; environmental regulation; uncertainties arising from world events; property taxes; the Fund's dependence on its operating subsidiaries; the unpredictability and volatility of the market price of the Fund Units; the nature of the Fund Units; the lack of certainty regarding cash distribution levels; cash on cash yield; the structural subordination of the Fund Units; leverage and restrictive covenants; restrictions on potential growth; changes in income tax legislation and other tax related risks; future sales of Fund Units from treasury; future sales of Fund Units by insiders; the rights of the Vendor in relation to XS Cargo LP; conflicts of interest; unitholder limited liability; the distribution of securities on redemption or termination of the Fund; and the restrictions on certain unitholders and the liquidity of Fund Units. For a discussion of these risks and other risks associated with an investment in Fund Units, see "Risk Factors" detailed in the Fund's Annual Information Form available at [www.sedar.com](http://www.sedar.com).

## **FORWARD LOOKING STATEMENTS**

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

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

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

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