



**LIQUOR STORES INCOME FUND**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION  
AND RESULTS OF OPERATION**

**For the Year Ended December 31, 2006  
As of March 7, 2007**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This management's discussion and analysis ("MD&A") should be read in conjunction with the consolidated financial statements and accompanying notes of Liquor Stores Income Fund (the "Fund") for the year ended December 31, 2006. Results are reported in Canadian dollars unless otherwise stated and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Certain dollar amounts have been rounded to the nearest hundred thousand dollars or thousand dollars. References to notes are to the notes to the Financial Statements unless otherwise stated.

Throughout this MD&A references are made to "distributable cash", "operating margin", and other "Non-GAAP Measures". A description of these measures and their limitations are discussed below under "Non-GAAP Measures". See also "Risk Factors" and "Forward-Looking Statements" below.

References to the Tax Fairness Plan in this MD&A are to the Tax Fairness Plan announced by the Federal Minister of Finance on October 31, 2006, the related draft legislation introduced by the Minister on December 21, 2006 and the "safe harbour" growth guidelines issued in connection to the Tax Fairness Plan by the Federal Department of Finance on December 15, 2006.

This MD&A is dated March 7, 2007.

### **OVERVIEW OF THE FUND**

#### **Issuance of Units and Development of the Business**

The Fund is an unincorporated open ended, limited purpose trust established under the laws of the Province of Alberta. The trust units ("Units") of the Fund trade on the Toronto Stock Exchange under the symbol LIQ.UN. Through its 75.6% ownership of Liquor Stores Limited Partnership ("Liquor Stores LP"), the Fund operates 105 retail liquor stores in Alberta and British Columbia and management believes it is the largest liquor store operator in Alberta by number of stores and one of the two largest by revenue.

The Fund commenced business operations on September 28, 2004, when it completed its initial public offering of Units and acquired the net assets of The Liquor Depot Corporation and Liquor World Group Inc. and other wholly owned subsidiaries or companies that were under common control (collectively, the "Vendors") for \$97.4 million in cash and Subordinated and Exchangeable LP Units.

In March 2005, March 2006 and October 2006 the Fund issued 1,830,000, 1,600,000 and 1,600,000 Units, respectively, from treasury for aggregate net proceeds of \$93.1 million. In conjunction with the March 2006 offering, the Vendors sold 827,132 Units by way of a secondary offering. As at March 7, 2007 there are 10,229,745 Units and 3,300,255 subordinated and exchangeable units outstanding. The Vendors now have a 24.4% non-controlling interest in Liquor Stores LP.

The net proceeds of the March 2005 and March 2006 issuances were used to acquire or develop 55 retail liquor stores and to temporarily repay bank financing. The net proceeds of the October 2006 issuance are also being used to temporarily repay bank financing related to inventory and will be used to fund future acquisitions and development of retail liquor stores. From inception to December 31, 2006, the aggregate cost to acquire and develop retail liquor stores, exclusive of working capital, is approximately \$53.4 million.

Subsequent to December 31, 2006, the Fund completed the acquisition of one retail liquor store in Calgary, Alberta. The Fund has also closed a small store in the same market area. The Fund has commitments in place to date that will see an additional six stores being developed and opened in 2007 and several more are under negotiation.

As at March 7, 2007, the Fund operates 105 retail liquor stores located in the following communities:

	Alberta			British Columbia		Total
	Edmonton	Calgary	Other	Lower Mainland	Other	
Number of Stores	42	35	20	3	5	105

References to Edmonton and Calgary are to stores located in or near those urban centres.

Other communities served in Alberta include Red Deer (3), Lethbridge (1), Fort McMurray (5), Slave Lake (3), Banff (1), Canmore (2), Grande Prairie (2), Edson (2) and High River (1).

In British Columbia other communities served include Victoria (1), Kamloops (1), Kelowna (2) and Chilliwack (1). The Fund also operates a pub connected to a retail liquor store in British Columbia.

### Business of the Fund

The Province of Alberta is the only province in Canada that has a fully privatized retail distribution system for adult beverages. With 98 liquor stores operating in Alberta, where there are approximately 1,050 liquor stores, the Fund is the largest liquor store operator by number of stores. We believe that the Fund is one of the two largest liquor store operators in Alberta by revenue.

The Fund also operates eight stores and a pub in British Columbia. The Province of British Columbia's model for liquor distribution is a blend of approximately 600 private stores and 208 government operated stores. There are also approximately 400 agency stores that service small communities.

### Distributable Cash and Cash Distributions

The Fund's policy is to distribute available cash from operations to unitholders to the extent determined prudent by the trustees of the Fund. Cash available for distribution is after cash required for maintenance capital expenditures, working capital reserve, and other reserves considered advisable by the trustees, including a provision for awards related to the Fund's long-term incentive plan (the "LTIP"). The policy allows the Fund to make stable monthly distributions to its unitholders based on estimates of distributable cash. The Fund pays cash distributions on or about the 15th of each month to unitholders of record on the last business day of the previous month.

The Fund reviews its historic and expected results on a regular basis. This review includes consideration of the expected performance of existing and new stores, the competitive environment and economic conditions, including labour market trends.

Based on this review and the financial performance of the Fund, cash distributions have been made or are contemplated as follows:

Payment Dates	Monthly	Annualized
November 15, 2004 to May 16, 2005	\$0.08333	\$1.000
June 16, 2005 to January 16, 2006	\$0.08958	\$1.075
February 15, 2006 to October 16, 2006	\$0.10000	\$1.200
November 15, 2006 to March 15, 2007	\$0.11667	\$1.400
Commencing April 13, 2007 <sup>(1)</sup>	\$0.12500	\$1.500

Notes:

- (1) *On February 7, 2007, the Fund announced an increase in the level of its cash distributions from \$0.1167 per month to \$0.125 per month commencing with the April 13, 2007 distribution.*

Distributions declared during the year ended December 31, 2006 were \$15,153,815 or \$1.24 per Unit. On a weighted average basis, distributable cash per Unit was \$1.39 for the year. Since inception, distributable cash has exceeded cash distributions by \$3,521,400 resulting in a cumulative payout ratio of approximately 88%.

For 2006, the tax deferred portion of distributions for Canadian federal income tax purposes was approximately 28%. It is proposed under the Tax fairness Plan that the taxable income distributed by the Fund be taxed commencing in 2011 or earlier in some circumstances more fully described under the heading "Tax Fairness Plan" below. The Fund is actively reviewing the implications of the Tax Fairness Plan to its unitholders of deferring elective tax deductions until the new regime is in place. As such, the Fund cannot now determine the portion, if any, of the 2007 distributions that will be tax deferred.

### **Distributable cash per unit (Fund Units, Exchangeable and Subordinated LP Units)**

The Fund views distributable cash as an important measure to unitholders as the Fund's objective is to provide a stable and sustainable flow of distributable cash to unitholders. The following table summarizes the distributable cash of the Fund for the three and twelve months ended December 31, 2006 and 2005:

	<b>Three months ended December 31,</b>		<b>Year ended December 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Cash provided by operating activities	\$ 6,165,712	\$ (106,229)	\$ 9,338,866	\$ 4,565,121
Net change in non-cash working capital	675,948	4,630,714	8,999,881	7,469,124
LTIP provision	350,000	–	(50,000)	–
Deferred performance bonus	(950,000)	–	(950,000)	–
Provision for non-growth property and equipment	(212,342)	(27,461)	(600,000)	(656,266)
Distributable cash	<u>\$ 6,029,318</u>	<u>\$ 4,497,024</u>	<u>\$ 16,738,747</u>	<u>\$ 11,377,979</u>
Weighted average units outstanding	13,495,218	10,330,000	12,000,137	10,024,165
Distributable cash per weighted average				
Unit	\$0.45	\$0.44	\$1.39	\$1.14
Distributions declared per unit	\$0.35	\$0.27	\$1.24	\$1.05
Basic earnings per unit	\$0.45	\$0.38	\$1.35	\$1.04
Diluted earnings per unit	\$0.45	\$0.37	\$1.32	\$1.03

Distributable cash is a Non-GAAP Measure. Adjustments related to non-cash working capital, obligations in respect of the LTIP and expenditures and provisions for maintenance capital are necessary to reconcile distributable cash to its nearest GAAP measure, cash provided by operating activities.

### ***Net Change in Non-cash Working Capital***

The Fund's investment in non-cash working capital is primarily related to increased inventory levels. This increase includes the cost of purchasing inventory for stores the Fund develops and opens, the cost of increasing inventory in acquired stores subsequent to their acquisition date, and an increase in current inventory purchased at times when favourable buying conditions exist. Other changes in non-cash working capital are relatively insignificant. The net change in non-cash working capital is added back to cash provided by operating activities in order to fairly reflect the Fund's historic and prospective ability to pay cash distributions.

### ***LTIP Provision***

The LTIP is a variable interest entity and is consolidated in the Fund's financial statements. Funding for the LTIP occurs subsequent to the approval of the Fund's annual financial statements. For accounting purposes, the compensation expense related to the LTIP is recognized as LTIP awards vest. Awards under the LTIP are calculated with reference to distributable cash per Unit. Although LTIP awards have no impact on current cash provided by operating activities, the likelihood of those awards requiring a cash payment is such that management believes they should be included in the calculation of distributable cash.

### *Deferred Performance Bonus*

A special deferred bonus in the amount of \$950,000 has been awarded to reward key management personnel for operational performance of the Fund for the year ended December 31, 2006. The bonus will be paid in Units which will vest over a three-year period. For accounting purposes, the compensation expense related to the deferred bonus is recognized as the Units vest. Although this bonus has no impact on current cash provided by operating activities, the likelihood of those awards requiring a cash payment is such that management believes they should be included in the calculation of distributable cash.

### *Provision for Non-growth Property and Equipment*

Non-growth property and equipment expenditures refer to capital expenditures that are necessary to sustain current productive capacity, principally store renovations and equipment replacement, together with reserves for further expenditures to maintain productive capacity. Routine repairs and maintenance expenditures are expensed. Management believes that maintenance non-growth property and equipment expenditures should be funded by cash provided operating activities and therefore included in the calculation of distributable cash. Capital spending for growth initiatives is expected to improve future distributable cash or is funded as part of the financing plan for specific acquisition or development initiatives and as such is not deducted from cash provided by operating activities.

The following table provides an analysis of the total expenditures on property and equipment, the amounts reserved for further non-growth expenditures and the amounts charged to expense in the Fund's accounts for repairs and maintenance:

	<u>Three months ended December 31,</u>		<u>Year ended December 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Purchase of property and equipment from the Statement of Cash Flows	\$ 1,687,736	\$ 910,398	\$ 6,838,851	\$ 2,618,341
Growth expenditures including amounts relating to development and acquired stores	(1,550,948)	(882,937)	(6,514,405)	(1,962,075)
Purchase of non-growth property and equipment	136,788	27,461	324,446	656,266
Provision for further non-growth property and equipment expenditures	75,554	—	275,554	—
Total provision for non-growth property and equipment	212,342	27,461	600,000	656,266
Repairs and maintenance	126,789	55,589	310,534	215,046
Total expenditures for non-growth property and equipment purchases and repairs and maintenance expense	\$ 338,131	\$ 83,050	\$ 910,534	\$ 871,312

Amounts relating to the development and acquisition of stores are considered growth expenditures. Growth expenditures are not included in the calculation of distributable cash.

## SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS

### Operating Results

The following table summarizes the operating results for the quarter and year ended December 31, 2006 with comparative figures for 2005:

	Three months ended December 31,		Year ended December 31,	
	2006 (unaudited)	2005 (unaudited)	2006 (unaudited)	2005 (unaudited)
Number of stores at December 31			105	75
Sales	\$ 71,009,534	\$ 50,685,505	\$ 221,997,189	\$ 157,443,781
Cost of sales, administrative, operating, and store acquisition and development expenses	63,869,351	45,922,695	202,497,814	144,508,035
Operating margin <sup>(1)</sup>	\$ 7,140,183	\$ 4,762,810	\$ 19,499,375	\$ 12,935,746
Percent of Sales	10.1%	9.4%	8.8%	8.2%

Note:

(1) *Operating margin has been calculated as described under "Non-GAAP Measures"*

### Sales

Sales for the year ended December 31, 2006 increased by \$64.6 million to \$222.0 million from \$157.4 million for the year ended December 31, 2005. The \$64.6 million increase comprises:

- an increase in same store sales of \$8.8 million or 7.2% to \$130.5 million for the year ended December 31, 2006
- an additional \$28.9 million in sales to \$64.6 million for the 25 stores acquired or opened in 2005
- sales of \$26.9 million for the 30 stores acquired or opened in 2006.

The 2006 same store sales increase of 7.2% was significant for the Fund. For 2007, we expect same store sales growth to moderate and be in the range of 2% to 4%.

Sales for the fourth quarter ended December 31, 2006 increased by \$20.3 million to \$71.0 million from \$50.7 million in the fourth quarter of 2005. The \$20.3 million increase comprises:

- an increase in same stores sales of \$3.3 million or 7.1%
- sales of \$17 million for stores that were acquired or opened after September 30, 2005

Management believes a major factor contributing to the Fund's strong same stores sales increases is the strength of the provincial economies of Alberta and British Columbia.

### Combined Cost of Sales, Administrative, Operating and Acquisition and Store Development Expense ("Operating Expense")

Operating Expense for 2006 increased to \$202.5 million, which is \$58.0 million higher than in 2005. These increases are consistent with the increase in number of stores being operated. For the three months ended December 31, 2006 Operating Expense was \$63.9 million compared to \$45.9 million in the same period of 2005.

## **Operating Margin**

Operating margin (as defined under Non-GAAP Measures) increased to \$19.5 million for the year ended December 31, 2006 from \$12.9 million in 2005. Operating margin as a percentage of sales was 8.8% for the year ended December 31, 2006 compared to 8.2% in 2005.

For the quarter ended December 31, 2006, operating margin increased by \$2.4 million over the same period in 2005 to \$7.1 million. As a percentage of sales, operating margin increased to 10.1% for the quarter compared to 9.4% for the same period last year.

For both the year and the quarter the factors contributing to the improvement in operating margin as a percent of sales compared to the same periods of 2005 are the benefit of increased product margins due to increased sales volumes and improved product margin rates. These were partially offset by upward pressure on hourly wage rates in Alberta and an increase in head office staffing to accommodate the Fund's growth strategy.

## **Earnings before Non-controlling Interest and Net Earnings**

Earnings before non-controlling interest for the year ended December 31, 2006 of \$16.0 million increased over the same period in 2005, which had earnings before non-controlling interest of \$10.3 million. Fourth quarter 2006 earnings before non-controlling interest of \$6.2 million compared to \$3.7 million for the fourth quarter of 2005.

Net earnings for the year increased by \$5.4 million over 2005 to \$11.5 million. For the three-month period ended December 31, 2006 net earnings increased by \$2.4 million to \$4.6 million from \$2.2 million in 2005.

## **Income Taxes**

Under existing income tax legislation, the Fund deducts distributions to unitholders that are not a return of capital in the determination of its taxable income. For accounting purposes income tax provisions are only recorded in respect of incorporated subsidiaries. Consequently, income taxes recorded in the Fund's accounts have been nominal.

GAAP requires the effect of changes in income tax legislation on tax provisions to be recorded prospectively once the legislation has been substantively enacted. Since the legislation related to the Tax Fairness Plan has not been substantively enacted, the Fund has not provided for any related income tax effect in its December 31, 2006 financial statements.

## **Deferred Performance Bonus**

A provision of \$950,000 has been made in respect of rewarding key management personnel for performance of the Fund for the year ended December 31, 2006. This provision has been factored into the determination of distributable cash for the year ended December 31, 2006. For accounting purposes, the compensation expense related to awards granted under the bonus in respect of 2006 will be recognized in the years 2007 through 2009 on a straight-line basis as the awards vest. For 2007 the expense related to the bonus is expected to be approximately \$0.6 million.

## Condensed Annual Information

	2006	2005	2004 <sup>(1)</sup>
	(thousands of dollars except per Unit amounts)		
<b>Balance Sheet</b>			
Cash and cash equivalents	\$ 3,397	\$ 2,047	\$ 1,004
Total assets	187,097	140,796	102,906
Bank indebtedness	5,455	15,493	12,222
Total current liabilities	12,896	20,416	14,107
Long-term debt	-	11,352	7,398
Unitholders' equity	140,706	67,327	38,200
Non-controlling interest	33,496	41,700	42,377
<b>Statement of Earnings</b>			
Sales	221,997	157,444	35,543
Earnings before non-controlling interest	15,978	10,312	2,957
Net earnings for the period	11,515	6,098	1,496
Basic earnings per Unit	\$1.35	\$1.04	\$0.35
Diluted earnings per Unit	\$1.32	\$1.03	\$0.35
Distributable cash per Unit	\$1.39	\$1.14	\$0.38

(1) Includes results of operations from September 28, 2004.

## Condensed Quarterly Information

	2006				2005			
	Dec 31	Sept 30	June 30	March 31	Dec 31	Sept 30	June 30	March 31
	(thousands of dollars except per Unit amounts)							
<b>Balance Sheet</b>								
Cash and cash equivalents	\$ 3,397	\$ 1,683	\$ 276	\$ 2,935	\$ 2,047	\$ 172	\$ 266	\$ 10,199
Total assets	187,097	173,736	165,812	141,511	140,806	127,114	118,425	126,040
Bank indebtedness	5,455	28,964	15,495	-	15,493	8,993	-	7,445
Total current liabilities	12,896	32,140	20,481	4,092	20,427	11,628	2,996	10,669
Long-term debt	-	2,500	7,500	-	11,352	7,359	7,500	7,481
Unitholders' equity	140,709	105,974	105,115	104,775	67,327	66,648	66,167	66,147
Non-controlling interest	33,496	33,120	32,716	32,643	41,700	41,471	41,762	41,742
<b>Statement of Earnings</b>								
Sales	71,010	60,751	52,215	38,021	50,686	41,434	38,505	26,819
Earnings before non-controlling interest	6,206	4,678	3,992	1,101	3,676	2,966	2,760	910
Net earnings for the period	4,627	3,332	2,871	684	2,202	1,764	1,637	495
Basic earnings per Unit	\$0.45	\$0.39	\$0.33	\$0.10	\$0.38	\$0.29	\$0.27	\$0.10
Diluted earnings per Unit	\$0.45	\$0.39	\$0.33	\$0.10	\$0.37	\$0.29	\$0.27	\$0.10
Distributable cash per Unit	\$0.45	\$0.43	\$0.38	\$0.14	\$0.44	\$0.29	\$0.26	\$0.14

The liquor retailing industry is subject to seasonal variations with approximately 45% of sales occurring in the first half of the year and 55% occurring in the second half of the year.

## LIQUIDITY AND CAPITAL RESOURCES

### Unitholders' Equity and Non-controlling Interest

The following units were outstanding as of March 7, 2007:

	<u>Units</u>
Fund Units	10,229,745
Liquor Stores LP Exchangeable LP Units	1,175,255
Liquor Stores LP Subordinated LP Units	<u>2,125,000</u>
	<u>13,530,000</u>

The Liquor Stores Subordinated and Exchangeable LP Units represent a non-controlling interest in the Fund.

In 2006, 848,637 Liquor Stores LP Exchangeable LP Units were exchanged for Fund Units resulting in an increase in Unitholders' Equity of \$8,390,994.

### Tax Fairness Plan

The Fund has generally relied on its ability to issue new equity to finance its growth strategy.

The Tax Fairness Plan provides that the income tax rules applicable to publicly traded trusts and partnerships will be significantly modified. In particular, certain income of (and distributions made by) these entities will be taxed in a manner similar to income earned by (and distributions made by) a corporation. These proposals will be effective for the 2007 taxation year with respect to trusts which commence public trading after October 31, 2006, but the application of the rules will be delayed to the 2011 taxation year with respect to trusts which were publicly traded prior to November 1, 2006 (although the announcement suggested that this transitional relief could be lost under certain circumstances, including the "undue expansion" of an income trust). On December 21, 2006, the Department of Finance issued for public comment the draft legislation to implement these proposals. There is no assurance that the draft legislation will be enacted in the manner proposed or at all.

On December 15, 2006, the Department of Finance (Canada) released guidance for income trusts and other flow-through entities that qualify for the four-year transitional relief. The guidance establishes objective tests with respect to how much an income trust is permitted to grow without jeopardizing its transitional relief. In general, the Fund will be permitted to issue new equity over the next four years equal to its market capitalization as of the end of trading on October 31, 2006 (subject to certain annual limits). Market capitalization, for these purposes, is to be measured in terms of the value of the Fund's issued and outstanding publicly-traded units. Those safe harbour limits are 40% for the period from November 1, 2006 to December 31, 2007, and 20% each for calendar 2008, 2009 and 2010. Moreover, these limits are cumulative, so that any unused limit for a period carries over into the subsequent period. If required to fund its growth strategy the Fund could issue new Units for proceeds of approximately \$100 million in 2007 and approximately \$235 million for the period 2007 to 2010 and remain within the safe harbour guidelines. If these limits are exceeded, the Fund may lose its transitional relief and thereby become immediately subject to the proposed rules.

Management currently believes that the provisions of the Tax Fairness Plan are not a material constraint on the Fund's growth prospects. The Fund is closely monitoring legislative developments and will continue to assess the impact of the proposed legislation on the business and financial outlook of the Fund.

### Credit Facilities

The Fund has a \$32 million demand operating loan that can be increased to \$38 million to accommodate seasonal inventory highs, a \$14.5 million committed non-revolving capital loan and a \$15 million committed non-revolving acquisition loan with a Canadian chartered bank. The total of all available credit facilities is \$61.5 million.

As of March 6, 2007, total indebtedness under all credit facilities is approximately \$7.0 million and is primarily related to inventory financing. As acquisitions occur and new stores are opened, credit facilities will be utilized as required.

## Capital Expenditures

During the year ended December 31, 2006, the Fund acquired or developed and opened 30 stores at an aggregate cost of \$30.0 million exclusive of working capital. Since inception, the Fund has acquired or developed and opened 55 stores at an aggregate cost of \$52.7 million exclusive of working capital.

The Fund will continue to pursue acquisition opportunities and to open new stores. In addition, the replacement of in-store information systems is anticipated to begin in 2007. The improvements in marketing and administrative processes related to this replacement are intended to reduce overheads and enhance the management of retail operations. The preliminary estimate of the cost to replace in-store systems is in the range of \$2.0 to \$2.5 million. This cost will be treated as growth capital when incurred.

## Interest Rate Risk and Sensitivity

The Fund's bank indebtedness and long-term debt bear interest at floating rates based on the bank's prime rate or at short term banker's acceptance rates.

The Fund is not subject to significant exposure to interest rate fluctuations. Based on a normal outstanding debt balance of \$32 million a 1.0% increase in interest rates would reduce distributable cash for the year by approximately \$320,000 or \$0.02 per Unit.

## Contractual Obligations

The table below sets forth, as of December 31, 2006, the contractual obligations of the Fund, due in the years indicated, related to various premises operating leases.

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012 and thereafter</u>
Operating leases	\$6,700,563	\$6,297,854	\$5,126,590	\$4,109,733	\$3,546,047	\$8,969,062
Total	<u>\$6,700,563</u>	<u>\$6,297,854</u>	<u>\$5,126,590</u>	<u>\$4,109,733</u>	<u>\$3,546,047</u>	<u>\$8,969,062</u>

## OFF BALANCE SHEET ARRANGEMENTS

The Fund has not entered into any off-balance sheet arrangements.

## CRITICAL ACCOUNTING ESTIMATES

### Goodwill

Goodwill is not amortized and is assessed for impairment at the reporting unit level. The impairment test is done annually unless circumstances arise that would potentially impair the carrying value of goodwill. Any potential goodwill impairment is identified by comparing the fair value of a reporting unit to its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value of the reporting unit exceeds its fair value, potential goodwill impairment has been identified and must be quantified by comparing the estimated fair value of the reporting unit's goodwill to its carrying value. Any goodwill impairment will result in a reduction in the carrying value of goodwill on the consolidated balance sheet and in the recognition of a non-cash impairment charge in earnings.

### Amortization Policies and Useful Lives

The Fund amortizes property, equipment and intangible assets over the estimated useful service lives of the assets. In determining the estimated useful life of these assets, significant judgment by management is required. In determining these estimates, the Fund takes into account industry trends and Fund-specific factors, including changing technologies and expectation for the in-service period of these assets. The Fund assesses the estimated useful life of these assets on an annual basis to ensure they match the anticipated life of the asset from a revenue producing perspective. If the Fund determines that the useful life of an asset is different from the original assessment, changes to amortization will be applied prospectively.

## **Purchase Price Allocations**

The allocations of the purchase price for acquisitions involve determining the fair values assigned to the tangible and intangible assets acquired. The Fund uses independent valuers to determine the fair value of the tangible assets and certain intangible assets of the acquired stores. Other intangible assets are allocated based on a calculation of fair values by management. A discounted cash flow analysis is prepared to determine these fair values. Goodwill is calculated based on the purchase price less the fair value of the net tangible and intangible assets stated above.

## **FUTURE CHANGES IN ACCOUNTING POLICIES**

### **Financial Instruments and other comprehensive income**

New accounting standards will be in effect for fiscal years beginning on or after October 1, 2006 for recognition and measurement of financial instruments and disclosure of comprehensive income. The Fund will apply these standards beginning on January 1, 2007 resulting in the recognition of other comprehensive income in a separate financial statement and the inclusion of accumulated other comprehensive income as a component of unitholders' equity. The Fund anticipates that the adoption of these standards will not result in a material impact on the financial statements.

## **FINANCIAL INSTRUMENTS**

Due to the nature of its business, the Fund does not engage in activities or hold assets that would require the Fund to acquire financial instruments for hedging or speculative purposes. The financial instruments that are held by the Fund consist of accounts receivable, bank indebtedness, accounts payable and accrued liabilities, distributions payable and long-term debt. The financial instruments are held in the normal course of operations and as a result no significant accounting policies need to be adopted or assumptions made in reporting the Fund's financial instruments.

## **TRANSACTIONS WITH RELATED PARTIES**

The Fund has a conflict of interest policy that requires the disclosure of potential conflicts and excludes persons with a material conflict of interest from any related decisions.

During the quarter and year ended December 31, 2006, the Fund incurred professional fees of \$69,112 and \$178,144, respectively, to a law firm of which a director of Liquor Stores GP, a subsidiary of the Fund Inc. (the "GP") is a partner. Rent paid to companies controlled by directors of the GP amounted to \$9,011 and \$84,490 respectively. The Fund paid fees and expenses to a company controlled by the Chief Executive Officer of the GP relating to supervision of the construction of acquired and developed stores and lease administration in the amount \$20,977 and \$116,294 respectively. Included in accounts payable and accrued liabilities is \$4,307 relating to these transactions (see note 17 to the Financial Statements).

Subsequent to December 31, 2006, the Fund has entered into a lease for new office premises with a company associated with the Chief Executive Officer of the GP. The Fund has received independent fairness and legal opinions concerning the terms of the lease.

## **OUTLOOK**

Beyond 2006, the Fund intends to continue to follow the acquisition and store development strategy that led to an increase in the number of stores to 105 from 75 at the beginning of the year. The Fund believes there will continue to be a consolidation trend in the industry and that the Fund is well positioned with the capital and human resources to benefit from this trend.

In addition to the store the Fund acquired to date in 2007, the Fund has commitments to develop and open 6 stores in 2007. The Fund has set an objective of doubling the number of stores it operates in the next three to five years.

The 2006 same store sales increase of 7.2% was significant for the Fund. For 2007, we expect same store sales growth to moderate and be in the range of 2% to 4%.

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

Management of the Fund has evaluated the effectiveness of the Fund's disclosure controls and procedures (as defined under Multilateral Instrument 52-109 ("MI 52-109") of the Canadian Securities Administrators) as of December 31, 2006, and has concluded that the design and effectiveness of these controls and procedures provides reasonable assurance that material information relating to the Fund, including its consolidated subsidiaries, will be made known to management on a timely basis to ensure adequate disclosure.

There have been no changes in the Fund's internal controls over financial reporting (as defined under MI 52-109) that occurred during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, the Fund's internal controls over financial reporting.

## **ADDITIONAL INFORMATION**

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

## **RISK FACTORS**

The Fund's results of operations, business prospects, financial condition, cash distributions to unitholders and the trading price of the Fund's Units are subject to a number of risks. These risk factors include: risks relating to government regulation; competition; its ability to locate and secure acceptable store sites and to adapt to changing market conditions; risks relating to future acquisitions and development of new stores; failure to successfully integrate acquisitions; dependence on key personnel; the Fund's ability to hire and retain staff at acceptable wage levels, risks related to the possibility of future unionization; supply interruption or delays; reliance on information and control systems; dependence on capital markets to fund its growth strategy beyond its available credit facilities; dependence of the Fund on Liquor Stores LP and Liquor Stores GP Inc.; leverage and restrictive covenants in agreements relating to current and future indebtedness of the Liquor Stores LP restrictions on the potential growth of Liquor Stores LP as a consequence of the payment by Liquor Stores LP of a substantial amount of its operating cash flow; income tax related risks including the Tax Fairness Plan; and the Vendors' right to approve certain material transactions.

For a discussion of these risks and other risks associated with an investment in Fund Units, see "Risk Factors" detailed the Fund's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

## **NON-GAAP MEASURES**

References to "distributable cash" are to cash available for distribution to unitholders in accordance with the distribution policies of the Fund. Management believes that, in addition to income or loss, cash available for distribution before debt service, changes in working capital, capital expenditures and income taxes is a useful supplemental measure of performance. Distributable cash of the Fund is a measure generally used by Canadian open-ended trusts as an indicator of financial performance. As one of the factors that may be considered relevant by unitholders and prospective investors is the cash distributed by the Fund relative to the price of the Fund's Units, management believes that distributable cash of the Fund is a useful supplemental measure that may assist unitholders and prospective investors in assessing an investment in the Fund. For a reconciliation of distributable cash to cash provided by operating activities please see "Distributable cash per unit (Fund Units, Exchangeable and Subordinated LP Units)".

Operating margin for purposes of disclosure under "Operating Results" has been derived by adding interest expense, amortization of property and equipment, intangibles and pre-opening costs and non-controlling interest to net earnings.

Operating margin and distributable cash are not measures recognized by GAAP and do not have a standardized meaning prescribed by GAAP. Investors are cautioned that operating margin and distributable cash should not replace net earnings or loss (as determined in accordance with GAAP) as an indicator of the Fund's performance, of its cash flows from operating, investing and financing activities or as a measure of its liquidity and cash flows. The Fund's method of calculating operating margin and distributable cash may differ from the methods used by other issuers. Therefore, the Fund's operating margin and distributable cash may not be comparable to similar measures presented by other issuers.

**FORWARD LOOKING STATEMENTS**

This management's discussion and analysis contains forward-looking statements. All statements other than statements of historical fact contained in this management's discussion and analysis are forward-looking statements, including, without limitation, statements regarding the future financial position, cash distributions, business strategy, proposed acquisitions, budgets, litigation, projected costs and plans and objectives of or involving the Fund or Liquor Stores Limited Partnership. You can identify many of these statements by looking for words such as "believes", "expects", "will", "intends", "projects", "anticipates", "estimates", "continues" or similar words or the negative thereof. These forward-looking statements include statements with respect to the amount and timing of the payment of the distributions of the Fund. There can be no assurance that the plans, intentions or expectations upon which these forward-looking statements are based will occur. Forward-looking statements are subject to risks, uncertainties and assumptions, including, but not limited to, those discussed elsewhere in this management's discussion and analysis. There can be no assurance that such expectations will prove to be correct.

Some of the factors that could affect future results and could cause results to differ materially from those expressed in the forward-looking statements contained herein include, but are not limited to, those discussed under "Risk Factors".

The information contained in this management's discussion and analysis, including the information set forth under "Risk Factors", identifies additional factors that could affect the operating results and performance of the Fund and Liquor Stores LP.

The forward-looking statements contained herein are expressly qualified in their entirety by this cautionary statement. The forward-looking statements included in this management's discussion and analysis is made as of the date of this management's discussion and analysis and the Fund assumes no obligation to update or revise them to reflect new events or circumstances except as expressly required by applicable securities law.