

**STERLING SHOES INCOME FUND**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**November 12, 2008**

*The following management's discussion and analysis ("MD&A") should be read in conjunction with the unaudited interim consolidated financial statements and accompanying notes ("Interim Financial Statements") of Sterling Shoes Income Fund (the "Fund") for the three and nine-month periods ended September 30, 2008. Results have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP" and reported in Canadian dollars unless otherwise indicated). The fiscal year-end of the Fund is December 31.*

*This MD&A contains forward-looking statements. Please see "Forward-Looking Statements" and "Risks and Uncertainties" for a discussion of the risks, uncertainties and assumptions relating to these statements. This MD&A also makes reference to certain non-GAAP measures to assist in assessing our financial performance. Non-GAAP measures do not have any standard meaning prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. See "Non-GAAP Measures" and "Adjusted Distributable Cash".*

**OVERVIEW OF THE FUND**

The Fund is a Vancouver-based, leading footwear retailer offering a broad selection of private label and brand name shoes and accessories through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet. These retail concepts were designed to serve identified market segments which we can effectively and profitably serve. Since 1987 the Sterling Shoes business (formerly carried on by Sterling Shoes Inc.) has grown from five locations to 160 stores as at November 12, 2008. These stores are located primarily in high-traffic, high-visibility locations within enclosed shopping malls, on high streets and in strip malls.

The Fund is an unincorporated, open-ended, limited-purpose trust established under the laws of the Province of British Columbia pursuant to the declaration of trust dated May 31, 2005. The Fund was established to acquire an 80% interest in Sterling Shoes Limited Partnership ("Sterling Shoes LP"), which had acquired the retail footwear business of SSI Investments Inc., previously named Sterling Shoes Inc. ("Inc"). Inc retained a 20% interest in Sterling Shoes LP.

As at November 12, 2008, there were 5,313,488 units ("Units") of the Fund issued and outstanding. In addition, to provide Inc with voting rights commensurate with Inc's retained interest in Sterling Shoes LP, Inc holds 1,328,372 special voting units of the Fund (equal to the number of Class D LP Units Inc holds in Sterling Shoes LP (the "Class D LP Units")), which entitle the holder to one vote per special voting unit at meetings of unitholders of the Fund ("Unitholders").

Distributions on the Class D LP Units were subordinated and the Class D LP Units themselves were not exchangeable for Units of the Fund until the Subordination End Date. As a result of the Fund achieving a specified EBITDA target for the year ended December 31, 2007 and distribution target for each of the fiscal years ended December 31, 2007 and 2006, the Subordination End Date has occurred.

Consequently, the Class D LP Units became freely exchangeable for Units on a one-for-one basis and were reclassified from non-controlling interest to unitholders' equity in 2008. Also, the distributions on the Class D LP Units are no longer subordinated and are made monthly, instead of quarterly.

On October 3, 2007 the Fund closed an offering of \$25 million of convertible unsecured subordinated debentures (the "Debentures") at a price of \$1,000 per debenture. The Debentures bear

interest at an annual rate of 6.5% payable semi-annually in arrears on October 31 and April 30 in each year commencing April 30, 2008. The maturity date for the Debentures is October 31, 2012.

The Debentures are convertible at any time at the option of the holders into Units of the Fund at a conversion rate of approximately 47.281 Units per \$1,000 principal amount of Debentures, which is equal to a conversion price of \$21.15 per Unit (or 1,182,025 Units). After October 31, 2010 and on or before October 31, 2011, the Fund will have the right to redeem in cash or in units of the Fund all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest, provided that the market price on the date on which the notice of redemption is given is not less than 125% of the conversion price. After October 31, 2011, the Fund will have the right to redeem all or a portion of the Debentures equal to the principal amount plus accrued and unpaid interest.

The Units trade on the Toronto Stock Exchange under the symbol SSI.UN and the Debentures trade under the symbol SSI.DB.

## RECENT EVENTS AND OUTLOOK

In response to current and expected market conditions, on November 12, 2008 the Fund announced a reduction in its monthly distribution to \$0.03333 (\$0.40 on an annualized basis) per Unit beginning with the November 2008 distribution, payable on December 15, 2008. The Fund takes a long term view of distributions that considers, among other criteria, current and expected economic and operating conditions. While our operations are sound, in view of the deteriorating economic conditions and the heightened risk in the credit markets, we consider it prudent to reduce the distribution in order to maintain our sound balance sheet. We intend to continue with our plans to focus on investing in our infrastructure. This will allow us to position our business for sustainable long-term earnings and distributions growth once economic conditions stabilize.

During the third quarter of 2008, we continued to expand with a focus on balancing store openings between eastern and western Canada as well as between our various banners. Since January 1, 2008, the Fund has opened 19 stores, renovated 5 stores and relocated 2 stores. The normal course of business also includes closing stores due to a number of factors such as the redevelopment of real estate in malls, high streets and strip malls, changes in the economic environment and lease terms. There were no store closures in the third quarter of 2008; however, we anticipate closing a few underperforming stores during 2009.

During 2009 the Fund has committed to opening 4 stores to date. Management is taking a cautious approach to additional store openings and expansion in light of uncertain economic conditions.

Our 160 stores operate under six retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

November 12, 2008								Dec 31, 2007	Dec 31, 2006	Dec 31, 2005	July 12, 2005
Province	Shoe Warehouse	Sterling	Joneve	Freedman	Gia	Sterling Outlet	Total	Total	Total	Total	Total
British Columbia	38	20	6	7	2	-	73	65	63	60	59
Alberta	14	8	2	-	-	1	25	25	25	24	24
Saskatchewan	2	2	-	-	-	-	4	3	3	4	4
Manitoba	9	3	-	-	-	-	12	12	11	11	11
Ontario	13	27	5	1	-	-	46	36	25	5	2
<b>Total</b>	<b>76</b>	<b>60</b>	<b>13</b>	<b>8</b>	<b>2</b>	<b>1</b>	<b>160</b>	<b>141</b>	<b>127</b>	<b>104</b>	<b>100</b>

### STERLING SHOES INCOME FUND

The actual timing of and number of additional store openings could differ materially from what is described herein if Sterling Shoes LP is unable to reach timely and satisfactory agreements with the various landlords as to the final lease documentation, to secure adequate labour and materials to construct the stores, to deliver sufficient inventory, to adapt its operational systems, or to hire, train and integrate employees.

## **FUTURE INCOME TAXES**

On October 31, 2006, the Minister of Finance announced proposed changes to the income tax treatment of “flow-through entities”, including income trusts. On June 22, 2007 the Government of Canada enacted new legislation imposing a tax on distributions paid by publicly traded income trusts in Canada, commencing in 2011. Unitholders will be treated as if they have received an eligible dividend from a Canadian public corporation equal to the taxable portion of their distributions and will be taxed accordingly.

Prior to June 22, 2007, the Fund calculated its future income tax on certain temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil tax rate. Under the newly enacted legislation, the tax rate on the post-2010 reversal of these temporary differences is estimated to be 27.5%. Temporary differences reversing prior to December 31, 2010 will still give rise to nil future income taxes. Based on its assets and liabilities as at December 31, 2007, the Fund has estimated the amount of its temporary differences which were previously not subject to tax and the period in which these differences will reverse.

As a result of this new legislation, Canadian accounting guidance requires that the Fund record a future tax liability and a corresponding, one-time, non-cash charge to net income. The Fund’s identifiable intangible assets, recorded on the balance sheet at \$49.0 million, (but which have nil basis for tax purposes), are treated as a temporary difference that will reverse after January 1, 2011.

The result of this treatment was a future income tax liability of \$7.7 million created during the second quarter of 2007. This future income tax liability was based on the expected tax rate of 31.5% and the assumption that the Fund will be a taxable entity in 2011. Based on the currently enacted tax rate of 27.5%, and the same assumptions, the Fund revised this future income tax liability during the first quarter of 2008 to \$7.0 million. For the three and nine-month periods ended September 30, 2008, the estimated future income tax liability was reduced by \$nil and \$0.7 million, respectively, based on the temporary differences between the accounting and tax basis of the Fund’s assets and liabilities as at September 30, 2008 expected to reverse after January 1, 2011.

In future periods, adjustments to this future tax liability may be required based on changes in the differences between the tax basis and financial statement basis of the Fund’s assets and liabilities. These adjustments could be material. Consistent with the initial recognition, any future adjustments will be non-cash in nature and will be either a charge or an addition to net income of the period.

Since this tax will not be in effect until 2011, any changes to the tax legislation or to the legal structure of the Fund prior to that time could have a material effect on the level of the future income taxes recorded by the Fund.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)

The Canadian Accounting Standards Board (AcSB) will require all public companies to adopt IFRS, replacing Canadian GAAP, for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Fund will be required to prepare comparative financial information using IFRS for the year ended December 31, 2010. The Fund expects the transition to IFRS to impact financial reporting, business processes, and information systems. The Fund is assessing the impact of adoption of IFRS and developing a plan for convergence. Training and additional resources will be utilized to ensure timely conversion to IFRS. The financial impact of the transition to IFRS cannot be reasonably estimated at this time.

## SUMMARY FINANCIAL INFORMATION

Statement of Income Items (\$000's)	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Sales	\$ 33,895	30,483	88,248	82,675
Cost of Sales	(17,333)	(13,315)	(45,603)	(35,870)
Gross Margin	16,562	17,168	42,645	46,805
<i>As a percentage of sales</i>	48.9%	56.3%	48.3%	56.6%
Store and selling expenses	(12,112)	(10,566)	(33,400)	(29,774)
General and administrative expenses	(1,736)	(1,643)	(5,370)	(5,194)
EBITDA <sup>(1)</sup>	2,714	4,959	3,875	11,837
Adjusted EBITDA <sup>(1)</sup>	2,617	4,874	3,593	11,599
<i>As a percentage of sales</i>	7.7%	16.0%	4.1%	14.0%
Interest expense	(494)	(194)	(1,647)	(488)
(Loss) / Gain on disposal	0	0	(333)	5
Amortization	(818)	(716)	(2,348)	(2,121)
Income / (Loss) before non-controlling interest and taxes <sup>(2)(3)</sup>	1,402	4,049	(453)	9,233
Future income taxes	0	0	724	(7,724)
Income / (Loss) before non-controlling interest <sup>(2)(3)</sup>	1,402	4,049	271	1,509
Non-controlling interest <sup>(2)(3)</sup>	-	815	-	317
Net income / (loss)	\$ 1,402	3,234	271	1,192
Maintenance capital expenditures <sup>(4)</sup>	330	653	2,339	2,591

  

Balance Sheet Items (\$000's)	September 30, 2008	December 31, 2007
Total assets	116,329	111,192
Long-term financial liabilities	21,689	21,243

Notes:

- (1) See definition of EBITDA and Adjusted EBITDA under "Non-GAAP Measures".
- (2) In any fiscal year Sterling Shoes LP and the Fund intend to make distributions of available cash to the maximum extent possible to the Unitholders and the non-controlling interest. Sterling Shoes LP and the Fund may make additional distributions in excess of monthly distributions during the year, as the Boards determine. Distributions to Unitholders and the non-controlling interest will be determined by the Boards.
- (3) Effective April 1, 2008, distributions to the non-controlling interest are made monthly and are no longer subordinated. These distributions were subject to subordination pending the Fund achieving explicit EBITDA targets, based on audited consolidated financial statements, and distribution targets. For further information see "End of Subordination". On the Subordination End Date, the non-controlling interest held by Inc, which retained a 20% in the business of Sterling Shoes LP, has been reclassified to unitholders' equity. As a result,

(loss) / income before non-controlling interest and taxes is applicable to the quarters up to December 31, 2007 only.

- (4) "Maintenance Capital Expenditures" is not a recognized measure under GAAP. Maintenance Capital Expenditures include those required to upgrade existing stores and to maintain information systems and equipment and our warehouse.

The table below summarizes the distributions declared during the three and nine-month periods ended September 30, 2008 and 2007 for Units of the Fund and to Inc on the Class D LP Units:

	<u>Three-months ended Sept 30</u>		<u>Nine-months ended Sept 30</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Trust Units	\$ 1,993	\$ 1,913	5,978	5,739
Inc's ownership in Sterling Shoes LP	498	478	1,494	1,435
Total	\$ <u>2,491</u>	\$ <u>2,391</u>	<u>7,472</u>	\$ <u>7,174</u>

## OPERATING RESULTS

### *Sales*

Sales were \$33.9 million during the three-month period ended September 30, 2008, representing an increase of 11.1% over the \$30.5 million in 2007. The growth in sales was a result of incremental growth from new stores not opened for the full quarter ended September 30, 2007 and sales from new stores opened since October 1, 2007.

The Fund experienced same-store sales growth of 2.1% in those stores that were open at least three months leading up to October 1, 2007.

For the nine-month period ended September 30, 2008, sales increased to \$88.2 million or 6.7% over the same period in 2007. During the nine-month period ended September 30, 2008 same store sales grew by 1.1% in those stores that were open at least nine-months leading up to October 1, 2007.

Our ability to grow sales will depend on a number of factors including our ability to successfully identify and respond to changes in trends and customer tastes, our ability to hire, train, motivate, manage and retain qualified buyers, retail store management and personnel, as well as other factors further outlined in Risks and Uncertainties.

### *Cost of sales, gross margin and change in inventory valuation methodology*

Cost of sales as a percentage of sales, for the three and nine-month periods ended September 30, 2008 was 51.1% and 51.7%, compared to 43.7% and 43.4% respectively for the same periods during 2007.

A number of factors contributed to higher cost of sales during the third quarter and nine-month period ended September 30, 2008, especially relative to the same periods during 2007. These factors include:

Cost of sales during the third quarter of 2008 was impacted by an increase in the obsolescence provision, whereas in the same quarter in 2007 there was a decrease in the obsolescence provision.

Increases in product costs, which include labour and material input costs at the factory level; transportation and distribution costs at local, national and international levels; as well as warehousing costs, also contributed to higher cost of sales during the third-quarter and nine-month period ended September 30, 2008.

A one-time \$3.3 million increase in inventory valuation at January 1, 2008 resulting from the application of a change in accounting standards.

Changing inventory valuation methodology has also changed the timing of the realization of markdowns in cost of sales. The impact of the timing of markdowns had a greater impact during the third quarter and nine-month period ended September 30, 2008 than during the same periods during 2007.

In June 2007, the CICA issued CICA Handbook Section 3031 – “Inventories”, which replaced Section 3030 of the same title. The new standard has been developed based on International Financial Reporting Standards (“IFRS”). See “Critical Accounting Estimates – *Inventory Valuation*”

This Section applies to interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The Fund has applied this section to the opening inventory for fiscal 2008 resulting in a one-time, \$3.3 million increase. Opening retained earnings as at January 1, 2008 was also adjusted for the difference on adoption of the new standard (prior periods will not be restated).

Tax treatment usually follows accounting principles; however, the Income Tax Act requires this write-up of inventory to be included into income for income tax purposes. Therefore, during 2008 taxable income will be \$3.3 million greater than accounting income.

Margins from season to season under the new inventory valuation method will vary greatly, and will be impacted by the above noted \$3.3 million write-up in inventory values until the January 1, 2008 opening inventory is completely sold. Management believes that in future calendar years, if all else remains the same, margins under the previous method and the new method are expected to be largely the same. The difference from season to season is expected to be related to timing. Margins calculated under the previous method and the new method are not comparable in finite periods.

#### ***Store and selling expenses***

Store and selling expenses for the three and nine-months ended September 30, 2008 were 35.7% and 37.9% of sales, compared to 34.7% and 36.0% for the same periods during 2007, respectively. Store and selling expenses have a fixed underlying core with a large variable component, primarily consisting of expenses relating to occupancy and employee costs.

The Fund opened 10 new stores during the third quarter of 2008, and an additional 2 up to November 12, 2008, for a total of 99 new leases since its initial public offering (65 new stores and 34 renewals). New stores have a higher rent profile than the average store base, which has resulted in higher occupancy charges compared to the third quarter of 2007. Higher lease rates on renewals further reflect the increasingly expensive real estate environment, especially in Western Canada.

Significant labour cost pressures were evident during the course of the year and continued into the third quarter of 2008. While pressures on labour costs are most acute in Western Canada, the cost of benefits is higher in Ontario than in the Western provinces. Staff training and other staffing-related store opening costs were also higher due to the number of store openings during the quarter.

### *General and administrative expenses*

General and administrative (“G&A”) expenses for the three and nine-months ended September 30, 2008 were 5.1% and 6.1% of sales, compared to 5.4% and 6.3% during the same periods in 2007, respectively.

Overall G&A expenses were higher in dollar terms in the third quarter of 2008 as compared to 2007, resulting from increased office expenses and professional fees.

On-going investments in the Fund’s growth initiatives involved higher salary costs as we hired key people into areas of need, higher professional fees as we review and assess various options to improve our inventory management and enterprise resource planning systems, offset in part by lower costs arising from no long-term incentive plan and management bonus accruals during the quarter.

### *Adjusted EBITDA* (see “Non-GAAP Measures”)

Adjusted EBITDA for the three and nine-months ended September 30, 2008 was 7.7% and 4.1% of sales, respectively, compared to 16.0% and 14.0% for the same periods during 2007.

### *Income before non-controlling interest and taxes*

As described above in “Overview of the Fund”, on the Subordination End Date, distributions on the Class D LP units were no longer subordinated and the Class D LP Units became freely exchangeable for Units on a one-for-one basis. As a result, the Class D LP Units have been reclassified from non-controlling interest to unitholders’ equity.

### **SELECTED QUARTERLY FINANCIAL INFORMATION**

<b>in (\$000's) except per Unit amounts</b>	<b>Q3-2008</b>	<b>Q2-2008</b>	<b>Q1-2008</b>	<b>Q4-2007</b>	<b>Q3-2007</b>	<b>Q2-2007</b>	<b>Q1-2007</b>	<b>Q4-2006</b>
Sales	\$ 33,895	\$ 29,405	\$ 24,948	\$ 36,083	\$ 30,483	\$ 28,242	\$ 23,950	\$ 31,415
Income / (Loss) before non-controlling interest and taxes <sup>(1)</sup>	\$ 1,402	\$ 866	\$ (2,723)	\$ 5,228	\$ 4,049	\$ 2,915	\$ 2,268	\$ 3,529
Future income taxes	-	-	724	-	-	(7,724)	-	-
Income / (Loss) before non-controlling interest <sup>(1)</sup>	\$ 1,402	\$ 866	\$ (1,999)	\$ 5,228	\$ 4,049	\$ (4,809)	\$ 2,268	\$ 3,529
Net income / (loss)	\$ 1,402	\$ 866	\$ (1,999)	\$ 4,153	\$ 3,329	\$ (3,849)	\$ 1,807	\$ 2,822
Basic and fully diluted income / (loss) per Unit	\$ 0.211	\$ 0.130	\$ (0.371)	\$ 0.787	\$ 0.610	\$ (0.724)	\$ 0.340	\$ 0.531
Cash distributions per Unit	\$ 0.375	\$ 0.375	\$ 0.375	\$ 0.780	\$ 0.360	\$ 0.360	\$ 0.360	\$ 0.815
Number of stores open at end of period	158	148	143	141	138	135	127	127

Notes:

- (1) During the quarter ended March 31, 2008, the non-controlling interest held by Inc, which retained a 20% in the business of Sterling Shoes LP has been reclassified to unitholders’ equity. For further information see “End of Subordination”. As a result, (loss) / income before non-controlling interest and taxes is applicable to the quarters up to December 31, 2007 only.

Refer to the discussion on the change in inventory valuation under “Operating Results” above for a description of its impact on the income for the period. Our sales are seasonal, primarily related to consumer spending patterns. The footwear and accessories sector of the Canadian retail market has two primary selling seasons during which new merchandise is introduced – Spring and Fall. Gross margins fluctuate over the course of these two primary selling seasons. Other factors include, and are not limited to, the timing of new store openings, merchandise mix and weather.

In any given period, weather can have a material impact on our business. As we become more geographically diversified, we expect weather-related effects to be less significant.

## CASH FLOW AND LIQUIDITY

The table below reconciles net income to cash flow from operations for the three and nine-months ended September 30, 2008 and 2007.

in (\$000's)	Three-months ended Sept 30		Nine-months ended Sept 30	
	2008	2007	2008	2007
<b>Income before non-controlling interest</b> <sup>(1)</sup>	\$ 1,402	4,049	271	1,509
Add charges (deduct credits) to operations not requiring a cash payment:				
Revaluation of inventory per CICA Handbook Section 3031	-	-	3,306	-
Future income taxes	-	-	(724)	7,724
Amortization of leaseholds and equipment	818	716	2,348	2,121
Accreted interest expense	17	-	446	-
Amortization of deferred leasehold inducements	(97)	(85)	(282)	(238)
Loss on disposal of leaseholds and equipment	-	-	333	-
	2,140	4,680	5,698	11,116
Net change in non-cash working capital balances related to operations:				
Accounts receivable	(295)	(31)	261	(359)
Inventory	(8,889)	(6,260)	(16,620)	(13,923)
Prepaid expenses and deposits	231	(85)	207	(337)
Accounts payable and accrued liabilities	5,322	6,053	4,729	7,924
<b>Cash (used in) / provided by operating activities</b>	\$ (1,491)	4,357	(5,725)	4,421

Notes:

- (1) During the quarter ended March 31, 2008, the non-controlling interest held by Inc, which retained a 20% in the business of Sterling Shoes LP has been reclassified to unitholders' equity. For further information see "End of Subordination". As a result, income / (loss) before non-controlling interest and taxes is applicable to the quarters up to December 31, 2007 only.

The Fund invested in capital expenditures of \$1.8 million and \$5.5 million during the three and nine-months ended September 30, 2008 (2007 - \$1.5 million and \$5.1 million), respectively. Of this amount \$1.2 million and \$3.1 million were invested in leaseholds and equipment to furnish new stores during the three and nine-months ended September 30, 2008 (2007 - \$0.8 million and \$2.5 million), respectively. The Fund incurred maintenance capital expenditures of \$0.3 million and \$2.3 million during the three and nine-months ended September 30, 2008 (2007 - \$0.7 million and \$2.6 million), which were related to upgrades to information technology ("IT") infrastructure, store renovations and store relocations. New store capital expenditures and maintenance capital expenditures were funded by cash from operations and the Fund's available credit facilities.

## DISTRIBUTABLE CASH AND DISTRIBUTIONS

In any fiscal year Sterling Shoes LP and the Fund intend to make distributions of available cash to the maximum extent possible to the Unitholders and the non-controlling interest. This includes the distribution of all available cash from operations after cash required for maintenance capital expenditures, and after consideration of changes in non-cash working capital balances and other reserves considered advisable by the Fund's Board.

The Fund may make additional distributions in excess of monthly distributions. Distributions declared in respect of the month ended December 31 of each year may include such amounts as are necessary to ensure that the Fund will not be liable for income taxes under Part I of the Tax Act.

The Fund reviews its historic and expected results on a regular basis. This review includes consideration of economic conditions, including seasonality, and the competitive environment. Distributions made may not equal Adjusted Distributable Cash generated in any one period. The Fund's policy is to make stable monthly distributions to Unitholders based on estimated Adjusted Distributable Cash for the year.

## ADJUSTED DISTRIBUTABLE CASH

On July 6, 2007 the Canadian Securities Administrators ("CSA") amended National Policy 41-201 "Income Trusts and Other Indirect Offerings" (the "CSA Guidance"). The Fund has calculated Standardized Distributable Cash based on the CSA Guidance as cash flows from operating activities, including the effects of changes in non-cash working capital, less sustaining (maintenance) capital expenditures. The Fund has also retained the Fund's historical Non-GAAP measure of Adjusted Distributable Cash (formerly Distributable Cash) by further adjusting Standardized Distributable Cash to exclude the effect of changes in non-cash working capital. The table below is a summary of Standardized Distributable Cash and Adjusted Distributable Cash and per Unit and Ratio disclosures for the three and nine-month periods ended September 30, 2008 and 2007.

in \$000's except per unit amounts and payout ratios	Three-months ended Sept 30		Nine-months ended Sept 30	
	2008	2007	2008	2007
<b>Standardized Distributable Cash</b>				
Cash (used in) / provided by operating activities	\$ (1,491)	4,357	(5,725)	4,421
Less: Maintenance Capital Expenditures	(330)	(890)	(2,339)	(2,591)
<b>Standardized distributable cash generated</b>	<b>\$ (1,821)</b>	<b>3,467</b>	<b>(8,064)</b>	<b>1,830</b>
Less: Changes in non-cash working capital balances related to operation	(3,631)	(323)	(11,423)	(6,695)
<b>Adjusted distributable cash generated</b>	<b>\$ 1,810</b>	<b>3,790</b>	<b>3,359</b>	<b>8,525</b>
Adjusted Distributable Cash available for distribution to Unitholders	\$ 1,810	3,032	3,359	6,820
Adjusted Distributable Cash generated per Unit	\$ 0.273	0.571	0.506	1.284
Distributions declared per Unit	\$ 0.375	0.360	1.125	1.080
Adjusted Payout Ratio	137.6%	63.1%	222.4%	84.1%
Number of units outstanding:	6,641,860	5,313,488	6,641,860	5,313,488

Management believes that the Standardized Distributable Cash calculation introduces significant volatility to the Fund's quarter-to-quarter distributable cash and payout ratios, as our non-cash working capital fluctuates significantly as a result of the seasonality of our business, changes in the timing of the payment of payable transactions and the investment in working capital required to open new stores. As a result, management believes our historical measure of Adjusted Distributable Cash, which excludes the impact of changes in non-cash working capital, is a better measure for determining our operating performance.

For the three and nine-months ended September 30, 2008, using the Adjusted Distributable Cash calculation, the adjusted payout ratio indicates that we have generated significantly less cash from on-going operations than we have paid out to Unitholders. The Fund's Board looks beyond quarter-to-quarter fluctuations in working capital when making decisions regarding monthly distributions. As mentioned earlier, the Fund's policy has been to make distributions to its Unitholders necessary to pay out its taxable income. The adjusted payout ratio for the trailing twelve months ended September 30, 2008 was 139.3%, as compared to 86.7% for the twelve months ended September 30, 2007.

As noted under "Recent Events and Outlook", on November 12, 2008 the Fund announced a reduction in its monthly distribution to \$0.03333 (\$0.40 on an annualized basis) per Unit beginning with the November 2008 distribution, payable on December 15, 2008.

Cash distributions have been made as follows:

Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit	Distribution History Year / Month	Distributions per Unit
<b>2005</b>		<b>2006</b>		<b>2007</b>		<b>2008</b>	
		January	\$ 0.08958	January	\$ 0.12000	January <sup>(9)</sup>	\$ 0.12500
		February	0.08958	February	0.12000	February	0.12500
		March	0.08958	March	0.12000	March	0.12500
		April	0.08958	April	0.12000	<b>Q1-2008</b>	\$ 0.37500
		May <sup>(3)</sup>	0.10500	May	0.12000		
		June	0.10500	June	0.12000	April	\$ 0.12500
		July	0.10500	July	0.12000	May	0.12500
		August	0.10500	August	0.12000	<b>June</b>	<b>0.12500</b>
July / August <sup>(1)</sup>	\$ 0.14737	September	0.10500	September	0.12000	<b>Q2-2008</b>	\$ 0.37500
September	0.08958	October	0.10500	October	0.12000		
October	0.08958	November <sup>(4)</sup>	0.12000	November	0.12000	July	\$ 0.12500
November	0.08958	December	0.12000	December	0.12000	August	0.12500
December	0.08958	December <sup>(5)</sup>	0.32000	December <sup>(7)</sup>	0.36000	September	0.12500
December <sup>(2)</sup>	0.16000	December <sup>(6)</sup>	0.15000	December <sup>(8)</sup>	0.06000	<b>Q3-2008</b>	\$ 0.37500
<b>Total 2005</b>	<b>\$ 0.66569</b>	<b>Total 2006</b>	<b>\$ 1.69832</b>	<b>Total 2007</b>	<b>\$ 1.8600</b>	October <sup>(10)</sup>	\$ 0.12500
						<b>Total year-to-date 2008</b>	<b>\$ 1.2500</b>

Notes:

- (1) The Fund made its initial distribution of \$0.14737 per Unit for the 51-day period from July 12, 2005 to August 31, 2005.
- (2) On December 13, 2005 the Fund announced a special distribution of \$0.16 per Unit to Unitholders of record on December 30, 2005, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2005. \$0.16 per Unit, the Fund's estimate of this amount, was paid on January 16, 2006 to Unitholders of record on December 30, 2005.
- (3) Effective May 1, 2006 the Fund raised its monthly distribution by 17.2% from \$0.08958 per Unit to \$0.105 per Unit.
- (4) Effective November 1, 2006 the Fund raised its monthly distribution by 14.3% from \$0.105 per Unit to \$0.12 per Unit.
- (5) On December 18, 2006 the Fund announced a special distribution of \$0.32 per Unit to Unitholders of record on December 29, 2006, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. This amount was paid on January 15, 2007 to Unitholders of record on December 29, 2006.
- (6) On March 22, 2007 the Fund announced a supplementary special distribution of \$0.15 per Unit to Unitholders of record on December 29, 2006, representing the Fund's remaining distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2006. The \$0.15 per Unit supplementary special is in addition to the \$0.32 per Unit that was estimated at December 18, 2006 and paid on January 15, 2007. The \$0.15 per Unit was paid on March 30, 2007 to Unitholders of record on December 29, 2006.
- (7) On December 17, 2007 the Fund announced a special distribution of \$0.36 per Unit to Unitholders of record on December 31, 2007, representing the Fund's estimate of the distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. This amount was paid on January 15, 2008 to Unitholders of record on December 31, 2007.
- (8) On March 26, 2008 the Fund announced a supplementary special distribution of \$0.06 per Unit to Unitholders of record on December 31, 2007, representing the Fund's remaining distribution required to ensure the Fund was not liable for income taxes under Part I of the Tax Act for fiscal 2007. The \$0.06 per Unit supplementary special is in addition to the \$0.36 per Unit that was estimated at December 17, 2007 and paid on January 15, 2008. The \$0.06 Unit was paid on March 31, 2008 to Unitholders of record on December 31, 2007.

- (9) Effective January 1, 2008 the Fund raised its monthly distribution by 4.2% from \$0.12 per Unit to \$0.125 per Unit.
- (10) Effective November 1, 2008 the Fund reduced its monthly distribution by 73% from \$0.125 per Unit to \$0.0333 per Unit.

Distributions are paid on the 15<sup>th</sup> of each month, or the next following business day, to Unitholders of record on the last business day of the preceding month. Unitholders who are non-residents of Canada are required to pay all withholding taxes payable on any distributions by the Fund. Effective April 1, 2008, distributions to the non-controlling interest are made monthly and are no longer subordinated. These distributions were subject to subordination until December 31, 2007 pending the Fund achieving specific EBITDA and distribution targets. For further information see "End of Subordination".

Effective January 1, 2008, the Fund raised its monthly distributions from \$0.12 per Unit to \$0.125 per Unit. The Fund declared distributions (excluding special distributions) to public Unitholders of \$2.0 million and \$6.0 million for the three and nine-months ended September 30, 2008 (2007 - \$1.9 million and \$5.7 million). Furthermore, Sterling Shoes LP declared distributions (excluding special distributions) to Inc, the holder of the Class D LP Units, of \$0.5 million and \$1.5 million for the three and nine-months ended September 30, 2008 (2007 - \$0.5 million and \$1.4 million), respectively. Effective November 1, 2008, the Fund reduced its monthly distributions from \$0.125 per Unit to \$0.03333 per Unit.

## **NON-GAAP MEASURES**

References to "EBITDA" are to earnings before interest, income taxes, depreciation and amortization and references to "Adjusted EBITDA" are to EBITDA after adjusting for amortization of leasehold inducements. EBITDA is a measure used by many investors to compare issuers on the basis of ability to generate cash flow from operations. Adjusted EBITDA is a measure our management believes facilitates the comparability and analysis of our financial performance. EBITDA and Adjusted EBITDA are not earnings measures recognized by GAAP and do not have standardized meanings prescribed by GAAP and are therefore unlikely to be comparable to similar measures presented by other issuers. We intend to distribute substantially all of our cash on an on-going basis (after providing for certain amounts described elsewhere in this MD&A) and, accordingly, our management believes that EBITDA and Adjusted EBITDA are important supplemental measures in evaluating our performance and in determining whether to invest in Units.

You are cautioned that EBITDA and Adjusted EBITDA should not be construed as an alternative to net income or loss determined in accordance with GAAP as indicators of our performance or to cash flows from operating, investing and financing activities as measures of our liquidity and cash flows.

"Maintenance Capital Expenditures" is not a recognized measure under GAAP. Maintenance Capital Expenditures include those required to upgrade existing stores and to maintain information systems and equipment and our warehouse.

## **CAPITAL RESOURCES**

On October 3, 2007 the Fund closed the offering of Debentures. The offering was completed on a "bought deal" basis by a syndicate of underwriters led by CIBC World Markets Inc. that included

BMO Nesbitt Burns Inc., Canaccord Capital Corporation and TD Securities Inc.

A portion of the net proceeds from the offering was used to repay existing bank indebtedness of approximately \$13 million. The balance of the net proceeds was used for existing expansion and corporate commitments during 2008. Since our initial public offering, the Fund has opened 65 stores (60 net openings), renovated 21 stores and relocated 11 stores. Previously we used our credit facilities to finance capital expenditure associated with our store openings, renovations and relocations, as well as the growth in inventory required for our new and existing stores. The Fund may access the capital markets to assist in its growth, as appropriate. There can be no assurance that the Fund will be able to access new capital or new long term debt on acceptable terms.

We have a \$15 million operating facility, which is available for working capital requirements, capital expenditures and for general corporate purposes. As at September 30, 2008, we have utilized \$7.8 million of the operating facility.

We have an additional \$10 million term facility, \$5 million of which is currently available for general funding of new store facilities. The other \$5 million is available dependent upon financial performance. As at September 30, 2008 we have not utilized any of the new store capital expenditure facility.

At September 30, 2008, the Fund was in compliance with all covenants of its credit facilities.

#### **OFF-BALANCE SHEET FINANCING**

The Fund enters into standby letters of credit to facilitate the international purchase of merchandise and to secure certain of our obligations, including insurance programs and duties related to import purchases. As of September 30, 2008 letters of credit totaling \$1,364 thousand have been issued. The Fund has no other off balance sheet arrangements.

#### **CONTRACTUAL OBLIGATIONS**

The Fund has the following inventory purchase, long-term debt and minimum rental commitments for premises, over the remainder of this year and the next four fiscal periods, in thousands of dollars:

<u>in \$000's</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Inventory purchase commitments	1,364				
Long-term debt					25,000
Minimum rental commitments <sup>(1)</sup>	<u>4,221</u>	<u>15,037</u>	<u>13,937</u>	<u>12,676</u>	<u>12,065</u>
	<u>5,585</u>	<u>15,037</u>	<u>13,937</u>	<u>12,676</u>	<u>37,065</u>

Note:

(1) Excludes percentage rent adjustments and operating expense adjustments.

#### **TRANSACTIONS WITH RELATED PARTIES**

- (a) The Fund paid rent to a company in which Jeremy Horwitz and Mannie Druker, trustees and officers of the Fund have an interest, amounting to \$71 thousand and \$212 thousand for the three and nine-month periods ended September 30, 2008 ( 2007 – \$53 thousand and \$158 thousand), respectively.

- (b) The Fund purchased equipment from a company in which Mannie Druker, a trustee and officer of the Fund has an interest, for \$190 thousand and \$413 thousand during the three and nine-month periods ended September 30, 2008 ( 2007 – \$137 thousand and \$464 thousand), respectively.

These transactions arose during the normal course of business and have been recorded at the exchange amount, which is the amount agreed upon by the parties.

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements requires us to estimate the effect of several variables that are inherently uncertain. These estimates and assumptions can affect the reported amounts of assets, liabilities, sales and expenses. Management bases its estimates on historical experience and other assumptions, which it believes to be reasonable under the circumstances. Management also evaluates its estimates on an ongoing basis. Our significant accounting policies are described in Note 2 of the Fund's unaudited interim consolidated financial statements for the three and nine-month periods ended September 30, 2008. Management believes that the following items represent the Fund's critical accounting estimates.

### ***Inventory Valuation***

Effective January 1, 2008, the Fund adopted CICA Handbook Section 3031, Inventories ("Section 3031"). Section 3031 requires inventories to be measured at the lower of cost and net realizable value. The Fund determines inventory cost based on a weighted average cost formula and values inventory at the lower of cost and net realizable value. The Fund previously valued its inventory at the lower of average cost and net realizable value less a normal profit margin, using the retail method. Under the previous method, the net realizable value included a reduction for a normal profit margin taking into consideration current and expected selling prices, historic sales patterns for the inventory, recent product introductions and the level of inventory on hand. Section 3031 excludes from the definition of net realizable value the ability to maintain a normal profit margin and notes that the retail method is only an acceptable technique for measuring inventories if the results approximate cost. Upon adoption of the new standard, inventory was increased by a one-time adjustment of \$3.3 million on January 1, 2008, which was credited to opening retained earnings.

### ***Intangible assets***

Identifiable intangible assets, including store banners and private label brand names, are carried at cost. These assets have been determined by management to have indefinite lives and are therefore not being amortized. These assets are reviewed at least annually for impairment or whenever events or changes in circumstances indicate that the carrying amount of an asset may be impaired.

If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds fair value.

### ***Goodwill***

Goodwill is recorded at cost and is not amortized. Goodwill is reviewed for impairment at least annually, or whenever events or changes in circumstances indicate that the carrying amount may be impaired. If goodwill is considered to be impaired, the impairment to be recognized is measured as the estimated amount by which the carrying amount of the goodwill exceeds fair value.

### ***Future income taxes***

Future income tax assets and liabilities are determined based on the difference between the tax basis of the Fund's assets and liabilities and the amounts reported in the financial statements. Future tax assets or liabilities are calculated using the tax rates for the periods in which the differences are expected to be settled. Future tax assets are recognized to the extent that they are considered more likely than not to be realized.

### ***Convertible Debentures***

The Fund has allocated the proceeds of the Debentures between debt and equity based on the relative fair values of the debt and the conversion option, as determined by the residual valuation of the equity component. Under this approach, the liability component was valued first, and the difference between the proceeds of the Debentures and the fair value of the debt was assigned to the conversion option. The present value of the liability component was calculated using a discount rate of 9.2%, the market interest rate at the date of issuance for similar debentures having no conversion rights.

## **NEW ACCOUNTING STANDARDS ADOPTED**

The Canadian Institute of Chartered Accountants ("CICA") issued four new accounting standards that became effective for the Fund on January 1, 2008: Handbook Section 3031, Inventories ("Section 3031") as described above, Handbook Section 3862, Financial Instruments – Disclosures ("Section 3862"), Handbook Section 3863 Financial Instruments – Presentation ("Section 3863"), and Handbook Section 1535, Capital Disclosures ("Section 1535").

### ***Section 3862, Financial Instruments – Disclosures and Section 3863 Financial Instruments – Presentation***

Section 3862 and Section 3863 applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007. These sections replace Handbook Section 3861, Financial Instruments – Disclosure and Presentation to revise and enhance the disclosure requirements and to carry forward its presentation requirements. These sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. The note disclosure on financial instruments in the unaudited interim financial statements has been expanded as a result of Section 3862 and 3863 for the three and nine-month periods ended September 30, 2008.

### ***Section 1535, Capital Disclosures***

Section 1535 applies to interim and annual financial statement relating to fiscal years beginning on or after October 1, 2007. Section 1535 specifies the disclosure of: (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and, (iv) if it has not complied, the consequences of such non-compliance. There is a note disclosure on capital disclosures in the unaudited interim financial statements as a result of Section 1535 for three and nine-month periods ended September 30, 2008.

## **RISKS AND UNCERTAINTIES**

### ***Maintaining Profitability and Managing Growth***

Our future operating results will depend on a number of factors, including:

- our ability to maintain or realize increased sales and profitability;
- our ability to successfully identify and respond to changes in trends and customer tastes;
- our ability to maintain cost-effective delivery of our merchandise to our distribution centre and our stores;
- our ability to hire, train, motivate, manage and retain qualified buyers, retail store management and personnel;
- the level of competition in the retail footwear industry in the markets in which we operate;
- the efficiency and effectiveness of our marketing programs in building brand awareness and increasing sales; and
- general economic conditions and consumer confidence.

There can be no assurance that we will be able to successfully implement our strategic plan or that such plan will enable us to maintain or increase historical sales, profitability or growth rates. Failure to successfully execute any material part of our strategic plan could have a material adverse effect on our business, financial condition, liquidity and results of operations. There can be no assurance that we will be able to effectively manage our growth, and any failure to do so could have a material adverse effect on our business, financial condition, liquidity and results of operations.

### ***Competitive and Economic Environment***

Retail footwear is a highly competitive global business that is subject to rapidly changing consumer demands. In addition, several external factors over which we have no influence affect the economic climate and consumer confidence.

In this competitive environment, the importance of the following cannot be over-emphasized: implementing efficient and effective marketing programs to build brand awareness; identifying and responding to changes in trends and customer tastes; providing quality service; and continually exceeding customer expectations so that we deliver a total customer experience.

We believe that our strong financial position, targeted marketing, purchasing expertise, strong sourcing capabilities, cost-effective delivery of merchandise, experienced management, and dedicated personnel will facilitate our continued success; however, there is no guarantee that we will be successful.

### ***Risks Associated with Leasing and Expansion***

Our continued growth will depend to a significant degree on our ability to expand our operations through the opening of new stores and to operate these stores on a profitable basis. The success of our planned expansion will be significantly dependent upon our ability to locate suitable store sites and negotiate acceptable lease terms. In addition, several other factors could affect our ability to expand, including the adequacy of our capital resources, the ability to hire, train and integrate employees and the ability to adapt our operational systems.

There can be no assurance that we will achieve our planned expansion or that any such expansion will be profitable. In addition, there can be no assurance that our expansion within our existing markets will not adversely affect the financial performance of our existing stores or our overall operating results, or that new stores will achieve net sales and profitability levels consistent with existing stores. As part of our expansion planning, we regularly evaluate the adequacy of our existing systems and procedures, including our product distribution facility, store management, financial controls and management information systems. However, there can be no assurance that we will anticipate all of the changing demands that expanded operations may impose on such systems. Failure to adapt our internal systems or procedures as required could have a material adverse effect on our business, financial condition and results of operations.

### ***Foreign Exchange***

Our foreign exchange risk is primarily limited to currency fluctuations between the Canadian and U.S. dollar. From time to time we enter into foreign exchange forward contracts that oblige us to purchase specific amounts of foreign currencies at set future dates at predetermined exchange rates. The contracts are matched with anticipated foreign currency purchases in U.S. dollars from time to time. We enter into the foreign exchange forward contracts to provide a hedge against the risk of losses should the value of the Canadian dollar decline compared to the foreign currency. We do not enter into foreign exchange contracts for speculative or trading purposes. See further discussion under “Financial Instruments”.

### ***Seasonality and Fluctuations in Quarterly Results***

Our business is seasonal and generally we experience lower sales in the months of January and February. As the Fund's fiscal year is the calendar year, this seasonal decline in sales will likely occur in the first quarter of each fiscal year.

The footwear and accessories sector of the Canadian retail market has two primary selling seasons during which new merchandise is introduced – Spring and Fall. Gross margins fluctuate over the course of each of these selling seasons, declining as the season draws to a close as mark-downs are taken on sales and the inventory is discounted.

Our quarterly results of operations may also fluctuate based upon such factors as delays in the flow of merchandise, the number and timing of new store openings and related pre-opening expenses, the amount of sales contributed by new and existing stores, the mix of products sold, competitive factors, changes to shipping costs, general economic conditions, labour market fluctuations, changes in accounting rules and regulations and unseasonable weather conditions.

### ***Cash Distributions Are Not Guaranteed and May Fluctuate with Sterling Shoes LP's Performance***

Although the Fund intends to distribute the interest and distributions received by the Fund on the Units and notes of SS Holdings Trust (the “Trust”) less expenses and amounts, if any, paid by the Fund in connection with the redemption of Units, there can be no assurance regarding the amounts of income to be generated by Sterling Shoes LP and paid, indirectly, to the Fund. The actual amount distributed in respect of the Units will depend upon numerous factors associated with Sterling Shoes LP, including its profitability, fluctuations in its working capital, the sustainability of its margins, interest expenses and its requirements for repayment of indebtedness and incurrence of capital expenditures.

The market value of the Units may deteriorate significantly if the Fund is unable to continue to distribute cash to Unitholders at current distribution levels.

### ***Nature of Units***

Unitholders own an equal undivided interest in the Fund. The Units do not and will not represent a direct investment in Sterling Shoes LP. As holders of Units, Unitholders do not have the statutory rights normally associated with ownership of shares of a corporation including, for example, the right to bring oppression or derivative actions. The Units represent a fractional interest in the Fund.

The Fund's primary assets are its 100% ownership interest in the notes and units of the Trust. The Trust, in turn, is a limited partner in Sterling Shoes LP. The price per Unit is, in part, a function of anticipated distributable income, distributions, as well as the consolidated indebtedness, net of cash and cash equivalents of the Fund including the net indebtedness of Sterling Shoes LP. The price per Unit may also be a function of interest rates or expected returns available, or perceived to be available, on alternative investments.

### ***Risks Associated with Convertible Debentures***

#### ***Interest Payments***

Interest payments on the Debentures and cash distributions on the Units issuable upon conversion, redemption or repayment of the Debentures are not guaranteed and are entirely derived from the business operated by related entities of the Fund and from the ability of each such entity to make distributions on its securities. There can be no assurance that the Fund and the related entities of the Fund will be able to make interest payments as they become due pursuant to the terms of the Debentures.

#### ***Prior Ranking Indebtedness***

The Debentures are subordinate to all Senior Indebtedness. The payment of the principal premium (if any) and interest on the Debentures is subordinated to Senior Indebtedness of the Fund. The Debentures are also effectively subordinate to claims of creditors of the Fund's subsidiaries except to the extent the Fund is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors.

#### ***Inability to Fund Purchase of Debentures***

The Fund is required to offer to purchase all outstanding Debentures upon the occurrence of a change of Control. However, it is possible that following a Change of Control, the Fund will not have sufficient funds at that time to make the required purchase of outstanding Debentures or that restrictions contained in other indebtedness will restrict those purchases.

#### ***Absence of Covenant Protection***

The Indenture does not restrict the Fund or any of its subsidiaries from incurring additional indebtedness or from mortgaging, pledging or charging its assets to secure any indebtedness. The Indenture does not contain any provisions specifically intended to protect holders of the Debentures in the event of a future leveraged transaction involving the Fund or any of its subsidiaries.

### ***Update for Tax Legislation***

On June 22, 2007, the Parliament of Canada passed into law Bill C-52, an Act to implement certain provisions of the federal budget tabled in Parliament on March 19, 2007, which included legislation to implement the proposal announced by the Minister of Finance on October 31, 2006 to tax specified investment flow-through trusts (“SIFTs”), including the Fund, on the taxable portion of their distributions. As a result of the enactment of Bill C-52 commencing January 1, 2011 (subject to the qualification below regarding the possible loss of the four year grandfathering period in the case of “undue expansion”), the Fund will not be entitled to deduct certain of its distributed income (referred to as specified income) and the Fund will be subject to a distribution tax on the specified income at a special rate estimated to be 27.5%.

The Fund may be subject to this distribution tax in respect of a taxation year of the Fund commencing earlier than January 1, 2011 if, prior to such date, the Fund engages in “undue expansion” as set out in the guidelines released by the Department of Finance on December 15, 2006 and which was incorporated by reference in Bill C-52. The implementation of the legislation could have an adverse effect on the Fund, its ability to pay distributions and the market value of its units.

On July 14, 2008 the Department of Finance published proposed amendments to the *Income Tax Act* (Canada) (the “Tax Act”) which are intended to facilitate the conversion of a SIFT into corporate form on a tax deferred basis (the “Conversion Rules”). The Conversion Rules address many of the principal substantive and administrative issues that currently arise when structuring the conversion of a SIFT under the Tax Act.

The Fund is considering these legislative changes and their possible impact on the Fund.

### **FINANCIAL INSTRUMENTS**

Our business is exposed to financial risks that arise from fluctuations in interest rates (in terms of our credit facilities) and foreign exchange rates (in terms of our U.S. dollar-denominated purchases) and the degree of volatility of these rates.

Risk from foreign exchange arises as a result of variations in exchange rates between the Canadian and the U.S. dollar. Historically, approximately 30% to 40% of the Fund’s product purchases are denominated in U.S. dollars. During the three and nine-month periods ended September 30, 2008 approximately 37% and 35% (2007 – 37% and 34%) of the Fund’s product purchases were denominated in U.S. dollars. The Fund does not hold or issue financial instruments for trading or speculative purposes. As at September 30, 2008, the Fund had outstanding forward foreign exchange contracts as follows:

Settlement dates	Face Value \$US	Average rate \$Cdn
October 2008	1,000,000	1.0056
November 2008	1,000,000	1.0058

We are subject to risks associated with fluctuating interest rates on our credit facilities, which contain interest terms which float with movements in prevailing interest rates.

## **DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING**

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the President and Chief Executive Officer (“CEO”) and the Chief Financial Officer (“CFO”), on a timely basis so that appropriate decisions can be made regarding public disclosure.

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles. Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Fund.

The Fund’s Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the MD&A and unaudited interim consolidated financial statements for the period ended September 30, 2008. These executives also certified that they are responsible for the design of disclosure controls and procedures and internal control over financial reporting. The Audit Committee reviewed this MD&A and the attached unaudited interim consolidated financial statements and the Board of Trustees approved the documents prior to their release.

There have been no changes in internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Fund’s internal control over financial reporting.

## **END OF SUBORDINATION**

On December 31, 2007, the Class D LP units became freely exchangeable for Units on a one-for-one basis. As a result, effective April 1, 2008, distributions to Inc. on the Class D LP Units are made monthly and are no longer subordinated.

## **FORWARD-LOOKING STATEMENTS**

This MD&A includes forward-looking statements. Forward-looking statements relate to, among other things, anticipated financial performance, business prospects, strategies, market forces, and commitments. Many of these statements can be identified by words such as “believe”, “expects”, “expected”, “will”, “intends”, “projects”, “anticipates”, “estimates”, “continues” or similar words. The Fund believes the expectations reflecting in such statements are reasonable but no assurance is given that such expectations will be correct. All forward-looking statements are based on the Fund’s beliefs and assumptions based on information available at the time the assumption was made and on management’s experience and perception of historical trends, current conditions and expected further developments as well as other factors deemed appropriate in the circumstances. In addition to other assumptions made in this MD&A, assumptions have been made in respect of factors such as, but not limited to, the following:

- industry activity levels;
- competitive conditions;
- consumer demand;
- access to capital;
- capital expenditure estimates, plans, schedules and activities;
- income tax considerations;
- operating risks; and

- cash distributions

By its nature, such forward-looking information is subject to various risks and uncertainties that are known and unknown, including those material risks discussed in the Fund's most recent annual information form and in this management's discussion and analysis of the Fund which could cause actual results and experience to differ materially from the anticipated results or other expectations expressed. Readers are cautioned not to place undue reliance on this forward-looking information, which is given as of the date it is expressed in this annual information form or otherwise, and the Fund undertakes no obligation to update publicly or revise any forward-looking information to reflect new events or circumstances, except as explicitly required by securities laws.

## **ADDITIONAL INFORMATION**

Additional information relating to the Fund, including the Fund's Annual Information Form and other public filings, are available on SEDAR ([www.sedar.com](http://www.sedar.com)) and on the Fund's website at [www.SterlingShoesIncomeFund.com](http://www.SterlingShoesIncomeFund.com).

## **INVESTOR RELATIONS**

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