# LIQUOR STORES N.A. LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS
**For the Three and Nine Months Ended September 30, 2013**
As at November 6, 2013

**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 unaudited condensed interim Consolidated Financial Statements and Notes thereto (the "interim financial statements") of Liquor Stores N.A. Ltd. (the "Company" or "Liquor Stores") for the three and nine months ended September 30, 2013, the audited Consolidated Financial Statements and MD&A for the year ended December 31, 2012, and the Annual Information Form ("AIF) dated March 5, 2013. In this MD&A, all references to "we", "us", "our", and "the Company" refer to Liquor Stores N.A. Ltd. and its subsidiaries. All references to "Management" refer to the directors and senior officers of the Company.

Unless otherwise stated, financial information is expressed in Canadian dollars and has been prepared in accordance with International Financial Reporting Standards ("IFRS"), as set out in the Handbook of the Canadian Institute of Chartered Accountants – Part I ("CICA Handbook"), for interim financial statements. Certain dollar amounts have been rounded to the nearest hundred thousand dollars or thousand dollars. References to notes are to notes of the interim financial statements unless otherwise stated.

Throughout this MD&A references are made to non-IFRS financial measures, including "operating margin", "operating margin as a percentage of sales", "adjusted operating margin", "adjusted net earnings", "adjusted earnings per share", "adjusting items" and "cash provided by operating activities before changes in non-cash working capital and adjusting items". A description of these measures and their limitations are discussed on page 24 under "Non-IFRS Financial Measures".

Management is responsible for the information contained in this MD&A and its consistency with information presented to the Audit Committee and Board of Directors. In accordance with its terms of reference, the Audit Committee of the Company's Board of Directors reviews the contents of the MD&A and recommends its approval by the Board of Directors on a quarterly basis. The Board of Directors has approved this MD&A as of November 6, 2013.

Additional information relating to the Company, including our Annual Information Form ("AIF") dated March 5, 2013, and other public filings, is available on SEDAR (www.sedar.com) and on the Company's website at www.liquorstoresna.ca.

## FORWARD LOOKING STATEMENTS

In the interest of providing current shareholders and potential investors with information regarding current results and future prospects, this MD&A contains forward-looking statements or information. All statements and information other than statements of historical fact contained in this MD&A are forward-looking statements, including, without limitation, statements regarding the future financial position and performance of the Company, business strategy, projected store openings, costs, as well as plans and objectives of or involving the Company. You can identify many of these statements by looking for words such as "believes", "expects", "will", "intends", "projects", "anticipates", "estimates", "continues", "forecasts" or similar words or the negatives thereof. These forward-looking statements include statements with respect to the amount and timing of the payment of the dividends of the Company. There is no assurance that the plans, intentions or expectations upon which these forward-looking statements are based will occur and such forward-looking statements included in this MD&A should not be unduly relied upon. Forward-looking statements are subject to risks, uncertainties and assumptions, including, but not limited to, those discussed elsewhere in this MD&A. There is 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". Specific forward-looking statements contained in this MD&A include, among others, the future payment and timing of dividends, the anticipated opening dates of new stores, and management's general expectations that the Company will have sufficient funds to complete store acquisitions, develop new stores and finance inventory.

The information contained in this MD&A, including the information set forth under "Risk Factors" identifies additional factors that could affect the operating results and performance of the Company.

The forward-looking statements contained herein are expressly qualified in their entirety by this cautionary statement. The forward-looking statements included in this MD&A are made as of the date of this MD&A and the Company assumes no obligation to update or revise them to reflect new events or circumstances except as expressly required by applicable securities law.

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## HIGHLIGHTS

**Three months ended September 30, 2013**

- Consolidated sales increased 5.1% to $172.9 million (2012 - $164.5 million);
- Same-store sales decreased by 1.0% in Canada ($1.3 million) and by 1.0% in the U.S. ($0.4 million);
- Gross margin was 25.3% (2012 - 25.5%); and
- Adjusted operating margin decreased by 5.9% ($0.9 million) to $13.7 million (2012 - $14.6 million).

**Nine months ended September 30, 2013**

- Consolidated sales increased 5.8% to $476.9 million (2012 - $450.7 million);
- Same-store sales increased by 0.2% ($0.7 million) in Canada and decreased by 2.3% ($2.4 million) in the U.S.;
- Gross margin was 25.2% (2012 – 25.3%);
- Adjusted operating margin decreased by 8.4% ($3.0 million) to $31.9 million (2012 - $34.9 million).

## Sales

The 5.1% sales increase in Q3 2013 compared to Q3 2012 is primarily attributable to the growth in the Company's store count (7 new stores opened subsequent to September 30, 2012).

Canadian same-store sales, which experienced a decline of 1.0% in the quarter, were impacted by the success of the Company's Wine and Beyond stores (2 large format stores opened in the Edmonton area in late September 2012) which, in addition to drawing customers away from our competitors, drew customers away from our convenience-focused Liquor Depot/Liquor Barn stores in the greater Edmonton region. Sales at Wine and Beyond, however, more than offset the decrease in Edmonton area same-store sales. We estimate that the impact of Wine and Beyond on Canadian same-store sales in Q3 2013 was approximately 1.0% to 1.3%. Canadian same-store sales have also been negatively impacted by sales tax changes in British Columbia and increased competition in that province (see the Analysis of Financial Results section for further discussion). The aggregate impact on Canadian same-store sales as a result of these matters in British Columbia is estimated to be 0.6%. Management estimates that Canadian same-stores sales increased between 0.6% and 0.9% after adjusting for and excluding the impact of the foregoing matters.

Same-store sales in the United States in Q3 2013 were primarily impacted (a decrease of 1.0% or $0.4 million) by certain counties in Kentucky going from 'dry' to 'wet' throughout 2012 (i.e. certain counties in close proximity to the Company's stores that did not previously permit retail package liquor sales are now permitting these sales). To counteract the impact of certain counties transitioning from 'dry' to 'wet', the Company has been made changes to our marketing strategies and is actively sourcing potential opportunities to develop new stores in counties that have gone 'wet' or in counties where we do not yet have a presence.

## Adjusted Operating Margin

Adjusted operating margin for the three months ended September 30, 2013 decreased by $0.9 million to $13.9 million, primarily due to a decline in Canadian and U.S. same-store sales, increases in operating expenses, and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy. Adjusted operating margin as a percentage of sales was 7.9%, down from 8.9%. In addition to the above noted factors, this decline was also due to the eight additional stores added since June 30, 2012, which are still in their ramp up phase (i.e. these stores have been open for less than one year) and generally take up to three years to mature and fully contribute to operating margin.

## Nine Months Ended September 30, 2013

For the nine months ended September 30, 2013, consolidated sales increased by 5.8% ($26.1 million) to $476.9 million. While Canadian same store sales increased 0.2% ($0.7 million) to $322.2 million, U.S. same stores sales were down 2.3% (US$2.4 million) due primarily to the increased competition that occurred when counties adjacent to the Company's stores in Kentucky went from 'dry' to 'wet'. Same store sales in both Canada and the U.S. were also negatively impacted as a result of 2012 having benefited from an additional day in the year as a result of the leap year. Consolidated gross margin as a percentage of sales was unchanged this year compared to the first nine months of 2012. Adjusted operating margin decreased $3.0 million primarily due to a decline in same-store sales, the loss of operating margin from stores closed subsequent to September 30, 2012 (four stores closed in 2013), increases in operating expenses, and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy. Adjusted operating margin as a percentage of sales was 6.7%, down from 7.7%. In addition to the above noted factors, this decline was also due to the eleven additional stores added since December 31, 2011, which are still in their ramp up phase (i.e. these stores have been open for less than one year) and may take up to three years to mature and fully contribute to operating margin.

## OUTLOOK

Consistent with our '*Business Strategy*' (discussed on page 6), the Company continues to focus on enhancing current operations and growth in new and existing markets.

The Company has been building on the strong fundamentals of the business during Q3 2013, by moving forward on initiatives to enhance relationships with customers, vendors and employees. These initiatives include enhancing our employee training programs to strengthen our selling culture, implementing new sales, marketing and advertising approaches, working with vendors on adopting a more collaborative approach towards product promotions and opportunities for event-driven marketing, and strengthening our Merchandising, Information Technology ("IT") and Human Resources functions to further support our growth plans. These investments in our business have impacted our adjusted operating margin for the period, however, towards the end of the third quarter we started to see indications that these initiatives are working, which is encouraging as we move forward into the most important quarter for our business.

We are actively pursuing new store growth opportunities for 2013 and beyond. New store openings are contingent upon a number of factors, primarily the availability of existing space suitable for our stores, prime commercial development opportunities and construction timing. While the rate of store growth in 2013 was slower than compared to 2012, we anticipate that the growth will accelerate starting in 2014. The execution of the Company's business strategy, including the development of new large-format stores and sourcing expansion opportunities in new regions, requires upfront investment and new stores require time to achieve sales maturity. New stores generally take up to three years to reach maturity and fully contribute to operating margin. As a result, over the next 12 to 24 months, operating and administrative costs are expected to trend higher and operating margin as a percentage of sales may decline. Neither the timing nor the degree of likelihood of success of developing new stores can be stated with any degree of accuracy.

Our financial results for the remainder of 2013 and into 2014 may face pressure from certain uncontrollable external factors including: (i) the potential for slower economic growth, (ii) increased competition from retail liquor stores that opened in counties in Kentucky that went from 'dry' to 'wet' throughout 2012, (iii) an increasingly competitive environment in the Province of British Columbia, and (iv) the potential outcome of a Province of British Columbia regulatory review of its liquor policy which is expected to be finalized prior to year end. In addition to these factors, there is the potential for changes to the licensing regime in Kentucky during 2013 or 2014, as further discussed in the '*Competitive Environment*' section on this MD&A, which could have a negative impact on the Company's operations and financial results in Kentucky if these changes are implemented.

Management believes that cash flow from existing operations is sufficient to sustain the Company's dividend at the current level. Management also believes that its cash flow from existing operations, its current available credit and access to new capital are sufficient to finance the execution of the Company's business strategy.

## OVERVIEW OF THE COMPANY

The Company's principal activity is the retailing of wine, beer and spirits in Canada (Alberta and British Columbia) and the United States (Alaska and Kentucky). The Company was incorporated on November 8, 2010 under the Canada Business Corporations Act ("CBCA") and is the successor entity to Liquor Stores Income Fund, which became a publicly traded entity in September 2004. The Company's common shares and convertible unsecured subordinated debentures trade on the Toronto Stock Exchange (the "TSX") under the symbols LIQ and LIQ.DB.A, respectively.

As at September 30, 2013, the Company operated 246 retail liquor stores. Management believes the Company is the largest liquor store operator in Alberta, Canada's largest private liquor retailer and North America's largest publicly-traded liquor retailer (based upon number of stores and revenue).

The Company operates under the brand names "Liquor Depot", "Liquor Barn" and "Wine and Beyond" in Alberta, "Liquor Depot", "Liquor Barn", and "Kitsilano Wine Cellar" in British Columbia, "Brown Jug" in Alaska, and "Liquor Barn, The Ultimate Party Source" and "Liquor Barn Express" in Kentucky.

## Stores and Operations

As of November 6, 2013, the Company had 245 stores in the following regions:

| Alberta | | | British Columbia | | | Alaska | Kentucky | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Edmonton(1) | Calgary(1) | Other(2) | Lower Mainland | Vancouver Island | Interior | Anchorage | Lexington | Louisville | Other(3) | |
| 81 | 45 | 50 | 13 | 11 | 12 | 21 | 6 | 4 | 2 | 245 |
| 176 | | | 36 | | | 21 | 12 | | | |

Notes:

(1) References to Edmonton and Calgary are to stores located in or near those urban centres. Note that a total of 5 stores have been closed year-to-date in 2013 (Q1 2013: 1 store; Q2 2013: 3 stores; Q4 2013: 1 store) of which four were underperforming (Edmonton: 2 stores; Calgary: 1 store; Other Alberta: 1 store) and one store in Edmonton that was closed as the property where it was located is being redeveloped and is expected to be reopened in mid to late 2014.

(2) Other communities served in Alberta include, by region, Northern (25), Southern (9), Central (14) and resort communities (2).

(3) Other communities served in Kentucky include Danville and Bowling Green.

## Competitive Environment

Alberta is the only province in Canada that has a fully privatized retail distribution system for adult beverages. The Company currently operates 176 liquor stores in Alberta where there are 1,317 liquor stores and 93 agency stores [Source: Alberta Gaming and Liquor Commission, as at June 2013].

The Company operates 36 stores in British Columbia. British Columbia's model for liquor distribution is a blend of 731 private stores and 195 government operated stores. There are also 224 private agency stores that service small communities. [Source: British Columbia Liquor Distribution Branch, as at September 2013].

The Company currently operates 21 stores in the greater Anchorage, Alaska area, including 2 stores in Wasilla, Alaska. In Alaska, there are 367 retail liquor stores with 99 stores in the greater Anchorage and Wasilla areas. Save for limited community liquor stores that are operated by certain municipal governments, there are no government owned or operated liquor stores and the state limits the number of liquor stores in the state to one per 3,000 people in urban areas [Source: Alaska's Alcoholic Beverage

Control Board, as at September 2013]. The Company's "Brown Jug" trade name is well recognized throughout the state as the leading alcoholic beverage retailer.

The Company operates 12 stores in Kentucky of which seven are large format stores. In Kentucky, there are no government owned or operated liquor stores. Liquor licenses are permitted based on whether the sale of alcoholic beverages is allowed in each county (wet or dry). The Alcoholic Beverage Control Board limits the number of retail liquor package licenses issued in wet counties to one per 2,300 persons with the exception of counties containing cities of first class such as Louisville, where liquor licenses are limited to one for every 1,500 persons. Grocery stores and gas stations are able to sell beer, but a retail liquor package license is required to sell beer, wine and spirits. There are 863 package retail license stores in Kentucky with 257 in Jefferson County, 79 in Fayette County, 8 in Boyle County, and 27 in Warren County [Source: Kentucky's Alcoholic Beverage Control Board, as at February 2013]. The Company currently operates 6 stores in Lexington (Fayette County), 4 stores in Louisville (Jefferson County), 1 store in Danville (Boyle County), and 1 store in Bowling Green (Warren County).

A coalition of grocers in Kentucky was recently successful at the trial court level in a legal challenge to the state statute which prohibits the sale of wine and distilled spirits within grocery stores and gas stations (these retailers are presently only permitted to sell beer). In August 2012, the United States District Court, Western District of Kentucky ruled that the state statute violates the equal protection clause of the United States Constitution and the Commonwealth of Kentucky Constitution. The decision is currently under appeal in the U.S. Court of Appeals and it is anticipated a decision in the matter will be made in the first half of 2014. In the event the appeal is unsuccessful, there may be a rapid proliferation of grocers, gas stations and convenience store operators adding wine and distilled spirits to their product offerings, substantially increasing competition for retail liquor store operators. An unsuccessful appeal may have a material negative impact on the Company's operations and financial results in Kentucky.

## BUSINESS STRATEGY

### Growth

During 2012, the Company implemented a five-year growth strategy designed to drive sales, further improve profitability and deliver shareholder value by focusing on:

- Strengthening our retail proposition to attract more customers to existing locations and increase sales per customer through an improved in-store experience, having the right product assortment, and competitive pricing. This will include investments in employee training at the manager and staff level, enhancing our marketing strategies, investing in our existing store portfolio to refresh our stores, and an investment to enhance our information systems to support the Company's growth plan.

- Expanding geographically through new store development and/or acquisitions to capitalize on opportunities in new regions and to reduce the concentration risk of any particular region. Based on a proven track record of success, the Company anticipates it will invest significantly in large-format expansion in both Canada and the United States.

- Developing new destination-focused/large-format stores in our current regions to complement our existing convenience-focused store network and expand market share.

- Strategically investing in new square footage in our existing regions (Alberta, British Columbia, Alaska, and Kentucky) as a result of population growth and, in the case of Kentucky, capitalizing on opportunities as a result of certain counties going from 'dry' to 'wet'. The Company continually explores opportunities to acquire and/or develop stores in Alberta, British Columbia and the United States where regulatory regimes permit private liquor stores. Management will continue to assess potential acquisitions and store development opportunities for their ability to add accretive cash flow and shareholder value. Neither the timing nor the degree of likelihood of success of developing new stores can be stated with any degree of accuracy.

**Competitive Differentiation**

Management focuses on differentiating the Company's stores from the competition by promoting its broad selection of products, by emphasizing the in-store customer experience, and through continued marketing and development of its well-known industry-leading brands. Management is also confident that its emphasis on establishing and maintaining a range of stores from large-format/destination-type stores (with a strengthened focus on product selection, customer experience, etc.) to convenience-focused stores (convenient and high-traffic locations) assists the Company in differentiating it from industry competitors. The successful introduction of Wine and Beyond to the Alberta marketplace was primarily for competitive differentiation. Management will also continue to concentrate marketing efforts on the Company's current brand structure.

## DIVIDENDS

**Policy**

The payment of dividends by the Company is subject to the discretion of the Board of Directors and may vary depending upon a variety of factors, including (but not limited to) the prevailing economic and competitive environment, the Company's results of operations and earnings, and fluctuations in working capital and ongoing capital requirements. Presently, the Board of Directors has approved a monthly dividend of $0.09 per share ($1.08 per share annually).

Dividends are declared payable each month to the Company's shareholders on the last business day of each month and are paid by the 15th of the following month. For Canadian residents, the Company's dividends are considered to be "eligible dividends" for income tax purposes (subject to gross up and the enhanced dividend tax credit).

**Cash Provided by Operating Activities before Changes in Non-cash Working Capital**

In reviewing the Company's financial statements, investors should consider that the statement of comprehensive income includes significant provisions for amortization of property and equipment and for intangible assets resulting from store acquisitions, deferred taxes and non-cash interest. Amortization and other non-cash transactions have a major impact on the basic and diluted earnings per share calculation.

Cash provided by operating activities before changes in non-cash working capital is an additional IFRS measure which the Company believes provides useful information to investors and management by providing an indication of cash flow available for sustaining its current annual dividend of $1.08 per share, investment in working capital, replacement or purchase of new fixed assets, acquisitions and debt repayment. Investors often compare basic and diluted earnings per share amounts to the Company's annual dividend. Basic and diluted earnings per share for the three and nine months ended September 30, 2013 were $0.25 and $0.54, respectively (2012 - $0.28 and $0.59, respectively). The Company believes that cash provided by operating activities before changes in non-cash working capital provides a better indicator of the Company's ability to sustain its current annual dividend than basic and diluted earnings per share.

Cash provided by operating activities before changes in non-cash working capital and adjusting items and the calculation of this measure and the additional IFRS measure on a per share basis are all non-IFRS financial measures (see Non-IFRS Financial Measures). Please refer to the Earnings per Share note in the Company's financial statements for the most directly comparable measured calculated in accordance with IFRS.

The following table provides a reconciliation of cash provided by operating activities before changes in non-cash working capital and adjusting items to its nearest IFRS alternative, cash provided by operating activities before changes in non-cash working capital:

| | **Three months ended September 30,** | | **Nine months ended September 30,** | |
|---|---|---|---|---|
| (expressed in thousands, except per share amounts) | **2013** | **2012** | **2013** | **2012** |
| Cash provided by (used in) operating activities | $ 9,282 | $ (2,843) | $ 19,726 | $ 12,430 |
| Changes in non-cash working capital (1) | 1,728 | 13,893 | (93) | 11,945 |
| Cash provided by operating activities before changes in non-cash working capital | 11,010 | 11,050 | 19,633 | 24,375 |
| Adjusting items (2) | 796 | 1,953 | 796 | 3,196 |
| Cash provided by operating activities before changes in non-cash working capital and adjusting items | $ 11,806 | $ 13,003 | $ 20,429 | $ 27,571 |
| Weighted average number of common shares outstanding – basic | 23,057,008 | 22,883,412 | 23,001,665 | 22,783,555 |
| Per share amount | 0.48 | 0.48 | 0.85 | 1.07 |
| Adjusted per share amount | 0.51 | 0.57 | 0.89 | 1.21 |
| Cash dividends per share | 0.27 | 0.27 | 0.81 | 0.81 |

(1) *Changes in non-cash working capital is excluded from the calculation as Management believes that it would introduce significant cash flow variability and affect underlying cash flow from operating activities. Significant variability can be caused by such things as timing of disbursements (such as the payment for large inventory purchases, income taxes, etc.). As well, significant increases in working capital are generally required when new stores are developed or acquired.*

(2) *Adjusting items for the three and nine months ended September 30, 2013 include aggregate amounts paid to a former officer of the Company and to one former member of the senior management team upon their departure in Q3 2013. Adjusting items for the three and nine months ended September 30, 2012 included costs associated with an anticipated store investment that was not completed and amounts paid to the Company's former President and Chief Executive Officer upon his departure in Q3 2012 (see the 'Operating and Administrative Expense' section on page 12 for further discussion).*

Cash provided by operating activities before changes in non-cash working capital and adjusting items for the three months ended September 30, 2013 decreased $1.2 million from the comparative period in 2012. Inflationary increases in operating expenses and investment in information technology infrastructure and head office staffing complement to support growth more than offset the increase in Canadian operating margins, non-recurring costs associated with store openings in 2012 and the decrease in cash interest expense.

The $7.1 million decrease in cash provided by operating activities before changes in non-cash working capital and adjusting items for the nine months ended September 30, 2013 as compared to the same period in 2012 is primarily due to an $8.8 million increase in current income tax expense, and, other matters discussed above as explanations for the decrease in Q3 2013. Q1 2013 represented the first quarter since the Company's December 2010 adoption of a corporate structure that Canadian income tax had to be remitted to the government (as previous periods had the benefit from a deferral of partnership income).

**Seasonality**

The retail liquor industry is subject to seasonal variations. The Company's sales are typically lowest early in the year and increase in the latter half. In 2012, 20% (2011 - 19%) of annual same store sales occurred in the first quarter, 26% (2011 - 26%) in the second quarter, 27% (2011 - 27%) in the third quarter, and 27% (2011 - 28%) in the fourth quarter. Over the course of a year, the Company expects that cash provided by operating activities before changes in non-cash working capital will exceed dividends.

**Dividend Reinvestment Plan**

The Company has a Dividend Reinvestment Plan (the "DRIP" or the "Plan") which provides shareholders with a cost-effective and convenient method of reinvesting their monthly cash dividends into additional common shares of the Company. Presently, shares issued pursuant to the DRIP are issued at a discount of 3% from the market price (as such term is defined in the Plan) and no brokerage or administration fees are charged by the Company for participating in the Plan.

As at October 31, 2013, shareholders enrolled in the DRIP held approximately 2.1 million shares.

Further information concerning the DRIP and enrolment forms for the Plan is available on the Company's website at www.liquorstoresna.ca.

## POLICY ON SAME-STORE SALES COMPARISONS

Comparable same-store sales, a measure that is generally used by retailers, includes sales for stores that have been open 12 full months at the beginning of the reporting period. This is one of the key metrics that we use to assess our performance and provides a useful comparison between periods. Same-store sales exclude (i) all sales to wholesale customers, (ii) stores where same-store sales have been negatively impacted due to sales being shifted to closely-located convenience-format stores opened by the Company in the last 12 full months, and (iii) stores where same-store sales have been positively impacted due to closely-located stores being closed in the last 12 full months.

For the three and nine months ended September 30, 2013:

- One existing store in the U.S. region has been excluded from the same-store sales comparison due to its close proximity to a new store that was opened by the Company during Q3 2013. As it is the Company's intention to continue to operate both the existing and new locations, these stores will return to the same-store sales comparison in the same period in which the corresponding new store is open 12 full months at the beginning of that reporting period.

- Two existing stores in the Canadian region have been excluded from the same-store sales comparison due to their close proximity to a store that was closed during Q3 2013. These stores will return to the same-store sales comparison in the period in which the corresponding closed store has been closed 12 full months at the beginning of that reporting period.

## ANALYSIS OF FINANCIAL RESULTS - THREE MONTHS ENDED SEPTEMBER 30, 2013

The following table summarizes the operating results for the three months ended September 30, 2013 and 2012.

| | Three months ended September 30, | | | |
|---|---|---|---|---|
| | **2013** | | **2012** | |
| (Cdn $000's, unless otherwise stated) | **$** | **%** | **$** | **%** |
| | (unaudited) | | (unaudited) | |
| Sales | | | | |
| Canadian same-stores [(1)] | 118,305 | 68.4% | 119,558 | 72.7% |
| Other Canadian stores [(2)] | 9,254 | 5.4% | 2,690 | 1.6% |
| Canadian wholesale [(1)] | 6,006 | 3.5% | 5,672 | 3.5% |
| Total Canadian store sales | 133,565 | 77.3% | 127,920 | 77.8% |
| U.S. same-stores (US$) | 35,672 | 20.6% | 36,039 | 21.9% |
| Other U.S. stores (US$) [(3)] | 2,214 | 1.3% | 718 | 0.4% |
| Foreign exchange on U.S. store sales | 1,452 | 0.8% | (187) | (0.1)% |
| Total U.S. store sales | 39,338 | 22.7% | 36,570 | 22.2% |
| Total sales | 172,903 | 100.0% | 164,490 | 100.0% |
| Gross margin | 43,726 | 25.3% | 41,916 | 25.5% |
| Operating and administrative expense | 30,797 | 17.8% | 29,281 | 17.8% |
| Operating margin | 12,929 | 7.5% | 12,635 | 7.7% |
| Adjusting items | 796 | 0.4% | 1,953 | 1.2% |
| Adjusted operating margin | 13,725 | 7.9% | 14,588 | 8.9% |

Notes:

(1) *To better represent the performance of same-stores, the concept of same-store sales was revised during the first quarter of 2013 so that same-store sales would only include retail sales and exclude all sales to wholesale customers. Previously, only stores that had significant wholesale business were excluded from same-stores. Canadian same-store sales and sales from Canadian wholesale operations have been restated in the MD&A for the comparative period.*

(2) *Sales for Other Canadian stores for the three months ended September 30, 2013 and 2012 include those of 7 stores opened and 4 stores closed subsequent to June 30, 2012, and 2 same-stores in Canada that are in close proximity to one of the stores closed.*

(3) *Sales for Other U.S. stores for the three months ended September 30, 2013 and 2012 include those of 1 store opened in Kentucky and 1 store opened in Alaska subsequent to June 30, 2012, and 1 same-store in Alaska that is in close proximity to the store that was opened in Alaska.*

***Third Quarter 2013 Operating Results Compared to Third Quarter 2012 Operating Results***

**Sales**

Total sales increased by $8.4 million or 5.1% to $172.9 million in the third quarter of 2013 (2012 - $164.5 million). The increase is primarily the result of new store expansion in Canada and the United States (8 new stores opened since June 30, 2012).

Same-Store Sales

- Canadian same-store sales decreased by $1.3 million or 1.0%. However, when adjusted for the following items Canadian same-store sales increased by 0.6% to 0.9%.
    - Same-store sales for the three months ended September 30, 2013 compared to 2012 were impacted by the success of the two Wine and Beyond stores opened by the Company in Edmonton during the last week of September 2012. In addition to drawing customers away from our competitors, these destination-type stores also drew customers away from our convenience-focused stores due to their uniqueness in the marketplace and larger selection of product. We estimate that the impact of Wine and Beyond on the Company's Canadian same-store sales was approximately 1.0% to 1.3%.
    - Same-store sales have been negatively impacted by sales tax changes in British Columbia and increased competition in that province. When the Province made the switch from the Harmonized Sales Tax (HST) of 12% to the combined Provincial Sales Tax (PST)/Goods and Services Tax (GST) of 15% on April 1, 2013, we were determined to remain competitive in the market and therefore we decided to leave prices, which have tax included, unchanged. All else being equal, this has had a negative impact of approximately 2.6% on same-store sales in the province. The estimated impact of this matter on Canadian same-store sales in the quarter was approximately 0.6%. Increased competition in British Columbia, especially for beer and spirits consumers, such as certain competitors increasing their cold beer availability (a previous advantage for our stores) and their in-store marketing/sales prices, has also led to downward pressure on pricing and margin.
- U.S. same store sales decreased by $0.4 million or 1.0%.
    - Same-store sales in the United States have continued to be negatively impacted by certain counties in Kentucky going from 'dry' to 'wet' throughout 2012 (i.e. certain counties in close proximity to the Company's stores that did not previously permit retail package liquor sales are now permitting these sales).

Other Sales

- Canadian wholesale sales, which include sales to licensee customers, were $6.0 million for the three months ended September 30, 2013, representing an increase of $0.3 million or 5.9% from the prior year (2012 - $5.7 million), primarily due to adding a select number of wholesale customer accounts during the quarter.
- Sales for the Other Canadian and U.S. stores have increased compared to 2012 primarily as a result of the eight (8) new stores opened since June 30, 2012, including the two Wine and Beyond stores opened in Canada during the last week of September 2012, offset by four store closures in Canada (Q1 2013: one store; Q2 2013: three stores).

### Gross Margin

For the three months ended September 30, 2013, gross margin was $43.7 million, up 4.3% from $41.9 million for the same period last year. Gross margin as a percentage of sales of 25.3% was maintained at a rate consistent with that achieved in the comparative period (2012 – 25.5%). Pressures on gross margin percentages in some regions were offset by the initial changes made to our marketing strategies which have resulted in overall increases in gross margin percentages and dollars.

### Operating and Administrative Expense

Operating and administrative expenses for the three months ended September 30, 2013 were $30.8 million, up 5.2% from $29.3 million a year earlier. Included in this increase are payments of $0.8 million made to a former officer of the Company and one former member of the senior management team upon their departures from the Company. The comparative period included a payment of $1.9 million made to the Company's former President and Chief Executive Officer. Normalizing for these adjusting items, the expense in Q3 2013 increased by 9.8% and was attributable, in part, to higher overall costs associated with the additional store locations that have been opened in the past twelve months (e.g. rent, payroll, utilities, etc.), rent escalations and increased marketing costs for existing stores, costs associated with the increased efforts to remodel certain stores, and as a result of ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy. These increases were offset by a $0.5 million decrease in pre-opening costs associated with the opening of new or remodeled stores in Q3 2013 compared to those incurred in Q3 2012 primarily due to fewer new store openings.

### Operating Margin

Operating margin was $12.9 million for the three months ended September 30, 2013, an increase of 2.3% from $12.6 million in 2012. After normalizing for the adjusting items in Q3 2013 and 2012, adjusted operating margin decreased 5.9% from the comparative period and represented 7.9% of total sales, down from 8.9%.

Canadian operating margin was $10.9 million or 8.2% as a percentage of Canadian sales (2012 - $10.2 million or 8.0% as a percentage of sales). Normalizing for the adjusting items referenced above, adjusted Canadian operating margin in Q3 2012 was $11.7 million or 8.8% of sales (2012 – $12.2 million or 9.5%). The decrease was as attributable to a decline in same-store sales, loss of operating margin from stores closed subsequent to September 30, 2012, an increase in operating expenses and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy, offset by increases in operating margin from same-stores and new stores opened in 2012. The seven additional stores added in Canada since June 30, 2012 are still in their ramp-up phase (i.e. these stores have been opened for less than one year) and may take between 24 and 36 months to mature and fully contribute to operating margin.

The U.S. operating margin for the second quarter of 2013 was $2.0 million or 5.1% as a percentage of U.S. sales compared with $2.4 million and 6.6% as a percentage of U.S. sales for the comparable period in 2012. This decrease was primarily due to the decline in U.S. same-store sales and an increase in operating expenses. To a lesser extent, the decrease was also due to the two additional stores added in the U.S. since June 30, 2012, which have not yet fully matured.

## Amortization

Amortization expense was up 50.7% to $2.7 million for the third quarter of 2013 (2012 - $1.8 million), primarily as a result of the additional stores opened in the last twelve months and due to the acceleration of amortization on certain stores that have been or are scheduled for remodeling or closure in 2013.

## Finance Costs

Finance costs are comprised of cash interest on bank indebtedness, long term debt and convertible debentures of $1.9 million (2012 - $1.8 million); non-cash interest of $0.3 million (2012 - $0.3 million), and an unrealized loss of $0.2 million on the mark-to-market adjustments related to an interest rate swap (2012 - $0.1 million gain). Cash interest expense was consistent with the prior period as the higher costs associated with the overall higher long-term debt balances were offset by lower borrowing costs on the new unsecured convertible debentures issued in Q2 2012.

## Income Taxes

Income taxes for the third quarter of 2013 were $2.0 million (2012 - $2.4 million), which equates to an effective income tax rate of approximately 26% (the effective rate for the year ended December 31, 2012 was approximately 26%). There has been no change in the rate as there are no expected changes in the tax rates or in the relative proportions of income earned in the various tax jurisdictions that the Company operates in compared to the prior year.

## Net Earnings

Net earnings for the three months ended September 30, 2013 were $5.8 million compared to $6.5 million for the same period in 2012. The decrease in net earnings in 2013 is primarily the result of the decline in Canadian and U.S. same-store sales, increase in operating expenses, and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy, increases to amortization expense and the $0.3 million change in the mark-to-market adjustments on the interest rate swap. These decreases in earnings were offset by the $1.2 million net change in adjusting items discussed further in the operating and administrative expense section earlier in this MD&A.

## ANALYSIS OF FINANCIAL RESULTS - NINE MONTHS ENDED SEPTEMBER 30, 2013

The following table summarizes the operating results for the nine months ended September 30, 2013 and 2012.

| | Nine months ended September 30, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| (Cdn $000's, unless otherwise stated) | $ | % | $ | % |
| | (unaudited) | | (unaudited) | |
| Sales | | | | |
| Canadian same-stores (1) | 322,187 | 67.6% | 321,495 | 71.3% |
| Other Canadian stores (2) | 26,033 | 5.5% | 6,469 | 1.5% |
| Canadian wholesale (1) | 18,178 | 3.8% | 16,354 | 3.6% |
| Total Canadian store sales | 366,398 | 76.9% | 344,318 | 76.4% |
| U.S. same-stores (US$) | 100,471 | 21.1% | 102,823 | 22.8% |
| Other U.S. stores (US$) (3) | 7,386 | 1.5% | 3,376 | 0.7% |
| Foreign exchange on U.S. store sales | 2,619 | 0.5% | 230 | 0.1% |
| Total U.S. store sales | 110,476 | 23.1% | 106,429 | 23.6% |
| Total sales | 476,874 | 100.0% | 450,747 | 100.0% |
| Gross margin | 120,219 | 25.2% | 114,007 | 25.3% |
| Operating and administrative expense | 89,085 | 18.7% | 82,351 | 18.3% |
| Operating margin | 31,134 | 6.5% | 31,656 | 7.0% |
| Adjusting items | 796 | 0.2% | 3,196 | 0.7% |
| Adjusted operating margin | 31,930 | 6.7% | 34,852 | 7.7% |

Notes:

(1) *To better represent the performance of same-stores, the concept of same-store sales was revised during the quarter so that same-store sales would only include retail sales and exclude all sales to wholesale customers. Previously, only stores that had significant wholesale business were excluded from same-stores. Canadian same-store sales and sales from Canadian wholesale operations have been restated in the MD&A for the comparative period.*

(2) *Sales for Other Canadian Stores for the nine months ended September 30, 2013 and 2012 include those of 8 stores opened and 4 stores closed subsequent to December 31, 2011, and 2 same-stores in Canada that are in close proximity to one of the stores closed.*

(3) *Sales for Other U.S. Stores for the nine months ended September 30, 2013 and 2012 include those of 2 stores opened in Kentucky subsequent to December 31, 2011, and 1 same-store in Alaska that is in close proximity to the store that was opened in Alaska.*

***Nine months ended September 30, 2013 Operating Results Compared to Nine months ended September 30, 2012 Operating Results***

## Sales

Total sales increased by $26.2 million or 5.8% to $476.9 million for the nine months ended September 30, 2013 (2012 - $450.7 million). The increase is primarily the result of new store expansion in Canada and the United States (11 new stores opened since December 31, 2011).

Same-Store Sales

- Canadian same-store sales increased by $0.7 million or 0.2%.
    - Same-store sales for the nine months ended September 30, 2013 compared to 2012 were impacted negatively as a result of 2012 having benefited from an additional day in the year. Management estimates that net impact of the additional day in 2012 on Canadian same store sales was approximately 0.3%. Weather conditions during the first half of 2013 were also generally unfavourable in Canada as compared to the comparative period which resulted in a negative impact on Canadian same-store sales.
    - Same-store sales for the nine months ended September 30, 2013 compared to 2012 were impacted by the success of the two Wine and Beyond stores opened in Edmonton during the last week of September 2012. In addition to drawing customers away from our competitors, these destination-type stores also drew customers away from our convenience-focused stores due to their uniqueness in the marketplace and larger selection of product. We estimate that the impact of Wine and Beyond on the Company's Canadian same-store sales was approximately 1.0% to 1.3%.
    - Same-store sales have been negatively impacted by sales tax changes in British Columbia and increased competition in the province (see further discussion of these matters on page 11 of this MD&A). Commencing with the beginning of the second quarter this year and all else being equal, this has had a negative impact of approximately 2.6% on same-store sales in the province. The aggregate impact of this matter on Canadian same-store sales in for the nine months ended September 30, 2013 was approximately 0.3%. Increased competition in British Columbia, especially for beer and spirits consumers, such as certain competitors increasing their cold beer availability (a previous advantage for our stores) and their in-store marketing/sales prices, has also led to downward pressure on pricing and margin.
- U.S. same store sales decreased by $2.4 million or 2.3%.
    - Same-store sales in the United States have continued to be negatively impacted by certain counties in Kentucky going from 'dry' to 'wet' throughout 2012 (i.e. certain counties in close proximity to the Company's stores that did not previously permit retail package liquor sales are now permitting these sales).
    - The decline in the quarter was also due to unfavourable weather experienced in Kentucky throughout the first and second quarters as compared to the prior year.
    - Management estimates that the leap year contributed approximately 0.2% to US same store sales deceases for the period.

Other Sales

- Canadian wholesale sales, which include sales to licensee customers, were $18.2 million for the nine months ended September 30, 2013, which is an increase of $1.8 million or 11.2% from the prior year (2012 - $16.4 million) primarily due to adding a select number of wholesale customer accounts during the period.

- Sales for the Other Canadian and U.S. stores have increased compared to 2012 as a result of the eleven new stores opened since December 31, 2011, including the two Wine and Beyond stores opened in Canada during the last week of September 2012, offset by four store closures in Canada (Q1 2013: one store; Q2 2013: three stores).

**Gross Margin**

For the nine months ended September 30, 2013, gross margin was $120.2 million, up 5.4% from $114.0 million for the same period last year. Gross margin as a percentage of sales has been maintained consistent with the comparative period at 25.2% (2012 – 25.3%).

**Operating and Administrative Expense**

Operating and administrative expenses for the nine months ended September 30, 2013 were $89.1 million, up 8.2% from $82.4 million a year earlier. Included in this increase are payments of $0.8 million made to a former officer of the Company and one former member of the senior management team upon their departures from the Company. The comparative period expense included a payment of $1.9 million made to the Company's former President and Chief Executive Officer and a $1.2 million adjusting item for costs associated with a store investment (with a prospective partner) that was not completed, and which costs were determined by the Company not to be recoverable. Normalizing for these adjusting items, the expenses in Q3 2013 increased 9.8% attributable, in part, to higher overall costs associated with additional store locations that have been opened in the past twelve months (e.g. rent, payroll, utilities, etc.), rent escalations and increased marketing costs for existing stores, costs associated with the closure of four stores year-to-date in 2013, and as a result of ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy. These increases were offset by a $0.1 million decrease in pre-opening costs associated with the opening of new or remodeled stores in Q3 2013 compared to Q3 2012 primarily due to fewer new store openings.

**Operating Margin**

Operating margin was $31.1 million for the nine months ended September 30, 2013, a decrease of 1.6% from $31.7 million in 2012. After normalizing for the adjusting items in the current and comparative periods, year-to-date adjusted operating margin in 2013 decreased 8.4% from the comparative period and represented 6.7% of total sales, down from 7.7%.

Canadian operating margin was $26.0 million or 7.1% as a percentage of Canadian sales (2012 - $26.5 million or 7.7% as a percentage of sales). Normalizing for the adjusting items referenced above, adjusted Canadian operating margin was $26.8 million or 7.3% of sales (2012 – $28.4 million or 8.2%). The decrease was as a result of a loss of margin from stores closed subsequent to December 31, 2011, an increase in operating expenses and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy, offset by increases in operating margin from same-stores and new stores opened in 2012. The eight additional stores added in Canada since December 31, 2011 are still in their ramp up phase (i.e. these stores have been open for less than one year) and may take between 24 and 36 months to mature and fully contribute to operating margin.

The U.S. operating margin was $5.1 million or 4.6% as a percentage of U.S. sales compared with $5.2 million and 4.9% as a percentage of U.S. sales for the comparable period in 2012. Normalizing for the adjusting item referenced above (related to the costs associated with a store investment with a prospective partner that was not completed in 2012), adjusted U.S. operating margin in the nine months ended September 30, 2012 represented 6.1% of sales. The decrease in the United States was primarily due to the decline in U.S. same-store sales and an increase in operating expenses. To a lesser extent, the decrease was also due to the three additional stores added in the U.S. since December 31, 2011, which have not yet fully matured.

**Amortization**

Amortization expense was up 37.5% to $7.5 million for the nine months ended September 30, 2013 (2012 - $5.5 million), primarily as a result of the additional stores opened in the last twelve months and due to the acceleration of amortization on certain stores that have been or will be remodeled in 2013.

**Finance Costs**

Finance costs are comprised of cash interest on bank indebtedness, long term debt and convertible debentures of $5.9 million (2012 - $5.6 million); non-cash interest of $0.8 million (2012 - $2.5 million), and a notional loss of $0.1 million on the mark-to-market adjustments related to an interest rate swap (2012 - $0.3 million gain). Cash interest expense is consistent with 2012 as a result of lower borrowing costs on the new unsecured convertible debentures issued in Q2 2012 being offset by higher overall debt levels. Non-cash interest has declined from 2012 primarily due to a charge taken in Q2 2012 related to accelerating the accretion of the Company's 6.75% convertible unsecured subordinated debenture to their principal amount of $57.5 million as they were redeemed on May 28, 2012, which was in advance of their original maturity date.

**Income Taxes**

Income taxes for the nine months ended September 30, 2013 were $4.4 million (2012 - $4.8 million), which equates to an effective income tax rate of approximately 26% (the effective rate for the year ended December 31, 2012 was approximately 26%). There has been no change in the rate as there are no expected changes in the tax rates or in the relative proportions of income earned in the various tax jurisdictions that the Company operates in compared to the prior year.

**Net Earnings**

Net earnings for the nine months ended September 30, 2013 were $12.6 million compared to $13.7 million for the same period in 2012. The decrease in net earnings in 2013 is primarily the result of a decline in U.S. same-store sales, increase in operating expenses, and ongoing investments in the Company's information technology infrastructure and head office staffing complement to support the Company's business strategy, offset by increases as a result of the net $2.4 million change in adjusting item from 2012 to 2013, the $1.1 million in non-cash interest expense in 2012 and the $0.5 million change in the mark-to-market adjustments on the interest rate swap.

## CONDENSED QUARTERLY INFORMATION

(expressed in thousands of Canadian dollars, except per Share amounts and number of stores)

| | 2013 | | | 2012 | | | | 2011 |
|---|---|---|---|---|---|---|---|---|
| | **Sept 30** | **Jun 30** | **Mar 31** | **Dec 31** | **Sep 30** | **Jun 30** | **Mar 31** | **Dec 31** |
| **Statement of Financial Position** | | | | | | | | |
| Cash | 5,550 | 4,223 | 3,159 | 5,130 | 1,825 | 765 | 1,725 | 1,707 |
| Total assets | 532,510 | 529,382 | 530,340 | 533,087 | 516,929 | 502,315 | 500,674 | 503,147 |
| Current bank indebtedness | 2,518 | 1,657 | - | 3,891 | - | 96 | 2,178 | 40,424 |
| Total current liabilities | 40,145 | 40,529 | 35,086 | 46,633 | 28,121 | 29,483 | 79,687 | 123,013 |
| Long-term debt | 154,965 | 152,253 | 164,160 | 146,566 | 150,702 | 135,673 | 92,196 | 46,469 |
| Total liabilities | 215,930 | 211,482 | 215,417 | 215,337 | 199,603 | 183,608 | 187,291 | 185,947 |
| Shareholders' equity | 316,580 | 317,900 | 314,923 | 317,750 | 317,300 | 318,707 | 313,383 | 317,200 |
| Non-controlling interest | 30 | 63 | 34 | 92 | 26 | 83 | 38 | 85 |
| **Statement of Earnings** | | | | | | | | |
| # stores, end of period | 246 | 245 | 248 | 249 | 243 | 241 | 240 | 239 |
| Sales | 172,903 | 167,669 | 136,302 | 179,359 | 164,490 | 159,621 | 126,636 | 168,244 |
| Adjusted operating margin (1) | 13,725 | 11,712 | 6,492 | 14,387 | 14,588 | 13,330 | 6,934 | 15,662 |
| Net earnings | 5,811 | 5,321 | 1,457 | 5,403 | 6,481 | 4,766 | 2,406 | 7,904 |
| Basic and diluted earnings per share | $0.25 | $0.23 | $ 0.06 | $ 0.23 | $ 0.28 | $ 0.21 | $ 0.10 | $ 0.35 |
| Dividends declared per share | $0.27 | $0.27 | $ 0.27 | $ 0.27 | $ 0.27 | $ 0.27 | $ 0.27 | $ 0.27 |

Notes:

(1) There were no adjusting items for the three month periods ended June 30, 2013 and March 31, 2013 and therefore adjusted operating margin for the three month periods ended September 30, 2013 and March 31, 2013 are equal to operating margin.

## LIQUIDITY AND CAPITAL RESOURCES

### Capital Expenditures

Historically, capital expansion has been financed by cash provided from operating activities, proceeds raised through equity and debt offerings or by utilizing existing long-term credit facilities. The Company believes cash provided from operating activities and amounts available under existing credit facilities are adequate to finance new store developments and acquisitions expected to occur in the next twelve months. The Company would require additional capital or financing for a larger acquisition.

The Company opened one store in Alaska during Q3 2013. There were no stores closed in Q3 2013, three stores were closed in Alberta during the three months ended June 30, 2013, and one store was closed in Alberta earlier in 2013.

The Company will continue to pursue acquisition opportunities and to open and develop new stores in 2013 and 2014. The Company currently has commitments to open one new store in the U.S. and three new stores in Canada in the next twelve months with an estimated aggregate cost of $9.0 million. The timing of the store openings is subject to, among other things, delays in the completion of store construction and/or fixturing.

As discussed in the 'Business Strategy' section of this MD&A, the Company will be investing in our current store portfolio through a store refreshment program and in our information systems. Management estimates that capital expenditures related to the store refurbishment program and information systems upgrade for the next twelve months will be approximately $6.0 million.

### Credit Facilities and Subordinated Debentures

The Company has a credit facility with a syndicate of Canadian banks, which is effective until February 10, 2015 and consists of a $150 million extendible revolving operating loan, and a US$5.0 million facility with a U.S. bank. At November 5, 2013 there was approximately $99 million drawn on the Canadian credit facility and US$3 million drawn on the U.S. credit facility. The Company has a US$5.0 million letter of credit that has been issued pursuant to the Canadian credit facility to secure the U.S. credit facility. Pursuant to the terms of the Canadian credit facility, the Company has the ability to request an additional $50 million (to be provided by the lenders on a best-effort basis).

The Company has $67.5 million in aggregate principal amount of convertible unsecured subordinated debentures due April 30, 2018 (the "Debentures"). The Debentures bear interest at a rate of 5.85% per annum, payable semi-annually in arrears on April 30 and October 31 of each year, which commenced on October 31, 2012. The Debentures are convertible at any time at the option of the holders into common shares of the Company at a conversion price of $24.90 per share.

The Company's Canadian credit facility is subject to a number of financial covenants. Under the terms of the Company's Canadian credit facility, the following ratios are monitored: funded debt to EBITDA, adjusted debt to EBITDAR, and fixed coverage ratio. There are no financial covenants attributable to the Company's convertible unsecured subordinated debentures due April 30, 2018 or the U.S. credit facility.

<u>Funded debt to EBITDA ratio</u>

Funded debt is all the Company's obligations, liabilities and indebtedness which would, in accordance with IFRS, be classified on a consolidated balance sheet of the Company as indebtedness for borrowed money of the Company, but excludes subordinated debt, deferred taxes and accounts payable incurred in the ordinary course of the Company's business.

EBITDA is defined under the amended and restated credit facility as the net income of the Company plus the following: interest expense, provision for income taxes, any portion of expense in respect of non-cash items including any long-term incentive plan amounts not to be settled in cash, depreciation, amortization, deferred taxes, and non-recurring losses to a maximum of $3.5 million in any fiscal year, write down of goodwill and other restructuring charges for store closures, and amortization of inventory fair value adjustments. EBITDA is also less any non-recurring extraordinary or one-time gains from any capital asset sales or certain foreign currency transactions.

Adjusted debt to EBITDAR

Adjusted debt is defined as the Company's debt plus seven times aggregate rent expense. EBITDAR is defined as EBITDA plus aggregate rent expense.

Fixed charge coverage ratio

Fixed charge coverage ratio is the ratio of EBITDAR less the aggregate amount of unfunded capital expenditures and cash taxes divided by the sum of all interest expense and scheduled repayment of debt for the relevant period, cash dividends and rent.

As at September 30, 2013, the Company was in compliance with all financial covenants.

| **Ratio** | **Covenant** | **As at September 30, 2013** |
|---|---|---|
| Funded debt to EBITDA | < 3.00:1.00 | 2.05:1.00 |
| Adjusted debt to EBITDAR | < 5.00:1.00 | 3.70:1.00 |
| Fixed charge coverage | > or = 1.00:1.00 | 1.12:1.00 |

The funded debt to EBITDA, adjusted debt to EBITDAR and fixed charge coverage ratios are calculated quarterly based on the latest rolling four quarter period completed, including acquired stores.

**Liquidity Risk**

Liquidity ensures the Company has sufficient financial resources available at all times to meet its obligations. The Company manages liquidity risk by ensuring it has a variety of alternatives available to fund acquisitions, new store development and ongoing operations, which include cash provided by operations, bank indebtedness, issuance of new equity or debt instruments or a combination thereof. The decision to utilize a specific alternative is dependent upon capital market conditions and interest rate levels. The degree to which the Company is leveraged may impact its ability to obtain additional financing for working capital or to finance acquisitions.

Management continuously monitors the marketplace for acquisitions and new store development opportunities and has developed financing strategies to support this growth in the current economic environment. Management believes the Company has managed liquidity risk appropriately and does not anticipate that the current economic environment will prevent the Company from being able to fund operating and liquidity needs in the near term. As at November 5, 2013, the Company has available credit of approximately $38.7 million to finance operating requirements and growth opportunities.

## Interest Rate Risk and Sensitivity

The Company's indebtedness in respect of its credit facility bears interest at floating rates. The Company manages its interest rate risk through credit facility negotiations and by identifying upcoming credit requirements based on strategic plans. The Company is party to an interest rate swap with a Canadian Schedule I bank that matures December 14, 2015 whereby the interest rate paid by the Company on Cdn$60.0 million is equivalent to 1.388% per annum plus the applicable credit spread determined with reference to the credit facility. At November 6, 2013, the fixed rate paid by the Company under the interest rate swap is 3.238% per annum. The Company is not using hedge accounting for this swap and accordingly, its fair value is recorded on the statement of financial position, with changes in fair value recorded in earnings.

Assuming an outstanding bank indebtedness of $102 million, of which $60 million is subject to the interest rate swap, the following table presents a sensitivity analysis to changes in market interest rates on floating rate indebtedness and their potential annual impact on the Company as at September 30, 2013.

| (expressed in thousands of Canadian dollars) | + 1.00% | - 1.00% |
|---|---|---|
| Increase (decrease) in interest expense | $ 420 | $ (420) |
| Increase (decrease) in net earnings | (315) | 315 |

An increase/decrease of 1.00% in market interest rates would result in a decrease/increase in the Company's net earnings of approximately $0.01 per share.

## Credit Risk

The Company's financial assets that are exposed to credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company maintains its cash and cash equivalents with a major Canadian chartered bank. The Company, in its normal course of operations, is exposed to credit risk from its wholesale customers in Alberta; however, wholesale customer purchases represent less than 5% of the Company's sales. Risk associated with accounts receivable is mitigated by credit management policies. Historically, bad debts from these accounts have been insignificant. The Company is not subject to significant concentration of credit risk with respect to its customers; primarily all receivables are due from businesses in the Alberta hospitality industry. Bad debts are insignificant in relation to total sales.

## Foreign Exchange Risk

The Company is subject to fluctuations in the value of the Canadian dollar relative to the U.S. dollar in the normal course of business. A portion of cash flows are realized in U.S. dollars and as such, fluctuations in the exchange rate between the Canadian dollar and U.S. dollar may have an effect on financial results. The Company's foreign exchange cash flow exposure is limited to U.S. intercompany management fees and interest payments which totalled US$7.6 million for the twelve months ended September 30, 2013.

Transactions denominated in foreign currencies are recorded at the rate of exchange on the transaction date. Monetary assets and liabilities are translated into Canadian dollars at the rate of exchange prevailing at the balance sheet date, with any resulting gain or loss being included in earnings. Other than as noted above, foreign currency transactions are generally not material.

**Contractual Obligations**

The table below sets forth, as of September 30, 2013, the contractual obligations of the Company due in the years indicated and relate to various premises operating leases, long-term debt and convertible unsecured subordinated debentures.

| (expressed in thousands of Canadian dollars) | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 and thereafter |
|---|---|---|---|---|---|---|
| Operating leases | $ 6,609 | $ 22,322 | $ 19,033 | $ 16,123 | $ 12,577 | $ 41,250 |
| 5.85% Debentures | - | - | - | - | - | 67,500 |
| Long-term bank indebtedness | - | - | 87,880 | - | - | - |
| Total | $ 6,609 | $ 22,322 | $ 106,913 | $ 16,123 | $ 12,577 | $ 108,750 |

## SHAREHOLDERS' EQUITY

At September 30, 2013, the Company had 23,074,380 common shares outstanding. Basic and diluted weighted average number of common shares outstanding for Q3 2013 were 23,057,008 and 23,069,251, respectively (compared to 22,883,412 and 22,948,520, respectively, for the comparative 2012 period). Basic and diluted weighted average number of common shares outstanding for the nine months ended September 30, 2013 were 23,001,665 and 23,029,418, respectively (compared to 22,783,555 and 22,836,327, respectively for the comparative 2012 period). As at November 6, 2013, 23,086,725 common shares of the Company were issued and outstanding.

## OFF-BALANCE SHEET ARRANGEMENTS

As at September 30, 2013 and November 6, 2013, the Company did not have any off-balance sheet arrangements in place, other than the operating leases identified under the heading Contractual Obligations.

## FINANCIAL INSTRUMENTS

The Company, as part of its operations, is party to a number of financial instruments. These financial instruments consist of cash and cash equivalents, accounts receivable, foreign exchange currency contracts, an interest rate swap, bank indebtedness, accounts payable and accrued liabilities, dividends payable and long-term debt including convertible unsecured subordinated debentures. Financial assets are classified as loans and receivables. Financial liabilities are classified as other financial liabilities, other than derivatives which are held for trading. Refer to "Liquidity and Capital Resources" for discussion of risks associated with financial instruments.

## RELATED PARTY TRANSACTIONS

The Company 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 nine months ended September 30, 2013, the Company incurred expenses in the normal course of business for (i) professional fees of $115 thousand (2012 - $116 thousand) paid to a law firm of which a director of the Company is a partner and (ii) rent paid to companies controlled by a director (and former Executive Chairman) of the Company which amounted to $360 thousand (2012 - $441 thousand). There was $42 thousand included in accounts payable and accrued liabilities as at September 30, 2013 relating to these transactions (December 31, 2012 - $nil). The amounts charged are recorded at their exchange amounts and are subject to normal trade terms.

## CRITICAL ACCOUNTING ESTIMATES

There are no updates to the Company's critical accounting estimates. For further discussion, refer to the Company's annual MD&A for the year ended December 31, 2012.

## RECENT ACCOUNTING PRONOUNCEMENTS

There were new IFRS pronouncements that have been issued and are effective for the Company on January 1, 2013. These pronouncements did not have a significant impact on the Company's financial statements. See Note 2 to the condensed interim financial statements as at and for the three and nine months ended September 30, 2013 for further discussion.

## INTERNAL CONTROLS AND PROCESSES

### Disclosure Controls and Procedures and Internal Control Over Financial Reporting

The Company's disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company is recorded, processed, summarized and reported within the time periods specified under Canadian securities laws and include controls and procedures designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, to allow timely decisions regarding required disclosure.

Management, including the Chief Executive Officer and Chief Financial Officer, are responsible for establishing and maintaining adequate internal controls over financial reporting, as such term is defined in National Instrument 52-109. A material weakness in internal controls over financial reporting exists if the deficiency is such that there is a reasonable possibility that a material misstatement of the Company's annual or interim consolidated financial statements will not be prevented or detected on a timely basis.

The Chief Executive and Chief Financial Officers certified that disclosure controls and procedures and internal controls over financial reporting were properly designed and effective for the year ended December 31, 2012. There have been no changes in the design of the Company's disclosure controls and procedures or internal control over financial reporting that occurred during the three months ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's disclosure controls and procedures or internal control over financial reporting.

## RISK FACTORS

There are no updates to the Company's Risk Factors. For further discussion, refer to the Company's Annual Information Form dated March 5, 2013 and the Company's annual MD&A for the year ended December 31, 2012.

## NON-IFRS FINANCIAL MEASURES

Operating margin, operating margin as a percentage of sales, adjusted operating margin, adjusted net earnings, adjusted basic and diluted earnings per share, adjusting items, cash provided by operating activities before changes in working capital and adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items on a per share basis, and same-store sales are not measures recognized by IFRS and do not have a standardized meaning prescribed by IFRS. Investors are cautioned that operating margin, operating margin as a percentage of sales, adjusted operating margin, adjusted net earnings, adjusted basic and diluted earnings per share, adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items on a per share basis, and same-store sales should not replace net earnings or loss (as determined in accordance with IFRS) as an indicator of the Company's performance, of its cash flows from operating, investing and financing activities or as a measure of its liquidity and cash flows. The Company's method of calculating operating margin, operating margin as a percentage of sales, adjusted operating margin, adjusted net earnings, adjusted basic and diluted earnings per share, adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items on a per share basis, and same-store sales may differ from the methods used by other issuers. Therefore, the Company's operating margin, operating margin as a percentage of sales, adjusted operating margin, adjusted net earnings, adjusted basic and diluted earnings per share, adjusting items, cash provided by operating activities before changes in non-cash working capital and adjusting items, cash provided by operating activities before changes in working capital and adjusting items on a per share basis, and same-store sales may not be comparable to similar measures presented by other issuers.

Operating margin for purposes of disclosure under "Operating Results" has been derived by subtracting Operating and Administrative expenses from Gross Margin. Operating margin as a percentage of sales is calculated by dividing operating margin by sales.

Adjusted operating margin represents operating margin adjusted for unusual, non-recurring or non-operating factors on both a consolidated and segmented basis. These factors, referred to as adjusting items, are reconciled and discussed in the *Highlights* and *Analysis of Financial Results* sections. Adjusted net earnings is calculated as net earnings less the tax effected adjusting items. The tax effect of the adjusting items is calculated by multiplying the adjusting items by the statutory rate of income tax of the applicable jurisdiction. Adjusted basic and diluted earnings per share is calculated as adjusted net earnings divided by basic or diluted weighted average number of common shares outstanding. Management believes the presentation of adjusted operating margin, adjusted net earnings, and adjusted basic and diluted earnings per share provides for useful information to investors and shareholders as it provides increased transparency and predictive value. Management uses adjusted operating margin to set targets and assess performance of the Company.

Cash provided by operating activities before changes in non-cash working capital and adjusting items is a non-IFRS financial measure that does not have a standardized meaning prescribed by IFRS and therefore is unlikely to be comparable to similar measures presented by other issuers. Investors are cautioned that this should not be construed as an alternative measure of profitability.

EBITDA and EBITDAR, which are used by Management only with reference to the calculation of covenants under the Company's credit facility, have been defined in the *Liquidity and Capital Resources* section of this MD&A.