

STERLING SHOES INC.

(formerly Sterling Shoes Income Fund)

MANAGEMENT'S DISCUSSION AND ANALYSIS

May 12, 2011

The following management's discussion and analysis ("MD&A") should be read in conjunction with the audited consolidated financial statements and accompanying notes ("Financial Statements") of Sterling Shoes Inc. ("Sterling" or the "Company") for the three months ended March 31, 2011. Results have been prepared in accordance with International Financial Reporting Standards ("IFRS" 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-IFRS measures to assist in assessing our financial performance. Non-IFRS measures do not have any standard meaning prescribed by IFRS and are therefore unlikely to be comparable to similar measures presented by other issuers. See "Non-IFRS Measures".

OVERVIEW OF THE COMPANY

Sterling Shoes Inc. ("Sterling" or the "Company") is incorporated under the laws of the Province of British Columbia. The business of Sterling is conducted by Sterling Shoes Limited Partnership, all of the interests in which are owned, directly or indirectly, by Sterling. The Company operates retail stores in five provinces in shopping malls, high-streets and strip malls, principally in Western Canada. The Company is a leading retailer offering a broad selection of private label and national brand name shoes and accessories through five separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia.

The dividend policy of Sterling is subject to the discretion of the Board of Directors which takes into account the Company'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 Company 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.

There are 6,641,860 shares of Sterling and 25,000 Debentures issued and outstanding as at May 12, 2011. 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 2010 annual and special meeting, a "shareholder rights plan" for Sterling (the "Rights Plan") was approved. 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 five separate retail banners: Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia. 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 May 12, 2011. 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. Sterling, Joneve, Shoe Warehouse, Freedman Shoes, and Gia compete with other local, regional and national footwear retailers. The fragmented nature of the Canadian retail footwear industry and our five 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 banners are provided below.

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

RECENT EVENTS AND OUTLOOK

Recent Performance and the Company's Reorganization

During the first quarter of 2011 we continued transforming the Company, as follows:

- Successfully launched our new ERP system at our 12 Freedman stores in January 2011. The system was launched at our 74 Sterling, Joneve and Gia stores on April 1, 2011 and at our 75 Shoe Warehouse stores on May 1, 2011.
- Reduced inventory by \$7.1 million compared to a year-earlier, a decrease of 17.2%.
- The freshness of our inventory improved from a year earlier due to our aggressive approach to clearing out older inventory. The Company had 45% less aged inventory than at the same point a year earlier.

- Store and selling expenses decreased by \$0.9 million compared to last year.
- Logistics and inventory carrying costs were \$0.7 million lower compared to a year earlier.
- Continued re-branding of store banners. A new concept store for Shoe Warehouse is opening in Mississauga, Ontario in May 2011.

Since November 2010, we have initiated a series of significant changes with the objective of streamlining the organization and improving the effectiveness and efficiency of our staffing, infrastructure and systems.

Three areas we have specifically addressed include inventory, merchandising and operations. After completing our key initiative of reducing aged inventory, we are now focusing on the supply chain to maximize efficiencies and deliver a more attractive product complement to our stores. This translates positively into the in-store environment in several ways: stores are more visually attractive, staff is available to provide superior customer service; and customers can look forward to more branded product and everyday low prices.

The transformation in operations is further augmented by the creation of a supply chain and merchandise planning group, concurrently shifting the management of inventory to this newly created department. The structure of this group has been developed and staffed over the past few months. On March 28, 2011 Sairose Kassam joined Sterling as Vice President, Supply Chain to lead this new department and continue its development to improve the efficiency and effectiveness of our store network. We are maximizing product flow and capitalizing on store intelligence to provide stores with improved allocation of product to allow our stores to realize their full potential and meet the demands of our customers.

With the re-organization of the store operations group, several initiatives have been carried out to further streamline store operations. We have completed the task of reducing aged inventory and have also re-merchandised the stores to create a more inviting, friendly and fashion-forward environment. By reducing clutter and clearly communicating to our customers with appropriate price point signage alongside an improved product assortment, we are creating an environment where our customers want to shop.

During this quarter, we also successfully launched our new enterprise resource planning (“ERP”) system and have turned on all planned areas of its functionality. The last of our banners, Shoe Warehouse, went live on May 1, 2011. The system has significantly increased visibility into our business and the timeliness of our inventory reporting. This new system will add to our existing knowledge of customer profiles for each store, which will aid us in delivering the right shoe to the right place at the right time in the right quantity. We are looking to further capitalize on this new source of information to manage and run our operations with increased insight and efficiencies.

The new pricing strategy that was recently implemented across all banners, and specifically promoted in Shoe Warehouse locations, allows us to rebuild the confidence of our customers and offer competitive prices on a daily basis, reducing the need for constant promotion to stimulate sales. We are also strengthening our vendor alliances, strategically shifting towards more branded products in our banners.

Finally, we have performed a brand strategy review of all divisions, and have clearly defined and differentiated customer profiles and market segmentation for each banner. We have used the information from this review to create improvements in all banners, and have also planned additional changes to re-introduce our newly realigned brands to the market. The new store concept for Shoe Warehouse opens at the Dixie location in Mississauga in May 2011. With it comes a revitalized brand and store environment that speaks to the family and teen target audiences in a more

modern, fun and fashion-forward way. The new look and feel directly reflects our commitment to deliver popular brands at attractive everyday prices. A new store concept for Sterling is in development and planned to launch in late summer 2011.

Though we have not seen the desired positive sales result yet, we believe that as we work through this transitional period of reducing and liquidating inventory and adjusting the product mix, we will ultimately create that opportunity.

Number of Stores

During the first quarter 2011, we closed one underperforming store. Subsequent to quarter-end we opened a new Freedman store in Southcentre Mall in Calgary, Alberta. We believe that there is significant growth potential from a sales and profitability perspective within our existing store network. During 2011 we will focus on improving our performance within our existing store base before adding significantly to our store base or growing through other methods. 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 five retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating													
May 12, 2011							Dec 31, 2010	Dec 31, 2009	Dec 31, 2008	Dec 31, 2007	Dec 31, 2006	Dec 31, 2005	July 12, 2005
Province	Shoe					Total	Total	Total	Total	Total	Total	Total	Total
	Warehouse	Sterling	Joneve	Freedman	Gia								
British Columbia	39	20	6	10	2	77	77	76	75	65	63	60	59
Alberta	14	9	3	1	-	27	25	27	26	25	25	24	24
Saskatchewan	2	2	-	-	-	4	5	4	4	3	3	4	4
Manitoba	9	3	-	-	-	12	12	12	12	12	11	11	11
Ontario	11	23	6	2	-	42	42	43	43	36	25	5	2
Total	75	57	15	13	2	162	161	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.

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. has decided 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 has elected 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.

Business Combination

IFRS 1 provides an option to apply IFRS 3, Business Combinations, (“IFRS 3”) on a full retrospective basis or prospectively from the transition date onwards. The full retrospective basis would require restatement of all business combinations that occurred prior to the transition date. The Company has elected not to retrospectively apply IFRS 3 to business combinations that occurred prior to the transition date and such business combinations have not been restated.

Financial Statement Impact on Transition to IFRS

The Company has not yet prepared the 2010 comparative results for the full year under IFRS, and may result in additional adjustments that have not been anticipated above. In addition, the IASB continues to update the International Financial Reporting Standards. If any standards change prior to December 31, 2011, we are required to apply such changes retrospectively to the date of transition (January 1, 2010), and any such changes may have a material impact on our financial statements. Moreover, our opening consolidated statement of financial position for January 1, 2010, together with our consolidated statements of financial position as at March 31, 2011 and December 31, 2011 will not be audited until the results of operations for 2011 are audited by our external auditors in 2012. Although we have engaged our external auditors to review the preliminary comparative financial results under IFRS, a review does not involve the same level of analysis as an audit, and as such cannot be expected to identify all matters that may need to be addressed in order to fully comply with IFRS as enacted at December 31, 2011. However, management has modified some of its accounting policies to apply prospectively in order to conform to IFRS requirements. Significant changes to accounting policies are discussed below.

Significant Changes in Accounting Policies

In determining what constitutes a significant change to accounting policies, the Company identified areas of difference between IFRS and Canadian GAAP which present greater risk of potential future financial statement impact. Information on those accounting policy changes that management considers most significant to the Company are 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 new write downs, 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 standards did not result in a change to the carrying value of our assets on transition to IFRS.

Under IAS 36, "Impairment of Assets" to reverse any previous impairment losses may be reversed 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

Three months ended March 31

Statement of Income Items (\$000's)	2011	2010
Sales	\$ 22,011	26,855
Cost of Sales	(12,259)	(13,337)
Gross Margin	9,752	13,518
<i>As a percentage of sales</i>	<i>44.3%</i>	<i>50.3%</i>
Store and selling expenses	(10,222)	(11,146)
General and administrative expenses	(2,238)	(1,743)
EBITDA ⁽¹⁾	(2,708)	629
<i>As a percentage of sales</i>	<i>-12.3%</i>	<i>2.3%</i>
Interest expense	(667)	(644)
(Loss) / Gain on disposal	(152)	-
Unrealized (Loss) / Gain on foreign exchange	(146)	-
Amortization	(790)	(946)
Income / (Loss) before taxes	(4,463)	(961)
Future income taxes	1,106	-
Net income / (loss)	(3,357)	(961)
	March 31,	December 31,
Balance Sheet Items (\$000's)	2011	2010
Total assets	69,814	71,345
Long-term financial liabilities	28,282	29,210

Notes:

(1) See definition of EBITDA under "Non-IFRS Measures".

OPERATING RESULTS

Sales

Sales were \$22.0 million during the three-month period ended March 31, 2011, representing a decrease of 18% over the \$26.9 million in the same period in 2010. Same-store sales for the three-month period ended March 31, 2011 decreased by 19.1%, compared to the same periods during 2010.

The decline in sales resulted primarily from the strategic changes underway in the business and unseasonable weather. The reduction of inventory balances during fourth quarter 2010 and the creation of our merchandise planning and supply chain organization created temporary imbalances in our product allocation and mix. As new product is received it is flowing to our store network based on store profiles with appropriate style, size and volume of inventory. Unseasonable weather and a late start to Spring have also affected our sales.

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 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-month period ended March 31, 2011 was 55.7%, compared to 49.7% for the same period during 2010.

The inventory clearance and markdown strategy initiated during late 2010 carried on during first quarter 2011, during what is traditionally a clearance season. These clearance sales are historically at a low margin, and are somewhat offset late in the first quarter by the sale of new product for the early Spring-season. During first quarter 2011, due to product mix and weather factors, we did not receive a sales (and margin) lift from early-Spring sales. As a benchmark, cost of sales as a percentage of sales during first quarter 2008 and first quarter 2009 were 55.6% and 56.6%, respectively.

Store and selling expenses

Store and selling expenses for the three-months ended March 31, 2011 was 46.4% of sales, compared to 41.5% for the same period during 2010. 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 transformation in our operations has been undertaken with the goal of streamlining our organization and how Sterling’s business is operated. The Company began to realize cost savings with respect to employee costs both in-store and throughout its distribution network. In nominal dollar terms, store and selling expenses decreased by \$924 thousand for the three-month period ending March 31, 2011.

General and administrative expenses

General and administrative (“G&A”) expenses for the three-months ended March 31, 2011 was 10.2% of sales, compared to 6.5% during the same period in 2010, primarily due to investments in human resource, strategy and business intelligence initiatives.

EBITDA (see “Non-IFRS Measures”)

EBITDA for the three-months ended March 31, 2011 was -12.3% of sales, compared to 2.3% for the same period during 2010. The variance in EBITDA is accounted for by the reduction in sales and the increase in cost of sales and general and administration expenses. These items were somewhat offset by a reduction in store and selling expenses during the period.

Interest expense

Net interest expense with respect to funds utilized under the credit facilities for the three-months ended March 31, 2011 was \$58 thousand, compared to \$59 thousand in 2010.

Interest expense with respect to the convertible debentures for the three-month period ended March 31, 2011 was \$605 thousand (2010 - \$585 thousand).

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-months ended March 31, 2011 was \$199 thousand (2010 - \$179 thousand), relating to this interest accretion.

Inventory

As noted earlier, in late 2010 management took action to make room for higher margin inventory and improve inventory turnover, which carried into the first quarter of 2011. Over the past few months we have been investing in and creating a supply chain and merchandise planning group, concurrently with shifting the management of inventory to this newly created department. Following the rapid reduction of our inventory levels during fourth quarter 2010 we are striving to optimize product flow as new product arrives to provide stores with appropriate style, size and inventory volumes.

As a result of the foregoing actions at March 31, 2011 we had \$7.3 million, or 17.8% less inventory than at the same time last year. The freshness of our inventory improved from a year earlier due to our aggressive approach to clearing out older inventory. The Company had 45% less aged inventory than at the same point a year earlier.

During first quarter 2011 the Company reduced its inventory carrying and logistics charges. These costs were \$660 thousand lower during the period, compared to the same period a year earlier.

SELECTED QUARTERLY FINANCIAL INFORMATION

<u>in (\$000's) except per Share amounts</u>	<u>Q1-2011</u>	<u>Q4-2010</u>	<u>Q3-2010</u>	<u>Q2-2010</u>	<u>Q1-2010</u>	<u>Q4-2009</u>	<u>Q3-2009</u>	<u>Q2-2009</u>
Sales	\$ 22,011	\$ 39,348	\$ 32,218	\$ 28,606	\$ 26,855	\$ 41,195	\$ 31,685	\$ 30,618
(Loss) / Income before non-controlling interest and taxes ⁽¹⁾	\$ (4,463)	\$ (108)	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (35,432)	\$ (651)
Future income taxes	1,106	1,571				-	4,636	-
(Loss) / Income before non-controlling interest ⁽¹⁾	\$ (3,357)	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)
Net (Loss) / Income	\$ (3,357)	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)	\$ (651)
Basic (loss) / income per Share	\$ (0.505)	\$ 0.220	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.939	\$ (4.637)	\$ (0.098)
Diluted (loss) / income per Share	\$ (0.505)	\$ 0.212	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.820	\$ (4.637)	\$ (0.098)
Cash dividends/distributions per Share	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.037	\$ 0.056	\$ 0.056
Number of stores open at end of period	161	162	162	160	161	162	162	161

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-month periods ended March 31, 2011 and 2010.

Sterling Shoes Inc.
Reconciliation of Net Income to Cash provided by operations
March 31, 2011

<u>in (\$000's)</u>	<u>Three-months ended Mar 31</u>	
	<u>2011</u>	<u>2010</u>
Net loss	\$ (3,357)	(961)
Add charges (deduct credits) to operations not requiring a cash payment:		
Future income taxes	(1,106)	-
Amortization of leaseholds and equipment	790	946
Accreted interest expense	199	179
Amortization of deferred leasehold inducements	(82)	(96)
Loss on disposal of leaseholds and equipment	152	-
	<u>(3,404)</u>	<u>68</u>
Net change in non-cash working capital balances related to operations:		
Accounts receivable	(565)	(248)
Inventory	(5,208)	(4,718)
Prepaid expenses and deposits	(164)	(47)
Accounts payable and accrued liabilities	<u>1,602</u>	<u>1,352</u>
Cash used in operating activities	\$ <u>(7,739)</u>	<u>(3,593)</u>

For the three-month period ended March 31, 2011, cash used in operations was \$7.7 million compared to \$3.6 million in the same period of 2010.

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-month period ended March 31, 2011 generally reflected these expectations.

Capital Expenditures

We invested in capital expenditures of \$605 (net of leasehold inducements) during the three-month period ended March 31, 2011 (2010 - \$Nil). Of this amount, \$41 was invested in leaseholds and equipment to furnish new stores during the three months ended March 31, 2011. We incurred maintenance capital expenditures of \$564 during the three-month period ended March 31, 2011 (2010

- \$208), of which \$364 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 is repayable on July 31, 2013. As at March 31, 2011, we had no utilization of the Operating Loan.

We have utilized \$4.3 million of our \$5 million 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 third payment was made on March 31, 2011.

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. Certain covenants have been amended.

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 March 31, 2011, letters of credit totaling \$2.1 million are outstanding. The last of these letters of credit expires on July 31, 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	2011	2012	2013	2014	2015
Inventory purchase commitments	2,122				
Long-term debt		25,000			
Term Loan	750	1,000	2,500		
Minimum rental commitments ⁽¹⁾	11,006	14,944	13,627	12,753	10,354
	<u>13,877</u>	<u>40,944</u>	<u>16,127</u>	<u>12,753</u>	<u>10,354</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-month period ended March 31, 2011 (2010 - \$Nil in distributions).

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

NON-IFRS 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 IFRS and do not have standardized meanings prescribed by IFRS 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 IFRS 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 IFRS. 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 IFRS. Net Senior Debt is equal to net 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 March 31, 2011 there was an income tax recovery of \$1.1 million (2010 - \$Nil).

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 for the three-month period ended March 31, 2011 (2010 – \$74 thousand) respectively.
- (b) The Company purchased equipment from a company in which Mannie Druker, a director and officer of Sterling, has an interest for \$46 thousand during the three-month period ended March 31, 2011 (2010 – \$6 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-month period ended March 31, 2011. 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 deemed cost, being the fair value amount of the assets as at December 31, 2010. 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 the assets may be impaired. In performing a formal impairment assessment, the Company estimates the recoverable amount of the asset by performing a comparison of the asset’s carrying value to the higher of fair value less costs to sell and value in use, which is defined as the present value of future cash flows expected to be derived from the asset in its current state. 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 the higher of fair value less costs to sell and value in use.

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 8.3%. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231 thousand.

CHANGES IN ACCOUNTING STANDARDS

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

The Canadian Accounting Standards Board (AcSB) requires 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 is 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 below for the three months ended March 31, 2011 and in our 2010 Annual Information Form, both of which can be found at www.sedar.com.

Dependence on Consumer Spending and Economic Environment

The success of our operations depends upon a number of general economic factors relating to consumer spending, including employment levels, business conditions, consumer confidence, interest rates, inflation and taxation. There can be no assurance that consumer spending will not decline further in response to economic conditions, thereby adversely affecting our operating results.

Management cannot estimate the level of growth or contraction for the economy as a whole or for the economy of any particular region or market that we serve. Adverse changes in our financial condition and results of operations may occur as a result of continuing uncertain economic conditions, employment levels, declines in stock markets, contraction of credit availability or other factors affecting economic conditions generally.

Maintaining Profitability and Managing Growth

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

- our ability to maintain or increase 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 centres 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 is no assurance that we will be able to successfully execute our strategy and maintain or increase historical sales, profitability or growth rates as there are many factors outside of management control. The inability to successfully execute any material part of our strategic plan could have an adverse effect on our business, financial condition, liquidity and results of operations.

Competition

The retail footwear market is highly competitive. We compete with department stores, mass-market general retailers, sporting goods stores and specialty shoe stores. Many of these competitors have stores in the markets in which we now operate and in those in which we plan to expand. Many of our competitors have significantly greater financial, marketing and other resources than we do. In addition, there can be no assurance that, in the future, new participants will not enter the retail footwear market; the recent announcements by US retailers of plans for expansion into Canada are an example of this risk. Our stores compete, among other things, on the basis of convenience of location and store layout, product mix and selection, customer service and price. Competitive pressures resulting from

competitors' pricing policies could materially adversely affect our gross margins. There can be no assurance that we will not face greater competition from other national, regional or local retailers or from retailers entering the market from outside Canada, or that we will be able to compete successfully with existing and new competitors. Our inability to respond to such competition 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. Approximately 27% of our inventory purchases in the three-month period ended March 31, 2011 were made in United States dollars. Although we take into consideration the Canadian/United States dollar exchange rate at the time of specific purchases and are therefore able to factor the applicable exchange rate into our purchasing decision, we are subject to the risk of exchange rate fluctuations between order and sale of goods. 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".

Risks Associated with Leasing and Expansion

Our success will depend to a significant degree on our ability to maintain our existing operations through the successful renewal, on a profitable basis, of our existing store leases as they come due. 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. Our ability to successfully negotiate lease renewals and to expand 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 successfully renew our existing leases as they come due on a profitable basis or achieve our planned expansion or that any such expansion will be profitable. In addition, there can be no assurance that 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.

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 Company'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.

Credit Facilities and Restrictive Covenants

The Company has third-party debt service obligations under the Credit Facilities. See "Credit Facilities". The degree to which the Company is leveraged could have important consequences to the shareholders, including: (i) a portion of the Company's cash flow from operations will be dedicated to the payment of the principal of and interest on the indebtedness, thereby reducing funds available for future operations, distributions to the Company and dividends to shareholders; (ii) certain of the Company's borrowings will be at variable rates of interest, which exposes the Company to the risk of increased interest rates; and (iii) the Company's ability to obtain additional financing for working capital, capital expenditures or acquisitions in the future may be limited. The Company's ability to make scheduled payments of principal and interest on, or to refinance, its indebtedness will depend on its future operating performance and cash flow, which are subject to prevailing economic conditions, prevailing interest rate levels, and financial, competitive, business and other factors, many of which are beyond our control. These factors might inhibit the Company from refinancing the indebtedness at all or on favourable terms, which could have a negative impact on our ability to pay out dividends to the shareholders.

The Credit Facilities contain numerous restrictive covenants that limit the discretion of management with respect to certain business matters. These covenants will place restrictions on, among other things, the ability of the Company to incur additional indebtedness, to create liens or other encumbrances, to pay distributions or make certain other payments, investments, loans and guarantees, and to sell or otherwise dispose of assets or merge or consolidate with another entity. A failure to comply with the obligations in the agreements in respect of the Credit Facilities could result in an event of default which, if not cured or waived, could permit acceleration of the relevant indebtedness. If the indebtedness under the Credit Facilities were to be accelerated, there can be no assurance that our assets would be sufficient to repay in full that indebtedness.

The Credit Facilities each expire on July 31, 2013, subject to extension provisions. The Company may need to refinance the Credit Facilities at the conclusion of their term, and there can be no assurance that the Company will be able to do so or able to do so on terms that are as favourable as the Credit Facilities. If the Company is unable to refinance the Credit Facilities or is only able to refinance the Credit Facilities on less favourable and / or more restrictive terms, this may have a material adverse effect on the Company's financial position. In addition, the terms of any new credit facilities may be less favourable or more restrictive than the terms of the Credit Facilities.

Future Capital Needs

We cannot assure you that we will be able to generate sufficient cash flow from operations or obtain sufficient borrowings under our credit facilities, on reasonable terms or at all, to finance our growth strategy and meet our other liquidity needs. Our actual costs may be greater than anticipated. We also require working capital to support inventory for our existing stores. Failure to generate or raise sufficient funds may require us to modify, delay or abandon some of our future growth or expenditure plans. Also, our results would be adversely affected if interest rates were to increase materially from present levels.

Management Information Systems

With the growth in our Business we are increasingly dependent on our computer systems to support our operations. We have used legacy systems to support the majority of our operations in the areas of finance, inventory management and point of sale. Management determined that these legacy systems were not the most effective to support our growth in the number of stores in our Business and has recently implemented a new enterprise resource planning system (“ERP”). The ERP is intended to be a centralized system that is linked to servers supporting localized processes and specialized applications, including payroll and distribution. There can be no assurance that we will not experience operational problems, with our existing legacy systems or with the ERP, as a result of implementation issues, system failures, viruses, security breaches or other causes. In addition there can be no assurance that we will be able to modify or adapt our systems to meet evolving requirements for our Business. Any material disruption or slowdown of our systems could cause operational issues.

Risks Associated with Convertible Debentures

Interest Payments

Interest payments on the Debentures and redemption or repayment of the Debentures are not guaranteed and are entirely derived from the business operated by related entities of the Company and from the ability of each such entity to make distributions on its securities. There can be no assurance that the Company and the related entities of the Company 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 Company. The Debentures are also effectively subordinate to claims of creditors of the Company’s subsidiaries except to the extent the Company is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors.

Inability to Fund Purchase of Debentures

The Company 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 Company 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 Company 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 Company or any of its subsidiaries.

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:

- Due to 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, 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 30% 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 March 31, 2011, the Company had forward foreign exchange contracts as follows:

Settlement dates	Face Value \$US	Average rate \$Cdn
April 2011	1,525	1.023
May 2011	1,050	1.014
June 2011	1,050	1.003
July 2011	1,820	0.995
Aug 2011	1,820	0.996
Sept 2011	1,820	0.996
Oct 2011	1,545	0.995
Nov 2011	2,020	0.995
Dec 2011	1,100	0.996
Jan 2012	1,000	0.977
Feb 2012	1,000	0.977
Mar 2012	500	0.976

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 International Financial Reporting Standards (“IFRS”).

Our Chief Executive Officer and Chief Financial Officer certified the appropriateness of the financial disclosures in the MD&A and consolidated financial statements for the three months ended March 31, 2011. 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 March 31, 2011 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 March 31, 2011 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 uncertainty of the current economic recovery, the cost and availability of capital, the possibility of deterioration in our working capital position, the impact on our liquidity and interest costs 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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