

STERLING SHOES INC.

(formerly Sterling Shoes Income Fund)

MANAGEMENT'S DISCUSSION AND ANALYSIS

November 9, 2010

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 Inc. ("Sterling" or the "Company") for the three and nine month periods ended September 30, 2010. 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 Company 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".

OVERVIEW OF THE COMPANY

Effective July 1, 2010 Sterling Shoes Income Fund (the "Fund") converted to a corporation, "Sterling Shoes Inc." ("Sterling" or the "Company").

The conversion to a corporation was undertaken in response to the federal government's intention to tax the taxable income of income funds effective January 1, 2011. As a corporation, the amount of income taxes payable upon the taxable income of Sterling will be less than the amount of income taxes that would be paid on this income if the Fund continued to exist. As a corporation, Sterling will be able to retain earnings to provide for anticipated liabilities and finance future growth. In addition, as a corporation, Sterling will carry on business in a more common form of business enterprise.

The conversion took place as a "plan of arrangement" (the "Arrangement") and was effective July 1, 2010. Under the Arrangement, unitholders of the Fund received common shares of Sterling, on a one-for-one basis. SSI Investments Inc., which previously held a 20% interest in Sterling Shoes Limited Partnership, the Fund's operating unit, exchanged its exchangeable units for common shares of Sterling, also on a one-for-one and tax deferred basis and its remaining units in the partnership for the debt owing to SS Holdings Trust by SSI Investments Inc. SSI Investments Inc. holds 20% of Sterling's issued and outstanding common shares with public shareholders holding the remaining 80%. The business of Sterling continues to be conducted by Sterling Shoes Limited Partnership, all of the interests in which is owned, directly or indirectly, by Sterling.

The dividend policy of Sterling replaced the distribution policy of the Fund and is subject to the discretion of the Board of Directors who will take into account the corporation's current and anticipated business needs and financial condition at the time a dividend is considered. Currently no dividends are paid on Sterling's common shares.

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.

In connection with the Arrangement, Sterling assumed all of the covenants and obligations of the Fund relating to the outstanding Debentures. The Debentures have become convertible unsecured subordinated debentures of Sterling and holders are entitled to receive Sterling common shares, rather than Units, at the same conversion price at which the Units were previously issuable upon conversion thereof (being \$21.15 per Sterling common share representing a conversion ratio of 47.281 Sterling common shares for each \$1,000 principal amount of Debentures converted), subject to adjustment in certain events as provided for in the Debenture Indenture.

The trustees of the Fund have become the directors of Sterling and the officers and management of Sterling Shoes Limited Partnership have become officers and management of Sterling.

There are 6,641,860 shares of Sterling and 25,000 Debentures issued and outstanding as at November 9, 2010. The shares of Sterling trade on the Toronto Stock Exchange under the symbol SSI and the Debentures trade under the symbol SSI.DB.

SHAREHOLDER RIGHTS PLAN

At the Fund's annual and special meeting of Unitholders held on June 24, 2010, Unitholders approved effective on completion of the conversion to a corporation, a "shareholder rights plan" for Sterling (the "Rights Plan"). The Rights Plan is designed to ensure that a person seeking control of the Company gives its shareholders and the directors sufficient time to evaluate the bid, negotiate with the initial bidder and encourage competing bids to emerge. The Rights Plan also seeks to ensure that all shareholders are treated fairly in any transaction involving a change of control of Sterling and that all shareholders have an equal opportunity to participate in the benefits of a take-over bid. The Rights Plan encourages potential acquirers to negotiate the terms of any offer for the Company's common shares with the board of directors or, alternatively, to make a Permitted Bid (as defined in the Rights Plan) without the approval of the board of directors. The Rights Plan may, however, increase the price to be paid by a potential offeror to obtain control of the Sterling and may discourage certain transactions.

OVERVIEW OF OUR BUSINESS

Sterling is a Vancouver-based, leading footwear retailer operating through six separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet. These retail concepts were designed to effectively and profitably serve identified market segments. Since 1987 the Sterling Shoes business has grown from five locations to 162 stores as at November 9, 2010. Our stores are located in leased premises primarily in high-traffic, high-visibility locations within enclosed shopping malls, on high streets and in strip malls.

Our products include dress and casual footwear ranging from sandals and athletic shoes to career footwear and special occasion shoes. We offer footwear products under both private label and national brands in each of our stores as well as a range of accessories, including handbags, shoe care products and hosiery.

Each of our banners targets a specific consumer group through different product, merchandising, location, pricing, service and advertising strategies.

Retail Banner	General Price Range	Products and Consumers	Key Private Label Brands	Key National Brands
<i>Sterling</i>	\$50 to \$140	<ul style="list-style-type: none"> • mid-range women's fashion and comfort footwear • latest fashion trends, current looks • targeted to women between 15 years of age & up 	<ul style="list-style-type: none"> • Roberto Gianni • Joy & Peace • Gianni Collections 	<ul style="list-style-type: none"> • Skechers • Puma • Franco Sarto • Steve Madden • Converse
<i>Joneve</i>	\$69 to \$180	<ul style="list-style-type: none"> • mid-high end women's fashion and comfort footwear • fashionable upscale career, comfort and dress shoes • dress, casual and fashion athletic shoes, boots and sandals • targeted to women 20 years of age & up 	<ul style="list-style-type: none"> • Roberto Gianni • Gianni Collections 	<ul style="list-style-type: none"> • Skechers • Puma • Nine West • Franco Sarto
<i>Shoe Warehouse</i>	\$19 to \$49 — kids \$39 to \$99 — ladies \$39 to \$99 — mens	<ul style="list-style-type: none"> • value-priced, family footwear products, including fashion, comfort, athletic footwear and work boots • leather and synthetic products representing good value to family-oriented or price-conscious consumers 	<ul style="list-style-type: none"> • Be Wild • Rinaldi • Blizzard • Workers • Urban XT • EC Collections 	<ul style="list-style-type: none"> • Bare Traps • Fila • Rockport • Nike • Kodiak • Sorel
<i>Freedman Shoes</i>	\$90 to \$350	<ul style="list-style-type: none"> • high-end men's and women's fashion and comfort footwear • 95% of products are national brands • wide selection of fittings and sizes • targeted to men and women 25 years of age & up 	<ul style="list-style-type: none"> • Gianni Collections • Roberto Gianni 	<ul style="list-style-type: none"> • Amalfi • Stuart Weitzman • Donald J Pliner • Johnson & Murphy
<i>Gia</i>	\$70 to \$360	<ul style="list-style-type: none"> • cutting-edge, funky women's street fashion • fashion-athletic footwear and accessories • 85% of products are national brands 	<ul style="list-style-type: none"> • Gianni Collections 	<ul style="list-style-type: none"> • Guess • Steve Madden • Jessica Simpson • Betsey Johnson • Rocket Dog
<i>Sterling Outlet</i>	\$50 to \$140	<ul style="list-style-type: none"> • mid-range women's fashion and comfort footwear • latest fashion trends at clearance prices • dress, casual and fashion athletic shoes, boots and sandals • targeted to women between 15 years of age & up 	<ul style="list-style-type: none"> • Roberto Gianni • Gianni Collections • Joy & Peace 	<ul style="list-style-type: none"> • Skechers • Puma • Franco Sarto • Steve Madden

Sterling, Joneve, Shoe Warehouse, Freedman Shoes, Gia and Sterling Outlet compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our six distinct retail banners means that we compete against a wide variety of participants at various levels of the value chain. Examples of who we believe to be the principal competitors for our Sterling/Joneve/Gia, Shoe Warehouse and Freedman Shoes banners are provided below.

Sterling/Joneve/Gia	Shoe Warehouse/Sterling Outlet	Freedman Shoes
<ul style="list-style-type: none"> • ALDO • Town Shoes • Nine West • Feet First • Little Burgundy • Mall-based specialty shoe stores • Apparel stores selling mid-to-high range fashion and fashion-athletic footwear products 	<ul style="list-style-type: none"> • Payless Shoe Source • The Shoe Company • Winners • Softmoc • The Bay • Zellers • National and regional comfort-oriented shoe stores • Style Sense 	<ul style="list-style-type: none"> • Browns • Town Shoes • Holt Renfrew • Harry Rosen • Feet First • B2

We now operate 162 stores across Canada, a significant increase from the 100 stores at the time of our initial public offering in July 2005. In light of the ongoing uncertain economic environment, we have slowed the pace of our expansion. We remain focused on our strategic objective: the right shoe, at the right price, at the right place, in the right quantity. We do so by managing the fundamentals that we control, including: managing purchasing, product mix and inventory, offering excellent customer service, tightening control over expenses and continually evaluating our planned capital expenditures. Additionally, we actively seek ways to improve the efficiency and profitability of our existing stores.

RECENT EVENTS AND OUTLOOK

Economic Conditions and our Recent Performance

Throughout 2009 economic conditions deteriorated in many countries and regions, including Canada. Volatility in financial markets, higher unemployment rates and recessionary conditions resulted in a low level of consumer confidence, increased promotional activity, reductions in consumer spending and economic weakness in a number of industries in the regions in which we operate. During 2010 signals of economic recovery remains uncertain. We cannot predict with certainty the strength or timing for full recovery.

Management undertook several initiatives commencing in 2009 in order to bring flexibility to our cost structure including: decreasing inventory levels, changing our product mix, restricting maintenance and capital expenditures, and reducing operating, overhead, administrative and selling costs. Our fourth quarter 2009 results started to reflect the benefit of many of these strategies and we continued to focus on these projects in 2010.

One of the most important strategic initiatives we have undertaken is the significant investment in our information technology systems. Development testing and training for the new information technology system continues.

Highlights for the three-month period ended September 30, 2010 are summarized below:

- On July 1, 2010 Sterling Shoes Inc. completed its conversion to a corporate entity from Sterling Shoes Income Fund;
- Sales increased 1.7% during the three-month period ended September 30, 2010, compared to the same period in 2009. Same-store sales increased 0.3%;
- Net bank indebtedness was \$5.0 million at September 30, 2010 down from \$11.8 million a year earlier;
- During the quarter the Company renewed its bank credit facilities for a 3 year term;
- The Company opened three new stores during the quarter ended September 30, 2010;
- The Company welcomes Mr. David Alves as President and Chief Executive Officer effective November 10, 2010, and will also be appointed as a director of Sterling Shoes Inc. on that day.

Number of Stores

During the third quarter of 2010, we opened three new stores and closed one store. We opened a Freedman store at Park Royal Mall in West Vancouver, BC, a Joneve store in the new Chinook Centre Mall expansion in Calgary, AB and a Freedman Outlet store on West 4th Avenue in Kitsilano, Vancouver, BC. We closed a Sterling store at Oakridge mall. We have slowed store expansion compared to previous years, in light of the uncertain economic conditions. The normal course of business 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.

Our 162 stores operate under six retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating													
November 9, 2010								Dec 31, 2009	Dec 31, 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	Total	Total
British Columbia	39	20	6	10	2	-	77	76	75	65	63	60	59
Alberta	13	9	3	-	-	1	26	27	26	25	25	24	24
Saskatchewan	3	2	-	-	-	-	5	4	4	3	3	4	4
Manitoba	9	3	-	-	-	-	12	12	12	12	11	11	11
Ontario	11	23	6	2	-	-	42	43	43	36	25	5	2
Total	75	57	15	12	2	1	162	162	160	141	127	104	100

INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)

On February 13, 2008, the Canadian Accounting Standards Board confirmed that publicly accountable enterprises will be required to adopt IFRS in place of GAAP for interim and annual reporting purposes for fiscal years beginning on or after January 1, 2011.

Our conversion project is led by finance management and includes input from various areas of the organization. Using the changeover plan that we developed to map conversion to these new standards, we have identified and documented the areas of significant change as follows:

First time adoption of IFRS

IFRS 1, “First-Time Adoption of International Financial Reporting Standards”, provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS. Sterling Shoes Inc. expects to apply the following optional exemptions:

Fair Value or Revaluation as Deemed Cost:

IFRS 1 provides an option to allow a first-time IFRS adopter to elect to use the amount determined under a previous GAAP revaluation as the deemed cost of intangible assets so long as the revaluation was broadly comparable to fair value under IFRS. Management considers the September 30, 2009 Canadian GAAP impairment of the carrying value of our intangible assets, specifically the store banners and private label brand names, as a “revaluation broadly comparable to fair value”; the Company will elect that amount to be deemed IFRS cost as of that date. The IFRS carrying value of those intangible assets on transition to IFRS is therefore consistent with the Canadian GAAP carrying value on the transition date.

Borrowing Costs:

IAS 23 “Borrowing Costs” requires capitalization of eligible borrowing costs directly attributable to the acquisition or construction of qualifying assets. Under Canadian GAAP, the Company’s accounting policy was to expense interest costs in connection with development activity. A first-time adopter may elect to apply the transitional provisions prescribed by IAS 23, and thereby be exempt from having to apply the standard to past transactions. The Company has elected to utilize this exemption, and will therefore apply IAS 23 on a prospective basis from the date of transition to IFRS (meaning for eligible projects with a commencement date after January 1, 2010).

Share-Based Payments:

IFRS 1 permits the application of IFRS 2 “Share-Based Payments” only to equity instruments granted after November 7, 2002 that had not vested by the date of transition to IFRS. The Company has applied this exemption and will apply IFRS 2 for equity instruments granted after November 7, 2002 that had not vested by January 1, 2010.

IFRS Changeover Plan – Impact of IFRS on:

1. ***Information technology and data systems*** –:
 - As at January 1, 2010, our accounting software was upgraded to include modules to support our changeover or conversion to IFRS. We have assessed the impact on system requirements and expect there will be no significant impact to applications arising from the transition to IFRS.
2. ***Internal controls over financial reporting*** –
 - We have identified the required accounting process changes that result from the application of IFRS accounting policies; these changes are not considered significant.
 - As part of the transition project, additional controls have been designed and implemented to ensure that the recorded balance is appropriately recorded in accordance with IFRS.
3. ***Disclosure controls and procedures*** –
 - As part of the transition project, additional controls have been designed and implemented to ensure proper disclosure in the areas of leaseholds and equipment and key management compensation.
4. ***Financial reporting expertise*** –
 - We engaged financial reporting consultants to assist with changeover to IFRS.
 - The finance & accounting professionals of Sterling Shoes Inc. have taken training sessions and attended seminars in order to familiarize themselves with IFRS.
 - Members of the Board of directors and Audit Committee have taken training sessions and attended seminars in order to familiarize themselves with IFRS.
 - In October 2010, we held an IFRS information session with the audit committee that included an in-depth review of accounting policy changes on transition to IFRS, a discussion of optional exemptions under IFRS 1 that the Company expects to elect on transition to IFRS, and an overview of draft IFRS financial statements.
 - We will continue to provide additional training and updates for key employees, senior management, the audit committee, the Board and other stakeholders throughout the convergence period.
 - Sterling Shoes Inc. has engaged its auditors, Deloitte & Touche LLP, to review IFRS transition documentation.
5. ***Business activities*** – Sterling Shoes Inc. has not identified any impact on its bank covenants, executive compensation, foreign currency or hedging activities as a result of IFRS implementation; therefore, Sterling does not expect that there will be any impact on business activities due to the implementation of IFRS.
6. ***Timing of each phase*** –
 - Scoping and diagnostic phase — this phase involved performing a detailed diagnostic comparing Canadian GAAP to IFRS and identifying key areas that may be impacted by the transition to IFRS; it was completed in October 2009.
 - Impact analysis and design phase — in this phase, each area identified from the scoping and diagnostic phase was addressed. The results of this phase identified the impact of the conversion on existing accounting policies, information systems, business processes and internal controls over financial reporting and disclosure. This phase included an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statements. Parallel second quarter 2010 IFRS financial statements were prepared in October 2010 and presented to the audit committee at that time. This phase was completed in October 2010.

- Implementation and review phase — this phase included execution of changes to business processes, completing formal authorization processes to approve recommended accounting policy changes and conducting training programs. The above activities were completed in October 2010. Sterling plans to present parallel third and fourth quarter 2010 IFRS financial statements and notes to its audit committee in early 2011.

Financial Statement Impact on Transition to IFRS

The Company expects that there will be no adjustments to balances in its financial statements on transition from Canadian GAAP to IFRS as at January 1, 2010, nor are there expected to be any adjustments to financial statement balances and results as at and for the year ended December 31, 2010. While the Company does not expect to have any adjustments to financial statement balances on transition to IFRS, management has modified some of its accounting policies to apply prospectively in order to conform with IFRS requirements. Significant changes to accounting policies are discussed below.

Significant Changes in Accounting Policies

Information on those accounting policy changes that management considers most significant to the Company is presented below.

Impairment of Assets:

Under both Canadian GAAP and IFRS, intangible assets are reviewed at least annually for impairment or whenever indicators of impairment are present. If such an indicator exists, a formal impairment assessment is performed.

Under Canadian GAAP, this is a two-step impairment test in which (1) undiscounted future cash flows are compared to the carrying value; and (2) if those undiscounted cash flows are less than the carrying value, the asset is written down to the fair value.

In performing a formal impairment assessment under IFRS, the entity estimates the recoverable amount of the asset by performing a one-step impairment test, which requires a comparison of the carrying value of the asset to the higher of value in use and fair value less costs to sell. Value in use is defined as the present value of future cash flows expected to be derived from the asset in its current state.

As a result of this difference, in principle, impairment charges may be more likely under IFRS than are currently identified and recorded under Canadian GAAP. The extent of any additional impairments, however, may be partially offset by the requirement under IAS 36, "Impairment of Assets" to reverse any previous impairment losses where circumstances have changed such that the impairments have been reduced. Canadian GAAP prohibits reversal of impairment losses. The adoption of these new standards does not result in a change to the carrying value of our assets on transition to IFRS.

The discussion above on IFRS 1 elections and significant accounting policy changes on transition to IFRS is provided to allow readers to obtain a better understanding of our IFRS changeover plan and the resulting potential effects on the financial statements of Sterling Shoes Inc. This information provides an indication of the major differences identified to date based on the current IFRS guidance, relative to the Company's current Canadian GAAP accounting policies. This discussion reflects management's most recent assumptions and expectations; circumstances may arise, such as changes in IFRS, regulations or economic conditions, which could change these assumptions or expectations. Any further changes to the election of IFRS 1 exemptions, the selection of IFRS accounting policies and any related adjustments to the financial statements would be subject to approval by the audit committee prior to being finalized. Accordingly, the discussion above is subject to change.

SUMMARY FINANCIAL INFORMATION

Statement of Income Items (\$000's)	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
Sales	\$ 32,218	31,685	87,679	89,975
Cost of Sales ⁽²⁾	(21,537)	(18,777)	(50,108)	(51,117)
Gross Margin	10,681	12,908	37,572	38,858
<i>As a percentage of sales</i>	33.2%	40.7%	42.9%	43.2%
Store and selling expenses	(11,215)	(11,502)	(33,418)	(34,122)
General and administrative expenses	(2,000)	(1,892)	(6,005)	(5,232)
EBITDA ⁽¹⁾	(2,500)	(4,000)	(1,851)	(496)
<i>As a percentage of sales</i>	-7.9%	-1.5%	-2.1%	-0.6%
Adjusted EBITDA ⁽¹⁾	(2,406)	(587)	(1,723)	(1,035)
<i>As a percentage of sales</i>	-7.5%	-1.9%	-2.0%	-1.2%
Interest expense	(653)	(672)	(1,955)	(1,968)
(Loss) / Gain on disposal	(2)	(26)	(220)	(260)
Impairment of goodwill and intangible assets	-	(33,246)	-	(33,246)
Amortization	(867)	(1,002)	(2,745)	(2,538)
Income / (Loss) before taxes	(4,056)	(35,432)	(6,771)	(38,508)
Future income taxes	-	-	-	-
Net income / (loss)	(4,056)	(35,432)	(6,771)	(38,508)
Maintenance capital expenditures	612	708	1,371	1,836

Balance Sheet Items (\$000's)	September 30	December 31,
	2010	2009
Total assets	73,845	77,165
Long-term financial liabilities	30,923	22,370

Notes:

(1) See definition of EBITDA, Adjusted EBITDA and Maintenance Capital Expenditures under "Non-GAAP Measures".

(2) A provision of \$2 million was taken in Cost of Sales, see below for additional discussion.

OPERATING RESULTS

Sales

Sales were \$32.2 million during the three-month period ended September 30, 2010, representing an increase of 1.7% over the \$31.7 million in the same period in 2009. Same-store sales increased by 0.3% in this period. These increases resulted primarily from strong price promotion aimed at reducing older inventory.

For the nine-month period ended September 30, 2010, sales were \$87.7 million compared to \$90.0 million in 2009 representing a 2.6% decline. Same store sales declined by 4.2% in this period. Given the decline in sales, and the pressure on gross margins due to promotional activity in response to our competitive position, we continue to evaluate how we manage our inventory management, including our product mix and purchasing and planning processes, to strengthen our operational results.

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 and gross margin

Cost of sales as a percentage of sales for the three and nine-month periods ended September 30, 2010 was 66.8% and 57.1%, compared to 59.3% and 56.8% respectively for the same period during 2009.

In September 2010 management took action to make room for higher margin inventory and improve inventory turnover. The Company discounted specific aged inventory resulting in an impairment charge of \$2 million during the quarter which negatively affected gross margin.

During the third quarter we continued a high level of promotional activity and opened a temporary Freedman Outlet store, to generate sales, clear aged inventory and respond to competitive activities.

Store and selling expenses

Store and selling expenses for the three and nine-months ended September 30, 2010 were 34.8% and 38.1% of sales, compared to 36.3% and 37.9% for the same periods during 2009, 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. In nominal dollar terms, store and selling expenses decreased by \$287 thousand and \$704 thousand for the three-month and nine-month periods ending September 30, 2010 as a result of management’s actions to reduce costs in managing the business through the current economic volatility. However the overall effect as a percentage of sales was nullified by the decrease in sales in the first nine months of 2010.

General and administrative expenses

General and administrative (“G&A”) expenses for the three and nine-months ended September 30, 2010 were 6.2% and 6.8% of sales, compared to 6.0% and 5.8% during the same periods in 2009, respectively.

G&A expenses have increased \$108 thousand in the three months ended September 30, 2010 due to non-recurring items such as the costs of conversion to a corporate entity and executive search fees incurred for recruiting a new CEO.

EBITDA (see “Non-GAAP Measures”)

EBITDA for the three and nine-months ended September 30, 2010 was -7.9% and -2.1% of sales, respectively, compared to -1.5% and -0.6% for the same periods during 2009. The variance in EBITDA is largely accounted for by the \$2 million inventory impairment charge taken during the three month period ended September 30, 2010.

Interest expense

Net interest expense with respect to funds utilized under the credit facilities for the three-month and nine-months ended September 30, 2010 was \$80 thousand and \$201 thousand respectively, compared to \$96 thousand and \$252 thousand in 2009.

Interest expense with respect to the convertible debentures for the three and nine-month periods ended September 30, 2010 was \$595 thousand and \$1.8 million (2009 - \$578 thousand and \$1.7 million), respectively.

The proceeds of the Debentures have been allocated 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% (at the date of issuance), the estimated market interest rate for similar debentures having no conversion rights.

The conversion option was valued at \$2,657 thousand at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt. Included in interest expense for the three and nine-months ended September 30, 2010 was \$188 thousand and \$552 thousand (2009 - \$169 thousand and \$496 thousand), respectively, relating to this interest accretion.

Inventory

In September 2010 management took action to make room for higher margin inventory and improve inventory turnover. The Company discounted specific aged inventory resulting in an impairment charge of \$2 million during the quarter.

At September 30, 2010, on a valuation basis, we had \$5.7 million, or 13.4% less inventory than at September 30, 2009.

We are currently working on major enhancements to our information technology systems which we believe will add to our ability to more effectively manage inventory in our business. We have made significant strides in the project and we are working diligently towards going live in early 2011.

SELECTED QUARTERLY FINANCIAL INFORMATION

in (\$000's) except per Unit amounts	Q3-2010	Q2-2010	Q1-2010	Q4-2009	Q3-2009	Q2-2009	Q1-2009	Q4-2008
Sales	\$ 32,218	\$ 28,606	\$ 26,855	\$ 41,195	\$ 31,685	\$ 30,618	\$ 27,672	\$ 42,520
(Loss) / Income before non-controlling interest and taxes ⁽¹⁾	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (35,432)	\$ (651)	\$ (2,428)	\$ 6,453
Future income taxes				-	4,636	-	-	-
(Loss) / Income before non-controlling interest ⁽¹⁾	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453
Net (Loss) / Income	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)	\$ (2,428)	\$ 6,453
Basic (loss) / income per Unit	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.939	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.972
Diluted (loss) / income per Unit	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.820	\$ (4.637)	\$ (0.098)	\$ (0.366)	\$ 0.897
Cash distributions per Unit	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.037	\$ 0.056	\$ 0.056	\$ 0.085	\$ 0.192
Number of stores open at end of period	162	160	161	162	162	161	159	160

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.

CASH FLOW AND LIQUIDITY

We assess liquidity in terms of our ability to generate sufficient cash flow to fund our operations. Net cash flow is affected by the following items:

- operating activities, including the level of accounts receivable, inventory, prepaid expenses and deposits and accounts payable and accrued liabilities;
- investing activities, including capital expenditures; and
- external financing, including bank credit facilities and other capital market activities, providing both short and long-term financing. See “Capital Resources”.

Cash Flow from Operations

The table below reconciles net income to cash flow from operations for the three and nine-month periods ended September 30, 2010 and 2009.

Sterling Shoes Income Fund
Reconciliation of Net Income to Cash provided by operations
September 30, 2010

in (\$000's)	Three-months ended Sep 30		Nine-months ended Sep 30	
	2010	2009	2010	2009
Net loss	\$ (4,056)	(30,796)	(6,771)	(33,872)
Add charges (deduct credits) to operations not requiring a cash payment:				
Impairment of goodwill and intangible assets	-	33,246	-	33,246
Future income taxes	-	(4,636)	-	(4,636)
Amortization of leaseholds and equipment	867	1,002	2,745	2,538
Accreted interest expense	188	169	552	496
Amortization of deferred leasehold inducements	(92)	(101)	(318)	(539)
Loss on disposal of leaseholds and equipment	2	26	220	260
	(3,091)	(1,090)	(3,572)	(2,507)
Net change in non-cash working capital balances related to operations:				
Accounts receivable	(1,171)	(336)	(1,096)	236
Inventory	(354)	(3,820)	(814)	(3,114)
Prepaid expenses and deposits	(78)	36	(147)	84
Accounts payable and accrued liabilities	5,453	3,353	3,231	3,395
Cash provided by / (used in) operating activities	\$ <u>759</u>	<u>(1,857)</u>	<u>(2,398)</u>	<u>(1,906)</u>

For the three-month period ended September 30, 2010, cash provided by operations was \$759 thousand as compared to cash used in operations of \$1.9 million in the same period of 2009. For the nine-month period ended September 30, 2010 cash used in operations was \$2.4 million as compared to \$1.9 million for the same period in 2009.

Interim period working capital requirements typically reflect the seasonality of the business. In order to ensure that we have adequate inventory in advance of in-season demand, inventory levels increase in the periods immediately preceding peak seasons throughout the year. Accordingly, inventory levels typically increase in the first and third quarters and decline in the second and fourth quarter as sales pick up. Operating results in the three and nine-month periods ended September 30, 2010 generally reflected these expectations.

Capital Expenditures

During the three and nine-month periods ended September 30, 2010, we opened three new stores. Consequently we made an investment of \$316 thousand in leaseholds and equipment to furnish new stores during the three-month period ended September 30, 2010 (2009 - \$0.9 million and \$2.9 million

respectively). We incurred maintenance capital expenditures of \$0.6 million and \$1.4 million during the three and nine-month periods ended September 30, 2010 (2009 - \$0.7 million and \$1.8 million) respectively, which were related to upgrades to our information technology system and store renovations. These maintenance capital expenditures were funded by cash from operations and available credit facilities.

CAPITAL RESOURCES

Cash flow from operations, bank borrowings and debentures issued have been the primary funding sources for working capital requirements and capital expenditures over the last several years.

A Canadian chartered bank has provided us with a revolving credit facility of up to \$15 million (the "Operating Loan"), which is available for working capital requirements, capital expenditures and for general corporate purposes and was repayable on July 31, 2013. As at September 30, 2010, we had no utilization of the Operating Loan.

We have utilized \$4.75 million of our \$5 million revolving credit facility (the "Term Loan") for funding capital expenditures including new store facilities. The Term Loan matures on July 31, 2013. The Term Loan is being amortized, with repayment terms calling for quarterly principal payments of \$250,000, plus interest, to effect a 5 year amortization. The first payment was made on September 30, 2010.

Loans under these facilities are pre-payable without any penalties and bear interest at a floating rate based on the Canadian dollar prime rate or on the bankers' acceptance rates plus, in each case, an applicable margin to those rates. The facilities are secured by a general security agreement covering all assets of Sterling Shoes GP.

The facilities are subject to customary terms and conditions, including limits on incurring additional indebtedness, granting liens or selling assets without the consent of the lender, and to customary financial covenants, including the maintenance of a minimum senior fixed charge coverage ratio. The facilities may in certain circumstances restrict our ability to pay distributions, including limiting distributions unless sufficient funds are available for the repayment of indebtedness and the payment of interest expenses. At September 30, 2010, we were in compliance with all covenants of these credit facilities.

OFF-BALANCE SHEET FINANCING

We enter 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, 2010, letters of credit totaling \$2.88 million are outstanding. The last of these letters of credit expires on February 28, 2011 for \$1.5 million. There are no other off-balance sheet arrangements.

CONTRACTUAL OBLIGATIONS

We have the following inventory purchase, long-term debt and minimum rental commitments for premises, for the remainder of the current fiscal year and over the next four fiscal periods, in thousands of dollars:

in \$000's	2010	2011	2012	2013	2014
Inventory purchase commitments	2,884				
Long-term debt			25,000		
Operating and Term Loans				4,750	
Minimum rental commitments ⁽¹⁾	4,169	15,653	14,963	13,735	11,775
	<u>7,054</u>	<u>15,653</u>	<u>39,963</u>	<u>18,485</u>	<u>11,775</u>

Note:

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

DIVIDENDS

The Company did not declare any dividends to the Shareholders for the three and nine-month periods ended September 30, 2010 (2009 - \$371 thousand and \$937 thousand in distributions).

The Board of Directors reviews the Company's dividend periodically in the context of the Company's overall profitability, free cash flow, capital requirements and other business needs.

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. Accordingly, our management believes that EBITDA and Adjusted EBITDA are important supplemental measures in evaluating our performance and in determining whether to invest in Shares. 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.

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.

"Net Senior Debt" is not a recognized measure under GAAP. Net Senior Debt is equal to bet bank indebtedness combining Operating loan balance and Term loan balance.

INCOME TAXES

Upon converting Sterling Shoes to a corporation, income taxes are now calculated differently from that of an income fund. See "Critical Accounting Estimates." For the three months ended September 30, 2010 there was no change to income taxes, compared to a recovery of \$4.6 million in the same period last year.

TRANSACTIONS WITH RELATED PARTIES

- (a) The Company paid rent to a company in which Mannie Druker, director and officer of Sterling, has an interest, amounting to \$79 thousand and \$227 for the three and nine-month periods ended September 30, 2010 (2009 – \$71 thousand and \$213 thousand) respectively.
- (b) The Company purchased equipment from a company in which Mannie Druker, a director and officer of Sterling, has an interest, for \$47 thousand and \$60 thousand during the three and nine-month periods ended September 30, 2010 (2009 – \$48 thousand and \$163 thousand).

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 Company's financial statements for the three and nine-month periods ended September 30, 2010. Management believes that the following items represent the Company's critical accounting estimates.

Intangible assets and Goodwill

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 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 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 proceeds of the Debentures have been allocated 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 estimated market interest rate at the date of issuance for similar debentures having no conversion rights.

The conversion option was valued at \$2,657 thousand at the date of issuance. The liability portion of the Debentures is being accreted to its face value over the term of the debt using the effective interest method, at an effective interest rate of 11.7%. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231 thousand.

FUTURE CHANGES IN ACCOUNTING STANDARDS

(i) International Financial Reporting Standards [“IFRS”], as discussed above.

The Canadian Accounting Standards Board (AcSB) will require all publicly accountable entities to adopt IFRS for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The Company will be required to prepare both current and comparative financial information using IFRS.

The International Accounting Standards Board (“IASB”) is responsible for the development and publication of IFRS standards and has indicated that IFRS standards will continue to change in the coming years. Upcoming changes which could affect Sterling include:

- Provisions & Contingencies
- Financial Statement Presentation
- Leases
- Income taxes
- Financial Instruments
- Revenue.

While the conceptual framework for IFRS and Canadian GAAP are similar, there are significant differences in recognition, measurement and disclosure requirements. The areas that are expected to significantly impact the Company are described above.

RISKS AND UNCERTAINTIES

A detailed discussion of our significant business risks is provided in the MD&A for the year ended December 31, 2009 and in our 2010 Annual Information Form, both of which can be found at www.sedar.com. There were no changes to our significant business risks during the nine months ended September 30, 2010 other than as set out below:

Risk Factors Relating to the Ownership of Sterling Common Shares

The following is a list of certain risk factors relating to the activities of Sterling and the ownership of Sterling common shares:

- The uncertainty of future dividend payments by Sterling and the level thereof Sterling’s dividend policy and the funds available for the payment of dividends from time to time will be dependent upon, among other things, operating cash flow generated by the Company, financial requirements for operations and the execution of Sterling’s growth strategy and the satisfaction of solvency tests imposed by the *Canada Business Corporations Act* for the declaration and payment of dividends; and

- Sterling may make future acquisitions or may enter into financings or other transactions involving the issuance of securities of Sterling which may be dilutive.

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 35% to 45% of the Company's product purchases are denominated in U.S. dollars. The Company does not hold or issue financial instruments for trading or speculative purposes. From time to time, the Company enters into contracts to manage the foreign exchange risk associated with anticipated purchases in US dollars.

At September 30, 2010, the Company had forward foreign exchange contracts as follows:

Settlement dates	Face Value \$US	Average rate \$Cdn
October 2010	2,250	1.014
January 2011	1,000	1.023
February 2011	1,000	1.023
March 2011	1,000	1.024
April 2011	1,000	1.027
May 2011	250	1.029

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.

CERTIFICATION OF DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for designing disclosure controls and procedures that: (a) provide reasonable assurance that material information required to be disclosed by us is accumulated and communicated to management to allow timely decisions regarding required disclosure; and (b) ensure that information required to be disclosed by us is recorded, processed, summarized, and reported within the time periods specified in applicable securities legislation. .

Our management is responsible for designing, establishing and maintaining an adequate system of internal control over financial reporting. Our internal control system was designed based on the Internal Control – Integrated Framework (“COSO Framework”) published by The Committee of Sponsoring Organizations of the Treadway Commission to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes, in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”).

Our interim Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the interim MD&A and unaudited interim consolidated financial statements for the period ended September 30, 2010. These executives also certified that they are responsible for the design of disclosure controls and procedures and internal control over financial reporting. There have been no changes in internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our

internal control over financial reporting.

The Company's board of directors and Audit Committee reviewed and approved the September 30, 2010 unaudited interim consolidated financial statements and this management's discussion and analysis prior to its release.

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.

We believe 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 our 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;
- tax laws;
- operating performance and risks;
- exchange rates; and
- cost of labour and services.

By its nature, such forward-looking information is subject to various risks and uncertainties that are known and unknown, including general economic conditions and markets and, in particular, the potential impact of the current economic downturn, the cost and availability of capital, the possibility of deterioration in our working capital position, the impact on our liquidity if we were to go offside of the covenants in our debt facilities, our ability to maintain profitability and manage growth, risks associated with leasing and expansion, competition, inventory and sourcing risk, ability to identify and respond to changing consumer fashion preferences, risks associated with international purchasing, reliance on key personnel, dependence on consumer spending, unseasonable weather conditions, uncertainties arising from world events, intellectual property risks, foreign exchange fluctuations on imported merchandise, labour relations, seasonality and fluctuations in cash distributions, fluctuations in distributable cash based on our performance, restrictions on potential growth, future issuances of shares by Sterling or future disposition of shares held by SSI Investments Inc., income tax matters, changes in accounting standards, including the transition to IFRS, and increases in interest rates. These risks are discussed in our most recent annual information form and in this management's discussion and analysis and 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 Sterling Shoes Inc.

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 Sterling, including the Company's Annual Information Form and other public filings, are available on SEDAR (www.sedar.com) and on our website at www.SterlingShoesInc.com.

INVESTOR RELATIONS

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