



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

**For Three and Nine Month Periods Ended September 30, 2007  
As of November 8, 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 interim consolidated financial statements (the "Financial Statements") and accompanying notes of Liquor Stores Income Fund (the "Fund") for the three and nine months ended September 30, 2007 and the annual consolidated financial statements and accompanying notes of 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", "operating margin as a percentage of sales", "payout ratio" 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.

This MD&A is dated November 8, 2007.

### **OVERVIEW OF THE FUND**

#### **The Fund's Business and Recent Developments**

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 ownership of 75.6% of Liquor Stores Limited Partnership ("Liquor Stores LP") and 90.0% of Liquor Barn Limited Partnership ("Liquor Barn LP"), the Fund operates 194 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 revenue.

On June 7, 2007, the Fund's offer to acquire all of the outstanding trust units of Liquor Barn Income Fund (the "Liquor Barn Fund") was accepted by the holders of approximately 81% of Liquor Barn Fund public trust units and by approximately 74% of its voting unitholders. In a transaction valued at approximately \$217 million the Fund issued 6,817,533 trust units (the "Units") in exchange for a 76.0% interest in Liquor Barn LP and assumed the outstanding indebtedness of Liquor Barn Fund. The Fund has subsequently issued an additional 1,267,635 Units as the result of exchanges made by Liquor Barn LP exchangeable and subordinated unitholders to increase its ownership of Liquor Barn LP to 90.0%.

#### **Liquor Barn LP Integration**

The integration of Liquor Barn LP is proceeding as contemplated. Early in the third quarter of 2007, the point of sales software of the 81 Liquor Barn LP stores acquired had been replaced by that used by Liquor Stores LP. Liquor Barn LP's head office and field supervisory staff have been integrated into Liquor Stores LP. At the time of the acquisition, Liquor Stores LP and Liquor Barn LP had a combined complement of 95 head office and field supervisory staff. Following the integration, this complement was reduced to 69. A cost reduction program has been successfully implemented. Liquor Barn LP's former head office lease was terminated. Although much has been accomplished there is opportunity to further improve on margin enhancements achieved to date including optimizing inventory levels. We are also improving depth and breadth of selection in the stores. Since the end of the second quarter approximately \$10 million has been invested to increase inventory levels in the Liquor Barn LP stores. The benefits of these improvements are expected to be realized over the next several quarters.

#### **Stores and Operations**

During the three months ended September 30, 2007, the Fund completed the acquisition of one retail liquor store in Edmonton, Alberta and one retail liquor store in Coquitlam, British Columbia. The Fund opened one retail liquor store in Vernon, British Columbia and one in Prince George, British Columbia. The Fund has three stores under construction that may open prior to the end of 2007.

The acquisition of Liquor Barn far exceeded our 2007 growth plans and diverted energy away from new store development. Provided the three stores under construction open prior to year end, the Fund will have developed 11 stores during 2007 compared to its target of ten. As at November 8, 2007, the Fund operates 194 retail liquor stores located as follows:

	Alberta			British Columbia			Total
	Edmonton <sup>(1)</sup>	Calgary <sup>(1)</sup>	Other <sup>(2)</sup>	Lower Mainland	Vancouver Island	Interior	
Number of Stores	74	46	43	12	11	8	194

Notes:

- (1) References to Edmonton and Calgary are to stores located in or near those urban centres.
- (2) Other communities served in Alberta include, by region, Northern (20), Southern (7), Central (12) and Resort communities (4).

### 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. The Fund currently operates 163 liquor stores in Alberta where there are approximately 1,050 liquor stores and 86 agency stores. Management believes the Fund is the largest liquor store operator by both number of stores and revenue.

The Fund also operates 31 stores and 2 small associated pubs 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") and other deferred compensation plans. 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.

Cash distributions have been made as follows from the inception of the Fund:

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	\$0.12500	\$1.500

On November 8, 2007, the fund announced that it would increase its monthly cash distribution from \$0.125 (\$1.50 –annually) to \$0.135 (\$1.62 – annually), commencing with the distribution to Unitholders of record December 31, 2007 payable January 15, 2008.

Distributions declared during the three months ended September 30, 2007 were \$8.4 million or \$0.375 per Unit. The weighted average distributable cash per Unit increased 23% from \$0.40 for the third quarter of 2006 to \$0.49 for the third quarter of 2007.

For the nine months ended September 30, 2007 distributable cash was \$1.26 compared to \$0.93 for the same period in 2006, an increase of 36%.

The retail liquor industry is subject to some seasonal variations with approximately 40% of sales occurring in the first half of the year and 60% occurring in the second half. As a result, distributable cash will be less than actual distributions early in the year, but are expected to exceed distributions for the latter portion of the year.

### **Effect of Trust Tax Legislation**

On June 22, 2007, Bill C – 52, including the provisions related to the taxation of income trusts (the “SIFT Rules”), received Royal Assent. Pursuant to the SIFT Rules, commencing in 2011 earnings of the Fund distributed to unitholders will be subject to tax at a rate of 31.5% (currently zero). Taxable distributions (other than return of capital) to unitholders will be characterized as eligible dividends, a change from their current treatment as ordinary income. For discussion of SIFT Rules and limitations on growth and expansion see “Capital Expenditures” below.

For 2006, the tax deferred portion of distributions for Canadian federal income tax purposes was approximately 28%. The Fund continues to review the current and long-term implications of the SIFT Rules to unitholders of various alternatives with respect to claiming elective income tax deductions in the period 2007 to 2010. As such, the Fund cannot now determine the portion, if any, of the 2007 distributions that will be tax deferred.

### **Distributable Cash**

The Fund views distributable cash as an important supplementary measure to assist unitholders in evaluating the Fund’s performance as the Fund’s objective is to provide a stable and sustainable flow of distributable cash to unitholders. When evaluating the cash available for distribution to unitholders the Fund takes into consideration the following factors:

#### ***Financing Strategy***

The Fund has a history of financing its acquisitions, store development costs and betterments with the proceeds of the issuance of Units from treasury and financing its investment in inventory with bank indebtedness. When proceeds from the issuance of Units are received prior to being used to finance growth, bank indebtedness is temporarily repaid.

#### ***Maintenance of Productive Capacity***

In order to maintain its productive capacity the Fund incurs expenses for routine maintenance and makes expenditures for the replacement of long lived assets. In the determination of distributable cash, provisions are made for anticipated replacements of long lived assets not yet recorded in the accounts of the Fund.

#### ***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. Inventory levels are also influenced by seasonal investments in inventory.

#### ***Long Term Incentive Plans***

Funding for the Fund’s long term incentive plans occurs subsequent to the approval of the Fund’s annual financial statements. For accounting purposes, the compensation expense related to the incentive plans are recognized as awards vest. Awards under the LTIP are calculated with reference to distributable cash per Unit.

***Distributable cash***

The following table provides the calculation of the distributable cash of the Fund for the three and nine months ended September 30, 2007 and 2006 and since inception:

	<u>Three months ended September 30,</u>		<u>Nine months ended September 30,</u>		<u>Since inception of the Fund</u>
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>	
Cash provided by operating activities	(\$949)	\$311	\$14,360	\$4,103	\$27,769
Net change in non-cash working capital	12,438	5,018	7,299	7,334	27,642
Equity earnings	-	-	-	28	79
Incentive plan provisions	(273)	(400)	(819)	(400)	(1,819)
Provision for non-growth property and equipment	(155)	(211)	(662)	(388)	(2,034)
Distributable cash	<u>\$11,061</u>	<u>\$4,718</u>	<u>\$20,178</u>	<u>\$10,677</u>	<u>\$51,637</u>
Weighted average units outstanding	22,622,892	11,930,000	15,960,365	11,496,300	12,400,418
Distributable cash per weighted average Unit	\$0.49	\$0.40	\$1.26	\$0.93	\$4.16
Distributions declared per unit	\$0.38	\$0.30	\$1.11	\$0.90	\$3.66

***Comparable GAAP Measures***

Distributable cash is a Non-GAAP Measure. Adjustments and provisions related to non-growth property and equipment, incentive plan provisions and non-cash working capital are necessary to reconcile distributable cash to its nearest GAAP measure, cash provided by operating activities.

The GAAP measure comparable to distributable cash per unit is earnings per unit. Basic and diluted earnings per unit are as follows:

Basic earnings per unit	\$0.30	\$0.39	\$0.01	\$0.86
Diluted earnings per unit	\$0.30	\$0.39	\$0.01	\$0.85

Diluted earnings per unit for the three ended September 30, 2007 were \$0.30 compared to \$0.39 last year. In aggregate for the quarter, \$2.5 million (\$0.11 per diluted unit) was charged to earnings in respect administrative costs related to the integration of Liquor Barn and non-cash charges for the amortization of a fair value adjustment recorded at the time of the Liquor Barn acquisition and future income taxes. These charges for the nine months ended September 30, 2007 aggregated \$16.3 million (\$1.02 per diluted unit) and as a result the diluted earnings per unit were \$0.01 compared to \$0.85 last year.

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 September 30,</u>		<u>Nine months ended September 30,</u>		<u>Since inception of the Fund</u>
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>	
Purchase of property and equipment	\$1,277	\$678	\$3,077	\$2,542	\$9,648
Growth expenditures including amounts relating to developed stores	(972)	(667)	(2,265)	(2,354)	(7,740)
Purchase of non-growth property and equipment	305	11	812	188	1,908
Provision for further non-growth property and equipment expenditures	(150)	200	(150)	200	126
Total provision for non-growth property and equipment	155	211	662	388	2,034
Repairs and maintenance expense	143	63	403	185	974
Total expenditures for non-growth property and equipment purchases and repairs and maintenance expense	\$298	\$274	\$1,065	\$573	\$3,008

## **SELECTED FINANCIAL INFORMATION AND RESULTS FROM OPERATIONS**

### **Operating Results**

The retail liquor industry is subject to some seasonable variations with respect to sales. Sales are typically slowest early in the year and increase in the latter half with the highest sales occurring in the last quarter. In 2006, 17% of sales occurred in the first quarter, 24% in the second quarter, 27% in the third quarter and 32% in the last quarter.

The following table summarizes the operating results for the quarter and nine months ended September 30, 2007 with comparative figures for 2006 including those of Liquor Barn LP since June 8, 2007:

	<u>Three months ended September 30,</u>		<u>Nine months ended September 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Number of stores at September 30	194	99	194	99
Sales	\$122,097	\$60,751	\$257,142	\$150,988
Cost of sales, operating, administrative, acquisition and store development	(111,119)	(54,965)	(237,086)	(138,629)
Add back amortization of inventory fair value adjustment	947	-	2,247	-
Operating margin <sup>(1)</sup>	<u>\$11,925</u>	<u>\$5,786</u>	<u>\$22,303</u>	<u>\$12,359</u>
Operating margin as a percentage of sales	<u>9.77%</u>	<u>9.52%</u>	<u>8.67%</u>	<u>8.19%</u>

Note:

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

### Sales

Sales for the quarter ended September 30, 2007 increased by \$61.3 million to \$122.1 million from \$60.8 million in 2006. For the nine months ended September 30, 2007, sales increased by \$106.1 million to \$257.1 million from \$151.0 million in 2006. These increases are primarily due to the increase in the number of stores operated to 194 at September 30, 2007 compared to 99 at September 30, 2006. The increases for the three and nine months ended September 30, 2007 comprise the following:

- an increase in same store sales of \$0.5 million or 1.0% to \$48.4 million for the three months ended September 30, 2007 and an increase in same stores sales of \$3.9 million or 2.5 % for the nine months ended September 30, 2007. Management expects some moderation in same store sales as a result of the increase in advertising in the Liquor Barn stores;
- sales from the Liquor Barn LP stores \$50.8 million for the three months ended September 30, 2007 and \$64.8 million since their acquisition on June 8, 2007;
- an increase of \$28.6 million in sales to \$41.3 million for the 30 stores acquired or opened in 2006, which are operating at September 30, 2007;
- sales of \$4.9 million for the three months ended September 30, 2007 and of \$10.0 million for the nine months ended September 30, 2007 for stores acquired or opened in 2007 net of the sales of a store closed in 2007.

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

Operating expenses for the three and nine months ended September 30, 2007 were \$111.1 million and \$237.1 million, respectively, which is \$56.2 million and \$98.5 million higher than in 2006, respectively. These increases are consistent with the increase in number of stores being operated.

Operating expense includes the recognition of deferred unit-based compensation expense for the LTIP, the 2007 Incentive Plan and the Deferred Share Unit Plan. During the three and nine months ended September 30, 2007 respectively, the Fund recognized

compensation expense of \$8,771 and \$19,735 for the LTIP, \$146,932 and \$355,249 for the 2007 Incentive Plan and \$52,664 and \$145,367 for the Deferred Share Unit Plan.

Operating Expenses for the three months ended September 30, 2007 includes \$0.9 million amortization of a \$2.2 million inventory fair value adjustment recorded as part of the purchase price allocation of the Liquor Barn acquisition. As of September 30, 2007, the inventory fair value adjustment has been fully amortized.

For the three and nine months ended September 30, 2007, respectively, approximately \$0.6 million and \$0.7 million in administrative expenses were incurred in connection with the integration of Liquor Barn.

### **Operating Margin**

Operating margin (as defined under “Non-GAAP Measures”) increased to \$11.9 million for the three months ended September 30, 2007 from \$5.8 million in 2006 and \$22.3 million for the nine months ended September 30, 2007 from \$12.4 million for the same period in 2006. Operating margin as a percentage of sales was 9.77% for the three months ended September 30, 2007 compared to 9.52% for the same period last year and 8.67% for the nine months ended September 30, 2007 compared to 8.19% for the same period in 2006. The increase in operating margin is due to the successful integration of Liquor Barn stores as well as improved performance of the other stores.

### **Future Income Taxes (a Non-cash Charge)**

Prior to substantive enactment of the SIFT Rules, income tax provisions were only recorded in respect of incorporated subsidiaries. Consequently, income taxes recorded in the Fund’s accounts had been nominal.

The Fund, in accordance with GAAP, follows the asset and liability method of accounting. With the substantive enactment of the SIFT Rules, the asset and liability method of accounting required non-cash provisions of \$0.9 million and \$13.4 million for future income tax during the three months and nine months ended September 30, 2007. This provision relates principally to the difference between the value of intangible assets, property and equipment, and goodwill assigned at the time of acquisitions in the accounts of the Fund and their value for tax purposes.

### **Net Earnings before Non-controlling Interest and Net Earnings and Comprehensive Income (Loss)**

The net earnings before non-controlling interest for the three months ended September 30, 2007 increased by \$2.5 million to \$7.2 million over the same period in 2006 and decreased by \$8.7 million to \$1.1 million for the nine months ended September 30, 2007 compared to 2006. Net earnings and comprehensive income increased \$2.0 million to \$5.3 million compared to the same period in prior year for the three months ended September 30, 2007 and decreased by \$6.8 million to \$0.1 million compared to 2006 for the nine months ended September 30, 2006. The decreases in net earnings before non-controlling interest and net earnings and comprehensive income for the three months and nine months ended September 30, 2007 is due to the requirement to record a future tax expense resulting from the substantive enactment of Bill C – 52 which occurred in the second quarter of 2007.



**Condensed Quarterly Information**

	2007			Dec 31	2006			2005
	Sept 30	June 30	March 31		Sept 30	June 30	March 31	Dec 31
<b>Balance Sheet</b>								
Cash and cash equivalents	\$ 6,891	\$ 3,391	\$ 1,715	\$ 3,397	\$ 1,683	\$ 276	\$ 2,935	\$ 2,047
Total assets	427,986	412,403	188,311	187,097	173,736	165,812	141,511	140,806
Bank indebtedness	37,198	35,107	11,893	5,455	28,964	15,495	–	15,493
Total current liabilities	55,403	54,916	17,489	12,895	32,140	20,481	4,092	20,427
Long-term debt	15,562	562	–	–	2,500	7,500	–	11,352
Unitholders' equity	290,425	279,708	137,922	140,706	105,975	105,115	104,775	67,327
Non-controlling interest	53,253	64,880	32,900	33,496	33,120	32,716	32,643	41,700
<b>Statement of Earnings</b>								
Sales	122,097	83,236	51,809	71,010	60,751	52,215	38,021	50,686
Earnings before non-controlling interest	7,182	(8,465)	2,383	6,206	4,677	3,992	1,101	3,676
Net earnings for the period	5,325	(6,992)	1,767	4,627	3,332	2,871	684	2,202
Basic earnings per Unit	\$0.30	(\$0.59)	\$0.17	\$0.45	\$0.39	\$0.33	\$0.10	\$0.38
Diluted earnings per Unit	\$0.30	(\$0.59)	\$0.17	\$0.45	\$0.39	\$0.33	\$0.10	\$0.37
Distributable cash per Unit	\$0.49	\$0.41	\$0.21	\$0.45	\$0.40	\$0.38	\$0.14	\$0.44

**LIQUIDITY AND CAPITAL RESOURCES****Unitholders' Equity and Non-controlling Interest**

The following units were outstanding as of November 8, 2007:

	Units
Fund Units <sup>(1)</sup>	18,096,467
Liquor Stores LP Exchangeable LP Units	1,175,255
Liquor Stores LP Subordinated LP Units	2,125,000
Liquor Barn LP Exchangeable & Subordinated LP Units (equivalent Fund Units)	1,111,091
	<u>22,507,813</u>

Note:

(1) Includes 45,504 treasury Units

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

In the first nine months of 2007, 1,425 Liquor Stores LP Exchangeable LP Units and 480,158 Liquor Barn Exchangeable LP units (on an equivalent Fund Units basis) were exchanged for Fund Units resulting in an increase in Unitholders' Equity of \$10.1 million. The Fund also issued 2,492 Units from treasury to the LTIP in this period.

The conditions related to the release of the Liquor Barn LP Subordinated LP Units from escrow were satisfied at the time of the Liquor Barn acquisition. During the three months ended September 30, 2007, 566,540 Liquor Barn Subordinated LP Units (on an equivalent Fund Units basis) were converted to Fund Units resulting in an increase in Unitholders' Equity of \$12.0 million. Subsequent to September 30, 2007, 220,936 Liquor Barn LP Subordinated LP Units were exchanged for Fund Units resulting in an increase in Unitholders' Equity of \$4.8 million.

### **Credit Facilities**

At September 30, 2007, the Fund had an available \$90 million operating line and an available \$30 million long term Capital/Acquisition line. The Fund also has available a \$3.5 million demand non-revolving loan to cover electronic funds transfer payments, and a \$4 million bank guarantee facility to be used in day to day issuance of letters of guarantee for operations. The total of all credit facilities is \$127.5 million.

As of September 30, 2007, total indebtedness under all credit facilities is approximately \$39.7 million, offset by \$2 million in outstanding cheques and deposits, and is primarily related to inventory financing. An additional \$15 million is drawn on the long term Capital/Acquisition line repayable on May 31, 2009. As acquisitions occur and new stores are opened, credit facilities will be utilized as required.

### **Capital Expenditures**

During the three months ended September 30, 2007, the Fund acquired two stores and opened two. Subsequent to September 30, 2007, one additional developed store was opened.

The Fund will continue to pursue acquisition opportunities and to open new stores.

The SIFT Rules provide that, while there is no intention to prevent "normal growth" during the transitional period, any "undue expansion" could result in the transition period being "revisited", presumably with the loss of the benefit to the Fund of that transitional period. As a result, the adverse tax consequences resulting from the SIFT Rules could be realized sooner than January 1, 2011. On December 15, 2006, the Department of Finance issued guidelines with respect to what is meant by "normal growth" in this context. Specifically, the Department of Finance stated that "normal growth" would include equity growth within certain "safe harbour" limits, measured by reference to a specified investment flow-through trust or partnership's ("SIFT") market capitalization as of the end of trading on October 31, 2006 (which would include only the market value of the SIFT's issued and outstanding publicly-traded trust units, and not any convertible debt, options or other interests convertible into or exchangeable for trust units). These guidelines have been incorporated into the SIFT Rules. Those safe harbour limits are the greater of \$50 million or 40% of the market capitalization benchmark 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 (other than the \$50 million annual limit), so that any unused limit for a period carries over into the subsequent period. Additional details of the Department of Finance's guidelines include the following:

- (a) new equity for these purposes includes units and debt that is convertible into units (and may include other substitutes for equity if attempts are made to develop those);
- (b) replacing debt that was outstanding as of October 31, 2006 with new equity, whether by a conversion into trust units of convertible debentures or otherwise, will not be considered growth for these purposes and will therefore not affect the safe harbour; and
- (c) the exchange, for trust units, of exchangeable partnership units or exchangeable shares that were outstanding on October 31, 2006 will not be considered growth for these purposes and will therefore not affect the safe harbour where the issuance of the trust units is made in satisfaction of the exercise of the exchange right by a person other than the SIFT.

(d) the merger of SIFT's not resulting in the issuance of additional units do not affect the safe harbour limits.

The Fund's market capitalization, including that of Liquor Barn Fund, as of the close of trading on October 31, 2006, having regard only to issued and outstanding publicly-traded units, was approximately \$327 million, which means the Fund's "safe harbour" equity growth amount for the period ending December 31, 2007 is approximately \$130 million, and for each of calendar 2008, 2009 and 2010 is an additional approximately \$66 million (in any case, not including equity, including convertible debentures, issued to replace debt that was outstanding on October 31, 2006, which was approximately \$30 million). In 2007 and prior to its acquisition, Liquor Barn Fund issued subordinated convertible debentures and trust units aggregating \$49 million. As a consequence the Fund could issue new units for proceeds \$81 million in the remainder of 2007 and remain within the "safe harbour" guidelines.

The Fund believes that while the application of the "safe harbour" guidelines are not a practical constraint on its ordinary growth prior to 2011, they could adversely affect the cost of raising capital and the Fund's ability to undertake more significant acquisitions. The long-term effect of the SIFT Rules on the Fund is yet to be determined. The Fund continues to review the impact of the SIFT Rules on its business strategy and to evaluate strategic alternatives that it could elect to pursue in response to the SIFT Rules. No assurance can be provided that the Fund will not undertake actions in the future that could cause the SIFT Rules to apply to it prior to 2011.

### 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 an assumed outstanding debt balance of \$55 million, a 1.0% increase in interest rates would reduce distributable cash for the year by approximately \$550,000 or \$0.03 per Unit.

### Foreign Exchange Risk

The Fund's business is not significantly affected by foreign exchange rate fluctuations. The majority of product cost is related to domestically sourced product and provincially regulated commodity taxes.

### Contractual Obligations

The table below sets forth, as of September 30, 2007, the contractual obligations of the Fund, due in the years indicated, related to various premises operating leases and Long term debt.

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013 and thereafter</u>
Operating leases	\$13,998	\$14,793	\$15,420	\$16,011	\$16,704	\$42,437
Long term debt	-	15,000	-	-	-	-
Total	<u>\$13,998</u>	<u>\$29,793</u>	<u>\$15,420</u>	<u>\$16,011</u>	<u>\$16,704</u>	<u>\$42,437</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 purchases 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.

## **CHANGES IN ACCOUNTING POLICIES**

### **Financial Instruments and Other Comprehensive Income**

New accounting standards are in effect for fiscal years beginning on or after October 1, 2006 for recognition and measurement of financial instruments and disclosure of comprehensive income. Effective January 1, 2007, the Fund has adopted Canadian Institute of Chartered Accountants ("CICA") Handbook sections 1530 – Comprehensive Income, 3855 – Financial Instruments – Recognition and Measurement, 3861 – Financial Instruments – Disclosure and Presentation, and 3865 – Hedges. As the Fund has no items of other comprehensive income, net earnings for the period is equivalent to comprehensive income.

Effective January 1, 2007, the Fund adopted CICA Handbook section 1506, "Accounting Changes" providing standards for accounting treatment and disclosure of changes in accounting policies, accounting estimates and correction of errors.

## **ACCOUNTING PRONOUNCEMENTS NOT YET IMPLEMENTED**

The following CICA handbook sections have an effective date of January 1, 2008 and their impact is being evaluated by the Fund:

### **Section 1535: Capital Disclosures**

This new standard establishes disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. The Fund will implement this new standard which is effective January 1, 2008.

### **Section 3862: Financial Instruments - Disclosures and Section 3863: Financial Instruments - Presentation**

These new standards replace Section 3861, Financial Instruments - Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. The Fund will implement these new standards which are effective January 1, 2008.

**Section 3031: Inventories**

This new standard provides guidance in determining the cost of inventory and its subsequent recognition as an expense. The standard is effective for fiscal periods beginning on or after January 1, 2008 and requires the retroactive application to prior period financial statements. The Fund is presently evaluating the impact of this new standard.

**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 three and nine months ended September 30, 2007, the Fund incurred professional fees of \$107 and \$268 respectively to a law firm of which a director of Liquor Stores GP Inc. (the "Liquor Stores GP"), a subsidiary of the Fund, is a partner. Rent paid to companies controlled by directors of the GP amounted to \$46 over the nine month period ended September 30, 2007. 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 developed stores and tax services of \$15 and \$31 (see note 7 to the Financial Statements).

The Fund 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. Rent for the three months ended September 30, 2007 was \$57.

**OUTLOOK**

On June 8, 2007, the Fund completed the strategic acquisition of Liquor Barn LP. During the third quarter of 2007, the Fund completed the operational integration of the 81 Liquor Barn stores and the administrative integration of head offices and field supervision. At the time of the acquisition, Liquor Stores LP and Liquor Barn LP had a combined complement of 95 head office and field supervisory staff. Following integration this complement was reduced to 69. A cost reduction program has been successfully implemented. Liquor Barn LP's former head office lease was terminated. Although much has been accomplished there is opportunity to further improve on the margin enhancements achieved to date. To fully realize this opportunity, inventory levels must be optimized and continued improvements in the depth and breadth of selection in the stores need to be achieved. While the Fund has invested \$10 million to increase inventory levels and selection in the Liquor Barn LP stores since the end of the second quarter, the benefits of this investment are expected to be realized over the next several quarters.

Management believes the Fund is the leading independent liquor retailer in Alberta and British Columbia with an estimated combined share of independent liquor store retail sales of over 16% in Alberta and British Columbia and approximately 19% of the Alberta market.

With the Liquor Barn acquisition completed and the integration of the stores nearing completion the Fund has a strong platform for future growth. The Fund has three stores under construction that may open prior to the end of 2007. The Fund's future growth plans will concentrate on acquisition in British Columbia and the development of greenfield locations in Alberta. As well, the Fund is evaluating the potential of expanding its operations into the United States where the regulatory regime in approximately half of the states permit the sales of alcoholic beverages through non-government agency channels.

**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

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 September 30, 2007, 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 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 Barn LP; leverage and restrictive covenants in agreements relating to current and future indebtedness of Liquor Stores LP and Liquor Barn LP; restrictions on the potential growth of Liquor Stores LP and Liquor Barn LP as a consequence of the payment by Liquor Stores LP and Liquor Barn LP of a substantial amount of their respective operating cash flow; income tax related risks including the SIFT Rules; and the Vendors' right to approve certain material transactions.

For a discussion of these risks and other risks associated with an investment in Units, see "Risk Factors" detailed in 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 inventory fair value adjustments, amortization of property and equipment, intangibles and pre-opening costs to net earnings before non-controlling interest. Operating margin as a percentage of sales is calculated by dividing operating margin by sales.

"Payout ratio" is calculated by dividing cash distributions declared by distributable cash.

Operating margin, operating margin as a percentage of sales, distributable cash and payout ratio are not measures recognized by GAAP and do not have a standardized meaning prescribed by GAAP. Investors are cautioned that operating margin, operating margin as a percentage of sales, distributable cash and payout ratio 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, operating margin as a percentage of sales, distributable cash and payout ratio may differ from the methods used by other issuers. Therefore, the Fund's

operating margin, operating margin as a percentage of sales, distributable cash and payout ratio 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 or recent acquisitions and the benefits to be derived therefrom, budgets, litigation, projected costs and plans and objectives of or involving the Fund, Liquor Stores LP or Liquor Barn LP. 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, Liquor Stores LP and Liquor Barn 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.