

## **Management's Discussion and Analysis of Financial Condition and Results of Operations for the quarter ended April 30, 2008**

**June 12, 2008**

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is dated as of June 12, 2008 and should be read in conjunction with Coastal Contacts Inc.'s (the "Company, our, we, us or Coastal Contacts") unaudited interim consolidated financial statements for the fiscal quarter ended April 30, 2008. We prepare our consolidated financial statements in accordance with Canadian generally accepted accounting principles ("GAAP") and use Canadian dollars as our reporting currency.

### **Forward-looking statements**

All statements made in this management's discussion and analysis, other than statements of historical fact, are forward-looking statements. The words "may", "would", "could", "will", "intend", "plan", "anticipate", "believe", "estimate", "expect", "goal", "target", "should," "likely," "potential," "continue," "project," "forecast," "prospects," and similar expressions typically are used to identify forward-looking statements. Persons reading this MD&A are cautioned that such statements or information are only predictions, and that our actual future results or performance may be materially different. Readers should therefore not place undue reliance on forward-looking statements and information, which are qualified in their entirety by this cautionary statement.

Forward-looking statements are based on the then-current expectations, beliefs, assumptions, estimates and forecasts about our business and the industry and markets in which we operate. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or implied by these forward-looking statements due to a number of factors, including but not limited to, changes in the market, potential downturns in economic conditions, consumer credit risk, our ability to implement our business strategies, competition, limited suppliers, inventory risk, disruption in our distribution facilities, mergers and acquisitions, foreign exchange fluctuations, regulatory requirements, demand for contact lenses and related vision care products, competition and dependence on the internet and other risks detailed in our filings with the Canadian securities regulatory authorities. Reference should be made to the section entitled "Risk Factors" contained in our Annual Information Form dated January 2, 2008 for a detailed description of the risks and uncertainties relating to our business. These risks, as well as others, could cause actual results and events to vary significantly. We expressly disclaim any intent or obligation to update these forward-looking statements, unless we specifically state otherwise.

## Overview

Coastal Contacts is a leading worldwide direct to consumer retailer of vision care products, selling to customers around the world, with operations in North America, Europe and Asia. Coastal has created a leading multinational optical business designed to provide significant savings to consumers and enhanced service levels when compared with traditional sources of vision care products, such as retail optical stores or directly from eye care practitioners.

Since our inception in 2000, our business has grown to over one million shipments representing over \$102 million in revenues in the 2007 fiscal year. Initially we focused on the North American market. However in recent years we have successfully executed on our strategy of global market diversification, achieving the largest market share of any direct to consumer contact lens retailer in many global markets. We are focused on achieving consistent and sustainable growth through the continued development of our core business. Our growth initiatives include the expansion into new markets through existing distribution hubs, the expansion of market share within existing markets and the introduction of new products.

### Results of Operations – three and six months ended April 30, 2008 compared to the three and six months ended April 30, 2007

(\$000's)	For the three months ended April 30,		For the six months ended April 30,	
	2008	2007	2008	2007
<b>Sales</b>	28,632	24,602	54,007	48,207
<b>Gross profit</b>	8,129	6,625	14,492	12,925
<b>Income (loss) before taxes</b>	(620)	671	(1,219)	1,483
<b>Net income (loss)</b>	(692)	313	(1,393)	994
<b>Adjusted EBITDA <sup>1</sup></b>	917	1,007	841	2,177

<sup>1</sup> Adjusted EBITDA is a non-GAAP measure that does not have standardized a meaning prescribed by Canadian GAAP and is therefore unlikely to be comparable to similar measures presented by other companies. See *Supplemental Non-GAAP Measures*.

Revenues increased by \$4 million or 16% in the second quarter of 2008 to \$28.6 million from \$24.6 million in the same quarter of 2007. Revenues increased by \$5.8 million or 12% in the first six months of 2008 to \$54 million from \$48.2 million in the same period of 2007. We operate globally, and sell products in many currencies, some of which, including the Swedish Krona and U.S. dollar, have weakened relative to the Canadian dollar over the last year. Excluding the negative effect of unfavorable foreign exchange rates, revenues for the quarter grew \$5.4 million or 22%, and \$9 million or 19% during the three and six month periods ended April 30, 2008 as a result of an increase in organic sales and the introduction of our prescription eyeglass business.

We shipped 291,607 orders for the second fiscal quarter of 2008, an increase of approximately 14% over the second quarter of fiscal 2007. Reorders represented 60% to 65% of the orders in the second quarter of 2008.

Gross margin increased to 28% in the quarter ended April 30, 2008 from 27% in the second quarter of fiscal 2007 as planned increases in product pricing in some of our markets exceeded certain additional costs relating to our prescription eyeglass business. For the six months ended April 30, 2008 gross margin remained constant at 27% when compared to the same period in 2007.

Selling, general and administrative expenses (“SG&A”) increased to \$7.2 million in the second fiscal quarter of 2008, as compared with \$5.8 million in last year’s second quarter, and to \$13.8 million in the six months ended April 30, 2008, from \$11.6 million in 2007. Overall SG&A spending increased primarily as a result of the launch of our prescription eyeglass business worldwide, increased payroll costs and an increase in marketing and advertising expenses.

In the quarter and six months ended April 30, 2008 we recognized a foreign currency exchange loss on the translation of our monetary assets of \$0.05 million and a gain of \$0.2 million, respectively, compared to gains of \$0.1 million and \$0.8 million in the same periods of the previous year.

Amortization for the quarter ended April 30, 2008 increased by \$0.2 million from the same quarter of the previous year to \$0.7 million. Amortization increased by \$0.3 million in the six months ended April 30, 2008 compared to the same period in 2007. The increase is due to a larger capital base of prior period investments in leasehold improvements and completed software development projects.

During the three months ended April 30, 2008, we incurred certain restructuring charges associated with the consolidation of our Dutch and Asian operations totalling \$0.8 million. This one time charge was comprised of severance costs and other costs such as inventory and other asset revaluations and general and administrative costs related to the restructuring.

Our tax expense, as a percentage of taxable income in the countries in which we generate taxable income, remained constant in the second quarter of 2008 compared to the same period of 2007. Our European operations generate taxable income, while in certain other jurisdictions we have loss carry forwards that can be applied against current and future taxable earnings to reduce our tax liability. As we are uncertain of realizing the future benefit

of those losses, we have taken a valuation allowance against these future tax assets. Consequently, our consolidated tax expense, as a percentage of income before income taxes, will vary from quarter to quarter in line with the mix of net income within each taxable jurisdiction.

### **Liquidity and Capital Resources**

At April 30, 2008 we had cash and cash equivalents of \$17.5 million, as compared to cash and cash equivalents of \$23.4 million and \$4.0 million short-term investments at October 31, 2007.

Net loss for the current quarter, excluding non-cash items, resulted in cash inflows of \$0.1 million compared to \$0.6 million for the same period in the prior year. For the first six months of 2008, net loss excluding non-cash items resulted in cash outflows of \$0.1 million, compared to cash inflows of \$1.2 million for the same period in 2007. Working capital requirements resulted in cash outflows of \$0.2 million during the second quarter of fiscal 2008 compared to cash outflows of \$2.1 million for the same period in the prior year, and cash inflows of \$0.4 million for the six months ended April 30, 2008, compared cash outflows of \$1.4 million in 2007.

We used \$0.5 million during the second quarter of the 2008 fiscal year to purchase equipment and leasehold improvements predominantly in relation to our prescription eyeglass business. In the same period of last year, we used \$4.4 million predominantly for the purchase of short term investments. For the six months ended April 30, 2008, cash of \$2.9 million was provided by investing activities as short term investment maturities of \$4.0 million exceeded spending on property, equipment and website development. This compares to \$5.1 million of cash used in the same period of 2007 largely for the purchase of short term investments and the development of our websites.

We used \$9.6 million in the second quarter of the 2008 fiscal year to purchase our common shares for cancellation compared to \$0.6 million used to purchase common shares for cancellation in the same period last year. For the six months ended April 30, 2008, we used \$10 million to buy back our common shares, compared to \$2.2 million of cash used in the same period of 2007 for the same purpose. Since October 2006, we have purchased and cancelled a total of 11,810,644 common shares for a total of \$13.8 million.

On October 16, 2006, the Toronto Stock Exchange accepted our notice of intention to make a Normal Course Issuer Bid (“NCIB”) for up to approximately 4.9 million of our common shares. Effective, October 18, 2006, we began buying back our common shares. Any shares we acquired were purchased at the market price for the common shares at the time of acquisition and were cancelled after purchase. The bid was terminated on October 17, 2007.

On October 24, 2007, the Toronto Stock Exchange accepted our notice of intention to make a NCIB for up to approximately 4.6 million of our common shares. Effective October 26, 2007, we began buying back our common shares. Any shares acquired have been and will be purchased at the market price for the common shares at the time of acquisition and cancelled after purchase. As at April 30, 2008, 1,154,700 shares had been purchased for cash of \$1.3 million, and subsequently cancelled.

On January 16, 2008 we announced an offer to purchase for cancellation up to 7,000,000 of our common shares through a modified “Dutch auction” issuer bid (“Issuer Bid”). On February 25, 2008, we acquired 6,837,344 common shares at \$1.25 per share, for total consideration of \$8.5 million.

We believe that available cash, together with cash flow from operating activities will be sufficient to support current operations, the NCIB and our operations through fiscal 2008.

We are actively expanding our product offerings, purchasing our common shares for cancellation and seeking strategic acquisitions. While our foreign subsidiaries hold a minority of our cash balances they generate most of our cash flows from earnings. We may incur additional tax costs transferring funds from these subsidiaries to our parent company. We may seek additional sources of funds for accelerated growth, common share purchases, acquisitions of companies or assets or other activities, and there can be no assurance that such funds will be available on satisfactory terms. Failure to obtain such financing could delay or prevent our planned growth, which could adversely affect our business, financial condition and results of operations.

### **Critical Accounting Estimates**

The Company prepares its consolidated financial statements in accordance with GAAP. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Estimates are based upon historical experience and other assumptions that are believed to be reasonable under the circumstances. These estimates are evaluated on an on-going basis and form the basis for making decisions regarding the carrying value of assets and liabilities and the reported amount of revenues and expenses. Actual results may differ from these estimates under different assumptions.

We have identified the following as critical accounting estimates, which are defined as those that are reflective of significant judgments and uncertainties, are the most pervasive and important to the presentation of our financial condition and results of operations and could potentially result in materially different results under different assumptions and conditions.

### *Accounting for Long-lived Assets*

The ability to realize long-lived assets which are primarily comprised of customer lists and website creation costs are evaluated periodically as events or circumstances indicate a possible inability to recover their carrying amount. Such evaluation is based on assessment of reorder rates and various analyses, including undiscounted cash flow and profitability projections that incorporate, as applicable, the impact on the existing business. The analyses necessarily involve significant management judgment. Any impairment loss, if indicated, is measured as the amount by which the carrying amount of the asset exceeds the estimated fair value of the asset.

### *Accounting for Goodwill and Intangible Assets with Indefinite Lives*

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired. Goodwill is not amortized and we perform an annual impairment test of our recorded goodwill. In addition, we test our other indefinite-lived intangible assets for impairment. These impairment tests can be significantly altered by estimates of future performance, long-term discount rates used or market price valuation multiples. The analyses necessarily involve significant management judgment. These estimates will likely change over time. Goodwill and intangible assets with indefinite lives totaled \$16.8 million and \$14.9 million at April 30, 2008 and October 31, 2007, respectively.

### *Allowance for Doubtful Accounts*

We offer credit to most of our customers. These customers do not have to pay for the order until the goods are received – generally estimated to be less than 15 days. The majority of the individual receivable balances are small amounts of less than \$150 and there are a large number of records. Given the composition of the receivable portfolio, using a specific balance approach to determine an allowance for doubtful accounts for the bulk of the receivables is not feasible. Consequently, management estimates an allowance for doubtful accounts based on the aging of the receivable portfolio. The analyses necessarily involve significant judgment. These analyses can be significantly altered by estimates of the probability of future collection or changes in payment patterns of customers. The allowance for doubtful accounts was \$0.9 million and \$0.6 million at April 30, 2008 and October 31, 2007, respectively.

### *Share-based Compensation*

The fair value of each share purchase option grant is estimated on the date of the grant using the Black-Scholes option-pricing model. The amount of share-based compensation associated with any share purchase options that are granted will be estimated and expensed, based on the vesting schedule, using assumptions involving the estimated dividend yield, expected volatility, the risk-free interest rate and the expected lives of the share purchase options.

## *Income Taxes*

We account for income taxes using the liability method of accounting. Under the liability method, future income tax assets and liabilities are determined based on differences between the carrying amounts of balance sheet items and their corresponding tax values. The determination of the income tax provision requires management to interpret regulatory requirements and to make certain judgements. While income tax filings are subject to audits and assessments, management believes that adequate provision has been made for all income tax obligations. However, changes in the interpretations or judgements may result in an increase or decrease in our income tax provision in the future. The amount of any such increase or decrease cannot be reasonably estimated.

## **Change in Accounting Policies**

Effective November 1, 2007, we adopted the new accounting standards related to financial instruments and capital disclosures that were issued by the Canadian Institute of Chartered Accountants. These accounting policy changes were adopted on a prospective basis with no restatement of prior period financial statements. The new standards and accounting policy changes are as follows:

### *Capital Disclosures (Section 1535)*

This standard requires disclosure of an entity's objectives, policies and processes for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance.

### *Financial instruments – Disclosure (Section 3862) and Presentation (Section 3863)*

These standards replace CICA 3861, Financial Instruments – Disclosure and Presentation. It increases the disclosures currently required, which will enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The quantitative disclosures must provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel.

New accounting pronouncements not yet adopted:

### *Inventories (Section 3031)*

This standard replaces CICA 3030, Inventories, and will harmonize accounting for inventories under Canadian GAAP and International Financial Reporting Standards ("IFRS"). This standard requires that inventories should be measured at the lower of cost and net realizable value, and includes guidance on the determination of cost, including allocation of overheads

and other costs. The standard also requires the reversal of previous write downs to net realizable value when there is a subsequent increase in the value of inventories. The new Section is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008. We are currently evaluating the impact of this new standard.

#### *Goodwill and Intangible Assets (Section 3064)*

This standard replaces existing Section 3062, Goodwill and Other Intangible Assets and Section 3450 Research and Development Costs and will harmonize accounting for goodwill and intangible assets under Canadian GAAP and IFRS. This Section establishes the standards for the recognition, measurement and disclosure of goodwill and intangible assets, including internally generated intangible assets. The new Section is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. We are currently evaluating the impact of this new standard.

#### **Common Shares**

As at June 12, 2008, we had 63,430,443 common shares and 3,026,271 options outstanding. Of these securities, 1,211,143 common shares are subject to voluntary pooling agreements and 2,280,526 options have not yet vested as of June 12, 2008.

**Quarterly Financial Information**  
(in \$000's, except per share amounts)

<b>Quarter ended</b>	<b>Apr. 30, 2008</b>	<b>Jan. 31, 2008</b>	<b>Oct. 31, 2007</b>	<b>July 31, 2007</b>	<b>Apr. 30, 2007</b>	<b>Jan. 31, 2007</b>	<b>Oct. 31, 2006</b>	<b>July 31, 2006</b>
<b>Sales</b>	28,632	25,375	26,657	27,310	24,602	23,605	23,344	21,657
<b>Net Income (loss)</b>	(692)	(701)	257	374	313	681	469	(2,143)
<b>Weighted Average # of shares - Basic</b>	65,092	71,275	72,015	72,454	72,974	74,339	71,250	69,705
<b>Weighted Average # of shares - Diluted</b>	65,353	71,275	72,194	73,031	73,457	74,869	73,882	69,705
<b>Basic Earnings (Loss) per share</b>	(0.01)	(0.01)	0.00	0.01	0.00	0.01	0.01	(0.03)
<b>Diluted Earnings (Loss) per share</b>	(0.01)	(0.01)	0.00	0.01	0.00	0.01	0.01	(0.03)

Seasonality may impact our revenue distribution throughout the year. Our sales are generally stronger during the spring, summer and fall months. Our industry generally experiences lower sales during the winter as customers choose to divert discretionary funds towards holiday purchases.

## Related Party Balances

The following amounts were due from related parties:

	April 30, 2008 \$000's	October 31, 2007 \$000's
Promissory notes receivable	353	342
Advances to officers	10	6
	363	348

During the year ended October 31, 2006, we issued nine promissory notes to officers ranging in value from \$0.01 million to \$0.1 million and totaling \$0.36 million. These loans are payable on demand and bear interest at a rate of 5% per annum.

## Contractual Obligations

The Company is committed to minimum annual payments, primarily related to lease costs on its premises, as follows:

	\$000's
2008	1,263
2009	1,153
2010	604
2011 and thereafter	133
	3,153

Operating costs on leases have been excluded. We have no obligations for annual payments related to long-term debt or capital lease obligations.

## Contingent Liabilities

In the ordinary course of our business, inquiries are made periodically by regulatory authorities and assertions are made. We review these and respond to them in due course. To date, no reservation or provision has been made in the financial statements in connection with these matters.

## Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements as defined by applicable securities regulations in Canada at April 30, 2008 that have, or are reasonably likely to have, a current or future material effect on our results of operations or financial condition.

## **Critical Suppliers**

We purchase significant amounts of inventory from three major suppliers. We believe that alternative suppliers are available should those suppliers be unable to provide us with product.

## **Subsequent events**

On September 6, 2007, the Company received a petition filed by the College of Opticians of British Columbia (the “Opticians”) in the Supreme Court of British Columbia. The Opticians sought an order to restrict Coastal Contacts Inc. from selling contact lenses to members of the public in British Columbia. On April 25<sup>th</sup>, 2008, the Supreme Court of British Columbia denied the petition filed by the Opticians.

Subsequent to the end of the period the Company received a notice of appeal filed by the Opticians with the British Columbia Court of Appeal seeking to overturn the ruling by the Supreme Court of British Columbia. Management of the Company believes the original petition and the subsequent appeal is without merit and intends to vigorously defend against the appeal.

## **Management Assessment of Internal Controls**

During the most recent interim quarter ending April 30, 2008, there have not been changes in the design of the Company’s internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company’s internal controls over financial reporting.

## **Supplemental Non-GAAP Measures**

We report our results in accordance with Canadian GAAP; however, we present adjusted EBITDA and the number of orders shipped and the reorder rate in our filings because we believe our investors use these figures to make investment decisions about us.

Adjusted EBITDA is a non-GAAP measure that does not have any standardized meaning prescribed by Canadian GAAP and is therefore unlikely to be comparable to similar measures presented by other companies. Adjusted EBITDA should be considered in addition to, and not as a substitute for, net income, cash flows and other measures of financial performance and liquidity reported in accordance with Canadian GAAP.

Adjusted EBITDA is a measure we believe is useful in assessing performance and highlighting trends on an overall basis. Adjusted EBITDA differs from the most comparable GAAP measure, net income, primarily because it does not include interest, income taxes, amortization, restructuring cost and share-based compensation expense.

The following table shows a reconciliation of net income to adjusted EBITDA:

(\$000's)	For the three months ended April 30,		For the six months ended April 30,	
	2008	2007	2008	2007
<b>Net income</b>	<b>(692)</b>	<b>313</b>	<b>(1,393)</b>	<b>994</b>
Depreciation and amortization	669	457	1,269	961
Interest income, net	(155)	(198)	(387)	(450)
Income tax expense - current	94	385	206	545
Income tax expense (recovery) - future	(22)	(27)	(32)	(56)
Share-based compensation	179	77	334	183
Restructuring cost	844	----	844	----
<b>Adjusted EBITDA</b>	<b>917</b>	<b>1,007</b>	<b>841</b>	<b>2,177</b>

### **Additional Information**

Additional information relating to the Company, including the Company's most recently filed annual information form, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).