

STERLING SHOES INC.

(formerly Sterling Shoes Income Fund)

MANAGEMENT'S DISCUSSION AND ANALYSIS

November 10, 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 nine month periods ended September 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 AND OUR BUSINESS

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 158 retail stores in shopping malls, high-streets and strip malls in locations from British Columbia to Ontario. The Company offers 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 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	

There are 6,641,860 common shares (the “Shares”) and 25,000 convertible debentures (the “Debentures”) issued and outstanding as at November 10, 2011. The Company has received notice from the Toronto Stock Exchange (the “TSX”) that the Shares and Debentures (Symbol: SSI and SSI.DB, respectively) will be delisted at the close of market on November 25, 2011 for failure to meet the continued listing requirements of TSX. The Shares and Debentures will remain suspended from trading until that date. The notice follows the initial order obtained by the Company under the *Companies’ Creditors Arrangement Act* on Friday, October 21, 2011. See “Recent Events – CCAA Order and TSX Delisting”.

RECENT EVENTS

CCAA Order and TSX Delisting

The Company has been facing liquidity and profitability issues with significant and unexpected declines in sales revenue in recent years. Despite progress being made in streamlining processes and cost-reduction initiatives, we continue to face balance sheet and declining and/or negative same store sales challenges. Our worsening financial performance has made it impossible to service our debt obligations, including our trade creditors. Our financial performance, demonstrated by the decline in our share price, together with poor economic conditions, undermined our efforts to address our business issues.

As a result, on October 21, 2011, the Company announced that it and Sterling Shoes GP Inc. (the general partner of Sterling Shoes LP) obtained an Initial Order (the “CCAA Order”) from the Supreme Court of British Columbia (the “Court”) under the *Companies’ Creditors Arrangement Act* (Canada), R.S.C. 1985, c. C-36, as amended (the “CCAA”). The Company will continue to operate during the restructuring under the CCAA.

The Court granted protection under the CCAA for an initial period expiring on November 18, 2011 to be extended as required and if approved by the Court. The Company expects to seek an extension of the CCAA Order on or before November 18, 2011. While the Company is under CCAA protection, all proceedings against or in respect of the Company are stayed.

The CCAA Order permits the Company to pay all expenses incurred in carrying on the business after the date of the CCAA Order, including the cost of goods and services delivered by suppliers. The terms and conditions of the restructuring plan have not yet been determined by the Company.

Alvarez and Marsal Canada Inc. has been appointed Monitor pursuant to the CCAA Order.

In connection with obtaining the CCAA Order, we entered into a forbearance agreement with our senior debt lender, the Bank of Montreal. See “*Capital Resources*”.

Non-Payment of Debenture Interest

The Company’s credit facility with the Bank of Montreal includes certain provisions and covenants limiting the Company’s ability to make the interest payments on the Debentures. Due to a continued challenging retail environment and the cash flow situation of the Company, the Company announced on September 27, 2011 that the Board of Directors had determined that the Debenture interest amount that was due and payable on October 31, 2011 would not be paid.

Restructuring

We operate a number of divisions, some of which are unprofitable; however, we continue to believe that there is a viable core business. In order to avoid possible enforcement proceedings by creditors, and other potential events that could harm our business, we require the protections afforded by a stay of proceedings to implement a restructuring for the benefit of the Company. We believe that the best way to preserve enterprise value for the Company is to develop a restructuring plan under the CCAA.

The key elements of a plan of compromise or arrangement will include the following:

- Closing non-performing or under-performing stores and/or banners;
- Reducing corporate overhead; and
- Pursuing strategies to grow the more successful aspects of the business.

Resignation of Directors

Mr. James Bruce resigned as a director of the Company effective October 20, 2011. Mr. Sol Oshry resigned as a director of the Company effective October 24, 2011.

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

During the quarter ended September 30, 2011, the Company recorded a non-cash impairment charge of \$16.6 million to write-down the valuation of its intangible assets to \$nil.

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 Sept 30		Nine months ended Sept 30	
	2011	2010	2011	2010
Sales	\$ 26,960	32,218	73,284	87,679
Cost of Sales	(14,953)	(21,537)	(38,210)	(50,108)
Gross Margin	12,007	10,681	35,074	37,572
<i>As a percentage of sales</i>	44.5%	33.2%	47.9%	42.9%
Store and selling expenses	(10,817)	(11,215)	(31,565)	(33,418)
General and administrative expenses	(2,290)	(2,000)	(6,758)	(6,005)
EBITDA ⁽¹⁾	(1,100)	(2,534)	(3,249)	(1,851)
<i>As a percentage of sales</i>	-4.1%	-7.9%	-4.4%	-2.1%
Impairment of intangible assets	(16,623)	-	(16,623)	-
Interest expense	(1,918)	(653)	(3,332)	(1,955)
Loss on disposal	(124)	(2)	(276)	(220)
Unrealized Gain / (Loss) on foreign exchange	1,057	-	974	-
Amortization of leaseholds and equipment	(939)	(867)	(2,675)	(2,745)
Loss before taxes	(19,647)	(4,056)	(25,181)	(6,771)
Deferred income taxes (expense) / recovery	(577)	-	793	-
Net loss	(20,224)	(4,056)	(24,388)	(6,771)

Balance Sheet Items (\$000's)	Sept 30, 2011	December 31, 2010
Total assets	58,266	71,345
Long-term financial liabilities	1,474	29,210

Notes:

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

OPERATING RESULTS

Sales

Sales were \$27.0 million during the three-month period ended September 30, 2011, representing a decrease of 16.3% from the \$32.2 million in the same period in 2010. For the nine-month period ended September 30, 2011, sales were \$73.3 million compared to \$87.7 million in 2010 representing a 16.4% decline. Same-store sales for the three and nine-month periods ended September 30, 2011 decreased by 15.9% and 17.3%, compared to the same periods during 2010. The decline in sales resulted primarily from the weak retail environment.

Our ability to grow sales will depend on a number of factors including our ability to source sufficient capital, 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 nine month periods ended September 30, 2011 was 55.5% and 52.1%, compared to 66.8% and 57.1% respectively for the same periods during 2010.

For the three-month period ended September 30, 2011 gross margin as a percentage of sales increased to 44.5% compared to 33.2% during the same period in 2010. For the nine month period ended September 30, 2011 gross margin as a percentage of sales increased to 47.9% compared to 42.9% during the same period in 2010.

We continued to make progress with respect to gross margins for the three and nine-months in 2011. Gross margins improved over the same periods in 2010 due to reduced markdowns taken in the current period and comparative charges incurred in 2010 with respect to clearing our old inventory.

Store and selling expenses

Store and selling expenses for the three and nine-months ended September 30, 2011 were 40.1% and 43.1% of sales, compared to 34.8% and 38.1% for the same periods during 2010, respectively largely due to the impact of lower sales. Store and selling expenses have a large fixed underlying component, primarily consisting of expenses relating to occupancy and employee costs. In nominal dollars, store and selling expenses were \$398 thousand and \$1.9 million lower in 2011, as compared to the same three and nine month period in 2010. The decrease in nominal dollars resulted from our initiatives over the past 12 months to improve store operations.

General and administrative expenses

General and administrative (“G&A”) expenses increased by \$290 thousand for the three-month period ended September 30, 2011 compared to the same period in 2010 and increased by \$753 thousand for the nine-month period ended September 30, 2011 compared to the prior year. The increase is due to restructuring expenses incurred. Due largely to the impact of lower sales in 2011, G&A expenses represent 8.5% and 9.2% of sales, compared to 6.2% and 6.8% during the same periods in 2010, respectively.

EBITDA (see “Non-IFRS Measures”)

EBITDA for the three and nine-months ended September 30, 2011 was negative 4.1% and negative 4.4% of sales, respectively, compared to negative 7.9% and negative 2.1% for the same periods during 2010, due to the increase in gross margin and reduction in store and selling expenses.

Interest expense

Interest expense with respect to funds utilized under the credit facilities for the three and nine months ended September 30, 2011 was \$182 thousand and \$380 thousand respectively, compared to \$75 thousand and \$201 thousand in 2010. This was due to higher average debt balances this year.

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.

Interest expense with respect to the convertible debentures for the three-month and nine-month periods ended September 30, 2011 was \$1.7 million and \$3.0 million (2010 - \$579 thousand and \$1.8 million), respectively, of which \$1.3 million and \$1.7 million (2010 - \$188 thousand and \$552 thousand), respectively, related to this interest accretion. As a result of the Company defaulting on the interest payment on the Debentures, the Debentures were repayable upon demand and, as such, have been reclassified to current liabilities and reflected at face value on the balance sheet. Included in the interest accretion amounts for the three and nine month periods ended September 30, 2011 was \$1.1 million related to accelerated interest accretion to bring the Convertible Debentures to face value at September 30, 2011.

The Company's credit facility with the Bank of Montreal includes certain provisions and covenants limiting the Company's ability to make the interest payments on the Debentures. Due to a continued challenging retail environment and the cash flow situation of the Company, the Company announced on September 27, 2011 that the Board of Directors had determined that the Debenture interest amount that was due and payable on October 31, 2011 would not be paid. While the Company operates under the CCAA Order, no interest on the Debentures will be paid.

Inventory

As noted earlier, in late 2010 management aggressively reduced prices on aged inventory 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 third quarter of 2011. We reduced the permanent employee count in our Richmond warehouse while improving capacity and increasing throughput. In the current three and nine month periods, we have saved \$0.7 million and \$2.0 million, respectively, in freight, logistics, and warehousing costs versus the same period in 2010.

At September 30, 2011, on a valuation basis, we had \$3.0 million, or 8.0% more inventory than at September 30, 2010. On a unit basis, we had 10.3% fewer units of inventory at September 30, 2011 compared to the same time a year earlier. The Company had 69% less aged inventory than at the same point a year earlier.

SELECTED QUARTERLY FINANCIAL INFORMATION

in (\$000's) except per Share amounts	Q3-2011	Q2-2011	Q1-2011	Q4-2010	Q3-2010	Q2-2010	Q1-2010	Q4-2009
Sales	\$ 26,960	\$ 26,960	\$ 22,011	\$ 39,348	\$ 32,218	\$ 28,606	\$ 26,855	\$ 41,195
(Loss) / Income before taxes	\$ (19,647)	\$ (1,075)	\$ (4,463)	\$ (108)	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238
Net (Loss) / Income	\$ (20,224)	\$ (811)	\$ (3,357)	\$ 1,463	\$ (4,056)	\$ (1,754)	\$ (961)	\$ 6,238
Basic (loss) / income per Share	\$ (3.044)	\$ (0.122)	\$ (0.505)	\$ 0.220	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.939
Diluted (loss) / income per Share	\$ (3.044)	\$ (0.122)	\$ (0.505)	\$ 0.212	\$ (0.611)	\$ (0.264)	\$ (0.145)	\$ 0.820
Cash dividends/distributions per Share	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.000	\$ 0.037
Number of stores open at end of period	158	160	161	162	162	160	161	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”.

The Company has been facing liquidity and profitability issues with significant and unexpected declines in sales revenue in recent years. Despite progress being made in streamlining processes and cost-reduction initiatives, we continue to face balance sheet and declining and/or negative same store sales challenges. Our worsening financial performance has made it impossible to service our debt obligations, including our trade creditors. Our financial performance, demonstrated by the decline in our share price, together with poor economic conditions, undermined our efforts to address our business issues. This led to our CCAA filing on October 21, 2011.

In light of these conditions, there is significant uncertainty regarding the Company’s ability to continue as a going concern, which is dependent on achieving on-going cash flow from operating activities and receiving additional support from our creditors and suppliers, as well as obtaining additional third party sources of financing to implement the restructuring plan. 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. Failure to do so would most likely result in liquidation proceedings.

BMO Forebearance Agreement

We have entered into a Forebearance Agreement with the Bank of Montreal as part our Amended Facility. The Amended Facility is a demand facility and could be called for payment at any time. In the event that the Amended Facility is called for payment, or if we are unsuccessful in negotiating terms for further financing with the Bank of Montreal or other replacement borrowings, there would be a material negative impact on our business, financial condition and results of operations. See “*Capital Resources*.”

CCAA

Should the stay period in the CCAA proceedings and any subsequent extensions thereof not be sufficient in duration or scope to allow the Company to develop and present a restructuring plan under the CCAA or should the restructuring plan not be accepted by affected creditors or confirmed by the Court and, in any such case, should the Company lose the protection of the stay of proceedings, creditors may immediately enforce their rights and remedies against the Company and its assets which would in all likelihood lead to liquidation proceedings. Failure to implement a restructuring plan and obtain sufficient exit financing within the time granted by the Court would in all likelihood also lead to liquidation of the Company’s assets.

There can be no assurance that a restructuring plan proposed by the Company will be supported by the Company’s creditors or confirmed by the Court or that it will be consummated or successful. The Company’s financial statements do not contain any adjustments to the amounts or classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

Cash Flow from Operations

The table below reconciles net loss to cash flow from operations for the three-month and nine-month periods ended September 30, 2011 and 2010.

in (\$000's)	Three-months ended Sept 30		Nine-months ended Sept 30	
	2011	2010	2011	2010
Net loss	\$ (20,224)	(4,056)	(24,388)	(6,771)
Add charges (deduct credits) to operations not requiring a cash payment:				
Impairment of intangible assets	16,623	-	16,623	-
Deferred income taxes expense / (recovery)	577	-	(793)	-
Amortization of leaseholds and equipment	939	867	2,675	2,745
Accreted interest expense	1,329	188	1,733	552
Amortization of deferred leasehold inducements	(78)	(92)	(250)	(318)
Loss on disposal of leaseholds and equipment	124	2	276	220
	(710)	(3,091)	(4,124)	(3,572)
Net change in non-cash working capital balances related to operations:				
Accounts receivable	142	(1,171)	71	(1,096)
Inventory	(4,730)	(354)	(11,613)	(814)
Prepaid expenses and deposits	(0)	(78)	(64)	(147)
Accounts payable and accrued liabilities	4,180	5,453	820	3,231
Cash (used in)/ provided by operating activities	\$ <u>(1,118)</u>	<u>759</u>	<u>(14,910)</u>	<u>(2,398)</u>

For the three-month period ended September 30, 2011, cash used in operations was \$1.1 million as compared to cash provided by operations of \$759 thousand in the same period of 2010. Cash used in operations was \$14.9 million for the nine-month period ended September 30, 2011 as compared to \$2.4 million for the same period in 2010.

Capital Expenditures

We incurred maintenance capital expenditures of \$0.4 million during the three-month period ended September 30, 2010 (2010 - \$0.6 million), which were related to upgrades to our information technology system and store renovations. We did not open any new stores in the third quarter of 2011 and therefore did not invest in any new capital expenditures during this time (2010 - \$0.3 million (net of leasehold inducements)). During the nine months ended September 30, 2011, we incurred capital expenditures of \$2.4 million (2010 - \$1.7 million) of which \$1.4 million was invested in IT infrastructure (2010 - \$0.7 million).

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.

Prior to obtaining the CCAA Order, we had a revolving credit facility of up to \$20 million (the "Operating Loan") with the Bank of Montreal, which is available for working capital requirements, capital expenditures and for general corporate purposes. We also had utilized \$4 million of a \$5 million credit facility with the Bank of Montreal (the "Term Loan") for funding capital expenditures including new store facilities.

During the third quarter we reached agreement with the Bank of Montreal to amend our Operating Loan and Term Loan, including provisions for overadvance (the "Amended Facility"). The Amended Facility was made on a demand basis and contained step-down provisions which would

have permanently reduced the availability of the overadvance limit by October 20, 2011. The overadvance limit under the Amended Facility was designed (and provided) by the Bank of Montreal to provide us with the additional liquidity necessary to address seasonal fluctuations.

On October 20, 2011, we concluded negotiations with the Bank of Montreal as to the terms and conditions of a forbearance agreement (the "Forbearance Agreement") to address our liquidity needs while we restructure our affairs under the CCAA. Pursuant to the Forbearance Agreement, the Bank of Montreal will continue to provide us with availability under the Amended Facility, including an overadvance limit of up to \$2.5 million, on the terms and conditions set out in the Amended Facility, as amended by the Forbearance Agreement.

As the Forbearance Agreement expires on December 31, 2011 (or such earlier time as provided in the Forbearance Agreement on the occurrence of certain events), we have entered into discussions with the Bank on the terms of an overadvance limit and availability after December 31, 2011 in amounts sufficient to allow us to complete its restructuring. We can give no assurances that we will be successful in these discussions on reasonable terms or at all.

Loans under the Amended Facility, as amended by the Forebearance Agreement, 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, Sterling Shoes GP Inc. and the Company.

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 make interest payments on the Debentures.

The Amended Facility is a demand facility and could be called for payment at any time. In the event that the Amended Facility is called for payment, or if we are unsuccessful in negotiating terms for further financing with the Bank of Montreal or other replacement borrowings, there would be a material negative impact on our business, financial condition and results of operations.

OFF-BALANCE SHEET FINANCING

We enter into standby letters of credit to facilitate the international purchase of merchandise and to secure certain of our obligations, including insurance programs and duties related to import purchases. As of September 30, 2011, letters of credit totaling \$2.6 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:

in \$000's	2011	2012	2013	2014	2015
Inventory purchase commitments	2,606				
Convertible Debentures	25,000				
Operating and Term Loans	14,227				
Minimum rental commitments ⁽¹⁾	4,041	15,067	13,809	12,355	11,197
	<u>45,874</u>	<u>15,067</u>	<u>13,809</u>	<u>12,355</u>	<u>11,197</u>

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

DIVIDENDS

The Company did not declare any dividends to the Shareholders for the three and nine month periods ended September 30, 2011 (2010 - \$Nil in distributions).

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." Given the current liquidity and profitability issues that the Company is facing, the value of the deferred income tax asset was written down to \$nil at September 30, 2011 resulting in an income tax expense of \$577 thousand for the three months ended September 30, 2011 and an income tax recovery of \$793 thousand for the nine months ended September 30, 2011 (2010 - \$Nil and \$Nil).

TRANSACTIONS WITH RELATED PARTIES

- (a) The Company paid rent to a company in which Mannie Druker, a director, has an interest, amounting to \$79 thousand and \$237 thousand for the three-month and nine-month periods ended September 30, 2011 (2010 – \$79 thousand and \$227 thousand) respectively.
- (b) The Company purchased equipment from a company in which Mannie Druker, a director, has an interest for \$7 thousand and \$86 thousand during the three-month and nine-month periods ended September 30, 2011 (2010 – \$47 thousand and \$60 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 nine-month periods ended September 30, 2011. Management believes that the following items represent the Company's critical accounting estimates.

Intangible assets

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.

At September 30, 2011 the Company determined that the fair value of the intangible assets was \$nil, resulting in a non-cash impairment charge of \$16.6 million for the three-months ended September 30, 2011. The impairment arose primarily due to future economic uncertainty and the higher cost of capital assumptions in the valuation methodology.

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.

As noted previously, given the current liquidity and profitability issues that the Company is facing, the value of the deferred income tax asset was written down to \$nil at September 30, 2011.

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.

As at September 30, 2011, the Debentures were repayable upon demand and, as such, have been reclassified to current liabilities and reflected at face value on the balance sheet.

RISKS AND UNCERTAINTIES

A detailed discussion of our significant business risks is provided 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 third quarter and nine months of 2011 other than as discussed above under “*Capital Resources*” and further discussed below.

Liquidity and Going Concern Uncertainty

The Company is experiencing negative cash flow from operations and there is no certainty as to when or if we will return to positive cash generation. This led to our CCAA filing on October 21, 2011. In light of these conditions, there is significant uncertainty regarding the Company’s ability to continue as a going concern, which is dependent on achieving on-going cash flow from operating activities and receiving additional support from our creditors and suppliers, as well as obtaining additional sources of financing.

Given the Company’s current level of cash flows from operations, the Company will need to rely upon outside sources and third party financings to obtain sufficient capital to implement a restructuring plan and continue as a going concern. 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. Failure to do so would most likely result in liquidation proceedings.

BMO Forebearance Agreement

We have entered into a Forebearance Agreement with the Bank of Montreal as part our Amended Facility. The Amended Facility is a demand facility and could be called for payment at any time. In the event that the Amended Facility is called for payment, or if we are unsuccessful in negotiating terms for further financing with the Bank of Montreal or other replacement borrowings, there would be a material negative impact on our business, financial condition and results of operations.

CCAA

Should the stay period in the CCAA proceedings and any subsequent extensions thereof not be sufficient in duration or scope to allow the Company to develop and present a restructuring plan under the CCAA or should the restructuring plan not be accepted by affected creditors or confirmed by the Court and, in any such case, should the Company lose the protection of the stay of proceedings, creditors may immediately enforce their rights and remedies against the Company and its assets which would in all likelihood lead to liquidation proceedings. Failure to implement a restructuring plan and obtain sufficient exit financing within the time granted by the Court would in all likelihood also lead to liquidation of the Company's assets.

There can be no assurance that a restructuring plan proposed by the Company will be supported by the Company's creditors or confirmed by the Court or that it will be consummated or successful. The Company's financial statements do not contain any adjustments to the amounts or classification of assets and liabilities that might be necessary should the Company be unable to continue in business.

TSX Delisting

With the delisting of the Shares and the Debentures from the TSX on November 25, 2011, there will be no market through which the Shares and the Debentures may be sold. There is no assurance that an alternate listing for the Shares and Debentures will be sought or obtained. As a result there is no liquidity for the Shares or the Debentures.

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

Settlement dates	Face Value \$US	Average rate \$Cdn
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 nine months ended September 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 September 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 September 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. Without limiting the generality of the foregoing, we have made forward-looking statements with respect to our restructuring under the CCAA, our ability to continue as a going concern and the viability of our core business.

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 our ability to develop and implement a restructuring plan and successfully emerge from the CCAA, general economic conditions and markets and, in particular, the uncertainty of current economic conditions, the cost and availability of capital, the possibility of further deterioration in our working capital position, the impact on our liquidity and interest costs if we are offside of the covenants in our debt facilities, our ability to increase profitability and manage growth, risks associated with leasing and expansion, competition, inventory and sourcing risk, our 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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