

STERLING SHOES INC.

(formerly Sterling Shoes Income Fund)

MANAGEMENT'S DISCUSSION AND ANALYSIS

August 11, 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 and six month periods ended June 30, 2011. Results have been prepared in accordance with International Financial Reporting Standards ("IFRS" and reported in Canadian dollars unless otherwise indicated). The 2010 prior period comparative financial information throughout this report has been restated in accordance with IFRS; however, 2009 information is presented in accordance with Canadian GAAP and has not been restated. 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 ("Sterling Shoes LP"), 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 August 11, 2011. The shares of Sterling trade on the Toronto Stock Exchange under the symbol SSI and the Debentures trade under the symbol SSI.DB.

OVERVIEW OF OUR BUSINESS

Sterling Shoes LP operates five Canadian retail businesses in locations from British Columbia to Ontario: Sterling, Freedman, Joneve, Gia and Shoe Warehouse. Each business is primarily focused on footwear, but also offers accessories such as handbags, as well as hosiery and shoe care products. Since 1987 the Sterling Shoes business has grown from five locations to 160 stores as at August 11, 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.

The divisions are clearly distinguished from each other by brand experience, product offering and target customer, providing our markets with a diverse and memorable selection of fashionable and functional footwear.

Each of our banners targets a specific consumer group through different product, merchandising, location, pricing, service and advertising strategies. Sterling, Freedman, Joneve, Gia and Shoe Warehouse, 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.

Shoe Warehouse	Sterling/Gia	Freedman	Joneve
Payless Shoe Source	ALDO	Brown's	Gravity Pope
The Shoe Company	Spring	B2	Brown's
Winners	Steve Madden	Nine West	B2
Softmoc	Town Shoes	Town Shoes	Holt Renfrew
Zellers	Little Burgundy	Holt Renfrew	Umeboshi and other
Style Sense	Apparel stores selling mid-to-	Harry Rosen	independent retailers
Walmart	high range fashion footwear	The Bay	
		Naturalizer	

RECENT EVENTS

During the second quarter of 2011:

- EBITDA increased to \$556 thousand compared to \$55 thousand a year earlier.
- Gross margin improved to 54.8% compared to 46.7% a year earlier.
- Reduced inventory units by 8% compared to a year-earlier.
- Aged inventory was 34% lower than at the same point a year earlier due to aggressive clearing of dated products.
- Store and selling expenses decreased by \$0.5 million and \$1.5 million in the three and six month periods compared to last year.
- Freight distribution and warehousing costs were \$0.4 million and \$1.3 million lower in the three and six month periods compared to last year.
- Completed the launch of our new ERP system Company-wide.
- However, sales during the three and six month periods ended June 30, 2011 were \$24.3 million and \$46.3 million representing decreases of 15.0% and 16.5% respectively.

Since November 2010, our primary objective has been to streamline the organization and improve the effectiveness and efficiency of our staffing, infrastructure and systems.

We focussed on four key areas: inventory, operations, merchandising, and branding. We completed a key initiative of reducing aged inventory and further reduced seasonal inventory on hand to keep our stock fresh and relevant.

Inventory

Operationally, we sought ways to maximize efficiencies in our warehouses. We reduced warehousing headcount during the first half of 2011, while increasing the physical capacity of the warehouse space in conjunction with retooling it to allow for an improved replenishment process flow. This enabled us to eliminate inventory handling and flow at a third party logistics location. For the three and six month periods ended June 30, 2011, we realized savings of \$0.4 million and \$1.3 million from freight, distribution, and warehousing costs compared to the same period in 2010. We also concentrated on cost controls in other areas of the business during the second quarter of 2011. Store and selling expenses decreased by \$0.5 million and \$1.5 million for the three and six month periods ending June 30, 2011 as a result of management's actions.

Merchandising

During the quarter, we successfully completed the launch of our new enterprise resource planning ("ERP") system and are beginning to benefit from the planned areas of its functionality. 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. We have moved past implementation and are now testing additional functionalities such as customer relationship management and supply chain replenishment modules.

Operations

We realigned roles in a number of areas of the organization to achieve further efficiencies which resulted in the elimination of several positions which have been made redundant. The total charge associated with this re-organization was \$170 thousand during the second quarter of 2011.

We are critically evaluating our stores and have identified a number of locations that do not effectively reach our target customers or fit our long-term vision for our business. We are actively working to exit these locations. In the first six months of 2011, we closed three under-performing stores.

Branding

During this quarter, the review of the four multi-unit banners has progressed so that we now have documented brand platforms and brand stories. These provide the foundation and context not only for our marketing decisions moving forward, but also inform many operational decisions and the products we buy. We have also invested in augmenting our messaging and communication channels for the banners, and are conducting a phased introduction of the revitalized brands to the market. This has been a very exciting quarter for all of the banners as we move closer to having our customers see all the positive changes we have been making when they walk in our doors and see the enhanced store environments, the re-focused and improved product mix and the fresh brand messaging.

Number of Stores

During the second quarter 2011, 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. 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 160 stores operate under five retail banners in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario as follows:

Number of Stores Operating														
Aug. 11, 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	Total
	Warehouse	Sterling	Joneve	Freedman	Gia									
British Columbia	39	19	6	10	1	75	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	56	15	13	1	160	161	162	160	141	127	104	100	

INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)

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.

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.

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 board of directors prior to being finalized. Accordingly, the discussion above is subject to change. (See also Note 4 of the Interim Consolidated Financial Statements for information relating to elections, mandatory exemptions and financial statement impact for first time adoption of IFRS)

SUMMARY FINANCIAL INFORMATION

Statement of Income Items (\$000's)	Three months ended June 30		Six months ended June 30	
	2011	2010	2011	2010
Sales	\$ 24,313	28,606	46,324	55,461
Cost of Sales	(10,998)	(15,234)	(23,257)	(28,571)
Gross Margin	13,315	13,372	23,067	26,890
<i>As a percentage of sales</i>	54.8%	46.7%	49.8%	48.5%
Store and selling expenses	(10,527)	(11,057)	(20,749)	(22,203)
General and administrative expenses	(2,232)	(2,261)	(4,469)	(4,004)
EBITDA ⁽¹⁾	556	55	(2,151)	683
<i>As a percentage of sales</i>	2.3%	0.2%	-4.6%	1.2%
Interest expense	(748)	(659)	(1,414)	(1,302)
Loss on disposal	-	(218)	(152)	(218)
Unrealized Gain / (Loss) on foreign exchange	63	-	(83)	-
Amortization of leaseholds and equipment	(946)	(932)	(1,736)	(1,878)
Loss before taxes	(1,075)	(1,754)	(5,536)	(2,715)
Deferred income taxes recovery	264	-	1,370	-
Net loss	(811)	(1,754)	(4,166)	(2,715)

Balance Sheet Items (\$000's)	June 30, 2011	December 31, 2010
Total assets	71,611	71,345
Long-term financial liabilities	25,223	29,210

Notes:

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

OPERATING RESULTS

Sales

Sales were \$24.3 million during the three-month period ended June 30, 2011, representing a decrease of 15.0% from the \$28.6 million in the same period in 2010. For the six-month period ended June 30, 2011, sales were \$46.3 million compared to \$55.5 million in 2010 representing a 16.5% decline. Same-store sales for the three and six-month periods ended June 30, 2011 decreased by 17.0% and 18.2%, compared to the same periods during 2010.

The decline in sales resulted primarily from the strategic initiatives underway in the business and the weak retail environment.

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 and six month periods ended June 30, 2011 was 45.2% and 50.2%, compared to 53.3% and 51.5% respectively for the same periods during 2010.

For the three-month period ended June 30, 2011 gross margin as a percentage of sales increased to 54.8% compared to 46.7% during the same period in 2010. For the six month period ended June 30, 2011 gross margin as a percentage of sales increased to 49.8% compared to 48.5% during the same period in 2010.

We implemented a disciplined inventory clearance and markdown strategy during late 2010 which carried on during first quarter 2011. Having significantly cleared our aged inventory and implemented a new pricing strategy, our product offering was fresher in the second quarter of 2011 as compared to the same quarter in 2010 and we realized higher gross-margins as a result of lower promotional activity on these products.

Store and selling expenses

Store and selling expenses for the three and six-months ended June 30, 2011 were 43.3% and 44.8% of sales, compared to 38.7% and 40.0% for the same periods during 2010, respectively largely due to the impact of lower sales. 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 \$530 thousand and \$1.5 million for the three and six month periods ending June 30, 2011 as a result of management's actions to reduce costs in managing the business. During June 2011, the Company closed two underperforming stores. Savings in store and selling expenses with respect to these closures will begin to be realized in the third quarter of 2011. The overall effect of the cost reductions as a percentage of sales was offset by the decrease in sales in the first half of 2011.

General and administrative expenses

General and administrative ("G&A") expenses decreased by \$29 thousand for the three-month period ended June 30, 2011 compared to the same period in 2010 and increased by \$466 thousand for the six-month period ended June 30, 2011 compared to the prior year. The Company has made investments in its human resources infrastructure and business intelligence initiatives with the expectation of lowering its overall cost structure. The benefits of these investments are shown in the reduction in cost of sales and store and selling expenses. Due largely to the impact of lower sales in 2011, G&A expenses represent 9.2% and 9.6% of sales, compared to 7.9% and 7.2% during the same periods in 2010, respectively.

EBITDA (see "Non-IFRS Measures")

EBITDA for the three and six-months ended June 30, 2011 was 2.3% and negative 4.6% of sales, respectively, compared to 0.2% and 1.2% for the same periods during 2010. EBITDA improved in the three-month period ended June 30, 2011, compared to the same period in 2010, due to the increase in gross margin and reduction in store and selling expenses. Lower EBITDA as a percentage of sales for the six-month period ended June 30, 2011 is largely due to high promotional activity during the first quarter of 2011 and lower sales during the period. Management believes that improvements during the second quarter of 2011 are a result of its strategic actions to reposition our product mix and permanently reduce our cost structure.

Interest expense

Net interest expense with respect to funds utilized under the credit facilities for the three and six months ended June 30, 2011 was \$136 thousand and \$198 thousand respectively, compared to \$62 thousand and \$121 thousand in 2010. This was due to higher average debt balances this year.

Interest expense with respect to the convertible debentures for the three-month and six-month periods ended June 30, 2011 was \$612 thousand and \$1.2 million (2010 - \$591 thousand and \$1.2 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-month and six-months ended June 30, 2011 was \$206 thousand and \$404 thousand (2010 - \$185 thousand and \$364 thousand), respectively, 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 continued to build our supply chain and merchandise planning group. Progress in the supply chain group continued during the second quarter of 2011. We reduced the permanent employee count in our Richmond warehouse while improving capacity and increasing throughput. In the current six month period we have saved \$1.3 million in freight, logistics, and warehousing costs versus the same period in 2010.

At June 30, 2011, on a valuation basis, we had \$1.4 million, or 3.8% less inventory than at June 30, 2010. On a unit basis, we had 8.3% fewer units of inventory at June 30, 2011 compared to the same time a year earlier. Inventory cost per unit has increased due to a shift in product mix to include more branded product, as well as inflationary pressures on labour and materials in China. The freshness of our inventory improved from a year earlier. The Company had 34% less aged inventory than at the same point a year earlier.

During first half 2011 the Company reduced its inventory carrying and logistics charges. These costs were \$0.4 million and \$1.3 million lower during the three and six month periods, compared to a year earlier.

SELECTED QUARTERLY FINANCIAL INFORMATION

<u>in (\$000's) except per Share amounts</u>	<u>Q2-2011</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>
Sales	\$ 24,313	\$ 22,011	\$ 39,348	\$ 32,218	\$ 28,606	\$ 26,855	\$ 41,195	\$ 31,685
(Loss) / Income before taxes	\$ (1,075)	\$ (4,463)	\$ (108)	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (35,432)
Net (Loss) / Income	\$ (811)	\$ (3,357)	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238	\$ (30,796)
Basic (loss) / income per Share	\$ (0.122)	\$ (0.505)	\$ 0.220	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.939	\$ (4.637)
Diluted (loss) / income per Share	\$ (0.122)	\$ (0.505)	\$ 0.212	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.820	\$ (4.637)
Cash dividends/distributions per Share	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.037	\$ 0.056
Number of stores open at end of period	160	161	162	162	160	161	162	162

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”.

We cannot provide assurance that the Company will generate sufficient cash from operations or obtain sufficient borrowings, on reasonable terms or at all, to meet our liquidity needs.

However, we have reached agreement in principle with our senior debt lender, the Bank of Montreal, to amend our Operating Loan and Term Loan, as defined below under “*Capital Resources*”, (the “Amended Facility”). See “*Capital Resources*” for further detail on the Amended Facility.

Cash Flow from Operations

The table below reconciles net income to cash flow from operations for the three-month and six-month periods ended June 30, 2011 and 2010.

in (\$000's)	Three-months ended Jun 30		Six-months ended Jun 30	
	2011	2010	2011	2010
Net loss	\$ (811)	(1,754)	(4,166)	(2,715)
Add charges (deduct credits) to operations not requiring a cash payment:				
Deferred income taxes recovery	(264)	-	(1,370)	-
Amortization of leaseholds and equipment	946	932	1,736	1,878
Accreted interest expense	206	185	404	363
Amortization of deferred leasehold inducements	(87)	(131)	(170)	(226)
Loss on disposal of leaseholds and equipment	-	218	152	218
	(10)	(550)	(3,414)	(482)
Net change in non-cash working capital balances related to operations:				
Accounts receivable	492	323	(71)	76
Inventory	(1,675)	4,259	(6,883)	(459)
Prepaid expenses and deposits	101	(22)	(63)	(70)
Accounts payable and accrued liabilities	(4,961)	(3,574)	(3,361)	(2,222)
Cash (used in)/ provided by operating activities	\$ (6,053)	436	(13,791)	(3,157)

For the three-month period ended June 30, 2011, cash used in operations was \$6.1 million as compared to cash provided by operations of \$0.4 million in the same period of 2010. Cash used in operations was \$13.8 million for the six-month period ended June 30, 2011 as compared to \$3.2 million for the same period in 2010.

Capital Expenditures

We invested in capital expenditures of \$1.3 million (net of leasehold inducements) and \$1.9 million during the three and six month periods ended June 30, 2011 (2010 - \$0.5 million and \$0.8million), respectively. Of these amounts, \$270 thousand and \$310 thousand were invested in leaseholds and equipment to furnish new stores during the three-month and six-month periods ended June 30, 2011 respectively (2010 - \$Nil and \$Nil). We incurred maintenance capital expenditures of \$1.1 million and \$1.7 million during the three and six month periods ended June 30, 2011 (2010 - \$0.5 million and \$0.8 million), respectively, which were related to upgrades to our information technology system and store renovations. These maintenance capital expenditures were funded by the 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.

We have a revolving credit facility of up to \$15 million (the “Operating Loan”) with the Bank of Montreal, which is available for working capital requirements, capital expenditures and for general corporate purposes and is repayable on July 31, 2013. As at June 30, 2011, we have utilized \$8.8 million of the Operating Loan.

We have utilized \$4.0 million of our original \$5 million credit facility with the Bank of Montreal (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 thousand, plus interest, to effect a 5 year amortization. The fourth payment was made on June 30, 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.

We have reached agreement in principle with the Bank of Montreal, to amend our Operating Loan and Term Loan, subject to final documentation. The Amended Facility will be made on a demand basis and will provide a maximum aggregate availability of \$27 million declining to \$20 million by October 31, 2011.

Loans under the Amended Facility are pre-payable without any penalties and bear interest at a floating rate based on the Canadian dollar prime rate rates plus an applicable margin to those rates. The Amended Facility is secured by a general security agreement covering all assets of Sterling Shoes LP.

The Amended Facility is 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 Amended Facility also requires us to meet certain conditions in order to maintain interest payments on the Convertible Debentures (see “*Risks and Uncertainties – Liquidity and Capital Resources*”).

The Amended Facility is intended to be a bridge to a full asset-backed lending facility (the “ABL Facility”). We are currently in negotiations with the Bank of Montreal regarding the terms for the ABL Facility.

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 June 30, 2011, letters of credit totaling \$3.6 million are outstanding. The last of these letters of credit expires on December 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:

<u>in \$000's</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Inventory purchase commitments	3,605				
Long-term debt		25,000			
Operating and Term Loans	12,780				
Minimum rental commitments ⁽¹⁾	<u>8,287</u>	<u>15,312</u>	<u>14,288</u>	<u>13,165</u>	<u>11,785</u>
	<u>24,672</u>	<u>40,312</u>	<u>14,288</u>	<u>13,165</u>	<u>11,785</u>

Note:

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

Management is actively exploring the re-financing options available for the repayment of the long-term debt.

DIVIDENDS

The Company did not declare any dividends to the Shareholders for the three and six month periods ended June 30, 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 and six-months ended June 30, 2011 there was an income tax recovery of \$264 thousand and \$1.4 million (2010 - \$Nil and \$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 and \$158 thousand for the three-month and six-month periods ended June 30, 2011 (2010 – \$74 thousand and \$148 thousand) respectively.
- (b) The Company purchased equipment from a company in which Mannie Druker, a director and officer of Sterling, has an interest for \$29 thousand and \$75 thousand during the three-month and six-month periods ended June 30, 2011 (2010 – \$7 thousand and \$13 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 and six-month periods ended June 30, 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 10.7%. Transaction costs consisting of commissions and professional fees related to the issuance of the Debentures amounted to \$1,231 thousand.

RISKS AND UNCERTAINTIES

A detailed discussion of our significant business risks is provided for the three and six-months ended June 30, 2011 in our 2010 Annual Information Form and our MD&A for the fiscal year ended December 31, 2010, both of which can be found at www.sedar.com. There have been no changes to these risks in the second quarter of 2011 other than as discussed above under “*Capital Resources*” and further discussed below.

Liquidity and Capital Resources

We cannot provide assurance that the Company will generate sufficient cash from operations or obtain sufficient borrowings, on reasonable terms or at all, to meet our liquidity needs.

We have reached an agreement in principle with the Bank of Montreal on the terms of the Amended Facility, subject to final documentation. The Amended Facility is a demand facility and could be called for payment at any time. In addition, it is intended that the Amended Facility will be replaced by the ABL Facility. In the event that the Amended Facility is called for payment, or if we are unsuccessful in negotiating terms for the ABL Facility or other replacement borrowings, there would be a material negative impact on our business, financial condition and results of operations.

The Amended Facility also contains requires us to meet certain conditions in order to maintain interest payments on the Convertible Debentures. We can give no assurance that we will be able to meet those conditions and make such interest payments. In addition, while we are actively

reviewing options to refinance the Convertible Debentures, there are no assurances that we will be able to finance the redemption of the Convertible Debentures on the maturity date.

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 June 30, 2011, the Company had forward foreign exchange contracts as follows:

<u>Settlement dates</u>	<u>Face Value \$US</u>	<u>Average rate \$Cdn</u>
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	2,000	0.971
Mar 2012	1,500	0.968
Apr 2012	500	0.964
May 2012	500	0.964
Jun 2012	500	0.964
Jul 2012	500	0.964

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 and six months ended June 30, 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 June 30, 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 June 30, 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 current economic conditions, 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, , 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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