

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

The following management's discussion and analysis should be read in conjunction with Coastal Contacts Inc.'s ("the Company") audited consolidated financial statements for the year ended October 31, 2005. The Company prepares its consolidated financial statements in accordance with Canadian GAAP. This discussion of our business may include forward looking statements about our future operations, financial results and objectives. These statements are necessarily based on estimates and assumptions that are subject to risks and uncertainties. Our actual results could differ materially from those expressed or implied by such forward looking information due to a variety of factors including, but not limited to, our ability to implement our business strategies, competition, general economic conditions, currency fluctuations, 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 the Annual Information Form dated February 10, 2006 for a detailed description of the risks and uncertainties relating to the business of the Company.

**CORPORATE OVERVIEW**

With operation and distribution hubs in both North America and Europe, the Company is one of the largest and fastest growing vision care providers in the world. The Company has shipped over one million orders since inception and continues to strengthen the Coastal Contacts brand through the compelling value proposition of savings and convenience. The Company leverages the efficiencies of the internet to bypass middlemen, sell directly to the consumer, and achieve superior management of information and working capital. Management believes that by combining these efficiencies with a singular product focus and multi-national operations, Coastal is able to maintain a competitive advantage in its market.

Since its formation, in October of 2000, the Company has experienced significant growth. The Company's revenue has grown from \$2.5 million in 2001 to \$8.9 million in 2002, an increase of 256% and to \$20.1 million in 2003, for an increase of 127%. Revenue for 2004 was \$31.2 million, an increase of 55%. Revenue in 2005 was \$67.5 million, an increase of 116%. This five year history represents a compound annual growth rate (CAGR) of 92%. Revenue in the first quarter of 2006 continued to trend upwards to \$18.4 million, an increase of 53% over the same quarter in 2005.

The Company has developed a strong annuity sales base from repeat customers which accounted for approximately 50% of total orders for the quarter ended January 31, 2006. With the average customer placing a re-order every six, nine or 12 months, the compounding effect of this annuity stream aids in driving profitable growth.

On March 31, 2004, the Company listed its common shares on the TSX Venture Exchange under the trading symbol "COA". On March 10, 2005, the Company closed a \$12.32 million private placement involving 11.2 million shares and 1,064,000 warrants. The net proceeds of \$11.38 million from the offering were allocated to finance further expansion, sales and marketing initiatives, and for working capital purposes.

On January 31, 2006, the Company completed on a bought deal underwritten basis, the sale of 9,000,000 special warrants by way of private placement, at a price of \$2.50 per special warrant, for net proceeds of \$21,084,690. The net proceeds from the offering will be used to accelerate its international mergers and acquisition strategy, increase sales and marketing initiatives and improve working capital to fund growth in new distribution channels.

SELECTED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

	Quarter ended Jan. 31, 2006	Quarter ended Oct. 31, 2005	Quarter ended Jul. 31, 2005	Quarter ended Apr. 30, 2005	Quarter ended Jan. 31, 2005	Quarter ended Oct. 31, 2004	Quarter ended Jul. 31, 2004	Quarter ended Apr. 30, 2004
<b>Sales</b>	\$18,409,548	\$20,820,006	\$19,817,514	\$14,854,904	\$12,036,729	\$11,726,733	\$6,996,983	\$5,842,511
<b>Gross Profit</b>	\$4,619,257	\$5,164,114	\$5,656,068	\$4,077,227	\$2,967,965	\$2,451,224	\$1,323,173	\$586,740
<b>EBITDA (1)</b>	\$563,314	\$502,984	\$1,610,479	\$729,374	\$534,663	\$346,268	(\$146,081)	(\$446,995)
<b>Net Income (loss)</b>	\$237,198	\$216,514	\$1,200,180	\$436,374	\$243,006	\$276,220	(\$176,540)	(\$590,722)
<b>Weighted Average # of shares - Basic</b>	58,034,604	50,573,011	50,044,222	43,123,319	35,777,134	33,874,960	21,235,996	16,901,900
<b>Weighted Average # of shares - Fully Diluted</b>	60,264,972	60,983,391	60,251,874	52,959,221	46,562,596	44,519,450	21,235,996	16,901,900
<b>Basic Earnings (Loss) per share</b>	\$0.00	\$0.00	\$0.02	\$0.01	\$0.01	\$0.01	(\$0.01)	(\$0.03)
<b>Diluted Earnings (Loss) per share</b>	\$0.00	\$0.00	\$0.02	\$0.01	\$0.01	\$0.01	(\$0.01)	(\$0.03)

- (1) EBITDA is defined as earnings from operations before interest, income taxes, amortization and stock based compensation. The Company reports its results in accordance with Canadian GAAP; however, although this is a non-GAAP measure, the Company presents EBITDA in its filings because it believes its current and potential investors use EBITDA to make investment decisions about the Company. Investors should not consider EBITDA to be an alternative to net income, nor to cash provided by operating activities nor any other indicator of performance or liquidity which has been determined in accordance with Canadian GAAP. The Company's method of calculating EBITDA may differ from the methods used by other companies.

	Quarter ended Jan. 31, 2006	Quarter ended Oct. 31, 2005	Quarter ended July 31, 2005	Quarter ended Apr. 30, 2005	Quarter ended Jan. 31, 2005	Quarter ended Oct. 31, 2004	Quarter ended July 31, 2004	Quarter ended Apr. 30, 2004
<b>Net income</b>	\$237,198	\$216,514	\$1,200,179	\$436,374	\$243,006	\$219,395	(\$119,715)	(\$590,722)
<b>Income tax expense (recovery) - current</b>	\$88,939	(\$171,349)	\$519,271	\$55,105	\$71,569	(\$21,347)	\$ -	\$ -
<b>Income tax expense (recovery) - future</b>	\$19,674	\$233,883	(\$313,899)	(\$10,409)	(\$3,278)	(\$38,045)	\$ -	\$ -
<b>Income (loss) before income taxes</b>	\$345,811	\$279,047	\$1,405,552	\$481,070	\$311,297	\$160,003	(\$119,715)	(\$590,722)
<b>Amortization</b>	\$260,615	\$257,377	\$228,831	\$172,225	\$174,398	\$151,689	\$14,774	\$19,707
<b>Interest on long-term debt</b>	\$15,998	\$17,797	\$22,516	\$22,984	\$35,704	\$27,678	\$15,702	\$25,020
<b>Interest income</b>	(\$86,121)	(\$80,266)	(\$76,713)	(\$44,948)	(\$5,003)	\$ -	\$ -	\$ -
<b>Stock based compensation</b>	\$27,011	\$29,029	\$30,293	\$98,043	\$18,267	\$6,898	\$ -	\$99,000
<b>EBITDA</b>	\$563,314	\$502,984	\$1,610,479	\$729,374	\$534,663	\$331,642	(\$146,081)	(\$446,995)

## RESULTS OF OPERATIONS

### Quarter Ended January 31, 2006

Sales for the quarter ended January 31, 2006 were \$18,409,548, an increase of \$6,372,819 or 53% over the first quarter of 2005. Total order volume for the quarter was 181,510 orders, an increase of 57,349 orders or 46% over the first quarter of 2005. There were 96,077 orders shipped to returning customers, an increase of 41,490 orders or 76% over the same quarter in 2005. This increase in orders from existing customers reflects the growing annuity aspect of the Company's business model. In the first quarter of fiscal 2006, 85,433 orders were shipped to new customers, an increase of 15,859 or 23% over the same quarter in 2005.

During the quarter ended January 31, 2006, revenue growth is impacted by the inherent seasonality associated with the contact lens industry at large. Consistent with the fashion and beauty industries, sales are generally stronger during the spring, summer and fall months. The industry generally experiences lower sales during the holiday season as customers choose to divert discretionary funds towards holiday purchases. As such, the Company's focus is to seize the opportunities that exist during the spring, summer and fall months to maximize its sales and earnings.

Gross profit for the quarter ended January 31, 2006 was \$4,619,257, an increase of \$1,651,292 or 56% over the first quarter of 2005. Gross profit was 25% of sales for the first quarter of 2006, representing an increase from the 24% in the same quarter in the preceding year. The Company's gross margin efficiency is driven by several factors. First, the acquisition of Lenslogistics AB (formerly Lensway AB) and Yourlenses Scandinavia AB ("Yourlenses"), along with increased sales volumes through the year allowed the Company increased purchasing leverage with its suppliers through consolidating large volume orders from both the Company and its European operations. The weak US dollar continued to have a negative impact on gross margin during 2006. The US dollar weakened from \$1.32 in October 2003 to \$1.22 in October 2004 to \$1.14 in January 2006. In response, beginning in 2004, the Company adopted a strategy of shifting the vast majority of its purchasing to US based suppliers to hedge against the weak US dollar. The success of this strategy is evidenced by the Company's gross margin improvement from 10.0% in the second quarter of 2004 to gross margins in excess of 18% for each quarter subsequent to the second quarter of 2004.

The Company's SG&A for the quarter ended January 31, 2006 was 22% of net sales, an increase over the 20% for the quarter ended January 31, 2005. In the first quarter of 2006, the Company saw its selling expenses as a percentage of net sales increase by approximately 1%. This increase was primarily a result of the Company electing to enter new markets aggressively through online and print media campaigns. Increased spending in these new markets was offset by controlling marketing expenditures in the Company's traditional markets, resulting in only a marginal increase in selling expenses as a percentage of net sales. Historically, when the Company enters a new market, the initial customer acquisition cost is high as it establishes initial brand awareness. Over time, as the Company increases its marketing presence in a particular market, the customer acquisition cost decreases. Coastal is currently applying this strategy in the German, UK, Australian and New Zealand markets. Combined, these markets are large and in order to achieve effective market penetration, the Company incurred higher customer acquisition costs compared to current markets where the Company is established. The Company believes that this is a necessary cost of growth and based on historical results believes that as these markets cycle through to re-orders, all of the above mentioned markets will provide profits. Reorders in the first quarter of 2006 increased by 41,490 orders or 76% over the same period in 2005. As a new entrant in a market the Company does not have these returning customers to rely on. Management believes that the short-term increase in SG&A costs are necessary in order to extend the Company's reach into new international markets.

Additionally, the Company continued to build out the Lens Logistics program in Europe in the first quarter of 2006. Approximately fifty percent of contact lenses are purchased directly from eye-care practitioners ("ECPs"). Coastal's large volume and centralized distribution model allows the Company to act as a cost effective service centric source of lenses for the ECP community at large. On behalf

of the ECP, the Company will ship orders directly to the residences of patients saving the customer both time and money. The ECPs save money on administrative costs, inventory costs and lens costs. It also provides the ECP a "one-stop shop" option versus the conventional methodology of contacting each manufacturer separately with manufacturer specific orders. The Company believes that by extending its service to include ECPs it increases the near and long-term market opportunity materially. An additional service offered through the Lens Logistics program is the marketing of eye-exams to existing customers in the Company's database.

Stock-based compensation represents a non cash expense resulting from the Company's issuance of stock options to employees and directors of the Company. The Company believes that the granting of stock options to employees is a key incentive to provide employees with ownership in the Company and an interest in the continued growth and success of the Company. Stock based compensation for the quarter ended January 31, 2006 was \$27,011 as compared to \$18,267 for the first quarter of the preceding year. The increase was due to stock options granted to employees and directors of the Company in the second quarter of 2005.

EBITDA for the quarter ended January 31, 2006 was \$563,314 as compared to \$534,663 for the same period in 2005. Increased SG&A as discussed above was offset by increased sales of \$6,372,819, an increase in new orders of 23% and an increase in orders to returning customers of 76%. Sales to returning customers are more profitable given the selling expenses relating to securing these re-orders are insignificant.

Amortization for the quarter ended January 31, 2006 increased by \$86,217 to \$260,615 from \$174,398 in the first quarter of the previous year. This increase was due in part to capital expenditures of \$264,314 on computer hardware, \$455,672 on computer software and \$699,344 on website development between February 1, 2005 and January 31, 2006. In addition, as a result of the acquisition of Yourlenses in May 2005, there was \$735,000 allocated to the Yourlenses customer list which is being amortized over a five year period. In the first quarter of 2006, there was approximately \$31,000 associated with the amortization of the Yourlenses customer list as opposed to nil in the first quarter of 2005.

Interest expense for the quarter ended January 31, 2006 was \$15,998 as compared to \$35,704 for the first quarter of 2005. This decrease in interest expense resulted from the Company having reduced its debt balances resulting from principal payments.

Interest income for the quarter ended January 31, 2006 was \$86,121 as compared to \$5,003 for the first quarter of 2005. Interest income consists primarily of interest earned on the funds raised through a private placement in March 2005.

Current income tax expense of \$88,939 for the first quarter of 2006 represents taxes payable on the Company's European operations. Earnings from the Company's North American operations have been sheltered through the application of previously unrecognized tax loss carry forwards.

Future income tax expense of \$19,674 for the first quarter ended January 31, 2006 is primarily attributable to an increase in Lensway AB's future income tax liability, partially offset by the draw down of the future income tax liability recognized in the purchase price allocation for the acquisition of Lensway AB and Yourlenses in 2004 and 2005, respectively.

Net Income for the quarter ended January 31, 2006 was \$237,198 as compared to \$243,006 for the same period in 2005. As discussed above, increased SG&A resulting from the Company's expansion into new markets and investing in its Lens Logistics program was offset by increased sales resulting from an increase in orders to returning customers of 76%. Sales to returning customers are more profitable given the selling expenses relating to securing these re-orders are insignificant.

### **Liquidity and Capital Resources**

## Financial condition

On January 31, 2006, the Company completed on a bought deal underwritten basis, the sale of 9,000,000 special warrants by way of private placement, at a price of \$2.50 per special warrant, for net proceeds of \$21,084,690.

Each special warrant is exercisable to acquire one common share of the Company for no additional consideration. The special warrants shall be exercisable by the holders thereof at any time and will be automatically exercised on the earlier of the following dates: (i) the fifth business day after a receipt is issued by the last of the securities regulatory authorities in each of the jurisdictions in Canada in which purchasers of the special warrants are resident for a final prospectus qualifying the common shares to be issued upon the exercise of the special warrants; and (ii) the date which is four months and one day after the closing date.

The final prospectus was filed and receipted on March 23, 2006 and substantially all conditions of the underwriting agreement have been satisfied.

In the fourth quarter of 2005, the Company fully implemented a program where the majority of the Company's customers were granted credit. The decision to offer this service was based on the success achieved by the Company's European operations, which has been historically offering this service for over four years. The Company believes that new customers might be wary of ordering contact lenses from an on-line retailer and having to pay for the contact lenses prior to receiving the product. The Company's program, named "Invoice Me Later" or IML allows the customer to order from the Company and only pay after receiving the product. This program has resulted in an increased rate of conversion in the number of customers ordering from the Company's websites, as customers realize they can try out the Company's product and receive the Company's product prior to paying.

Net cash used by operating activities for the quarter ended January 31, 2006 was \$4,228,139 as compared to cash provided by operating activities of \$797,309 in the first quarter of the preceding year. This increase was primarily due to an increase in accounts receivables of \$678,513, an increase in inventory of \$814,364, a reduction in supplier payables of \$3,044,135, offset by amortization expense of \$260,615. This increase in accounts receivable was primarily a result of the Company's implementation of its IML program in the fourth quarter of 2005.

Net cash used in investing activities for the quarter ended January 31, 2006 was \$19,346,397 as opposed to cash provided by investing activities of \$209,539. Primary uses of cash in the quarter ended January 31, 2006 were the net acquisition of short term investments of \$26,632,685, investments in computer hardware and leasehold improvements of \$308,399 and investments in website development of \$315,572.

Net cash provided by financing activities for the quarter ended January 31, 2006 was \$21,914,226 as compared to cash used in financing activities of \$188,467 in the first quarter of 2005. The principal source of financing was the issuance of nine million special warrants at \$2.50 resulting in net proceeds of \$21,084,690 on January 31, 2006. There was a further \$682,406 obtained through option and warrant exercises in the first quarter of 2006. This cash provided through financing activities was offset by repayment of the Company's long term debt of \$130,541.

The Company believes that its available cash, together with cash flow from operations and its recently completed special warrants financing will be sufficient to support current operations and organic growth at least through fiscal 2006.

The Company may seek additional sources of funds for accelerated growth or continued growth after that point, and there can be no assurance that such funds will be available on satisfactory terms.

Failure to obtain such financing could delay or prevent the Company's planned growth, which could adversely affect the Company's business, financial condition and results of operations.

In addition, in 2006 the Company will likely pursue additional acquisitions that are in line with our current growth strategies and the Company anticipates the need to seek additional equity financing in 2006 in order to execute on these opportunities.

### **Common Shares**

As at March 28, 2006, the Company had 60,470,869 common shares, 973,075 options and 11,629,137 warrants issued and outstanding. Of these securities, 4,715,615 common shares and 391,280 options remain in escrow or have not yet vested as of March 28, 2006. 9,000,000 special warrants remain to be converted into shares when the terms of the January 31, 2006 private placement have been met.

### **Critical Accounting Estimates**

Coastal Contacts Inc. prepares its financial statements in accordance with Canadian generally accepted accounting principles ("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.

### **Stock Based Compensation**

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

### **Revenue Recognition**

Revenue from product sales is recognized when the product has been shipped to the customer. At this point, the amount of sales revenue is determinable, no significant vendor obligations remain and the collection of the revenue is reasonably assured.

Deferred revenue includes revenue collected in advance of the product being shipped to the customer.

### **Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired. Goodwill is not amortized and is reviewed for possible impairment annually or more frequently if events or changes in circumstances indicate possible impairment, based on the profitability and cash flows of Lensway AB. There have been no indicators of potential impairment during the quarter or any other circumstances that would require us to perform a goodwill impairment test other than the annual test that will was performed in the fourth quarter.

### **ACQUISITION OF YOURLENSES**

On May 4, 2005 through the Company's wholly owned subsidiary, Lenslogistics AB (formerly Lensway AB), the Company completed the acquisition of all of the shares of Yourlenses Scandinavia

AB("Yourlenses"), a European retailer of contact lenses. The consideration paid consisted of cash of \$949,032 (5,380,000 Swedish Krona) and the assumption of debt in the amount of \$156,167, with fifty percent of the cash paid upon signing on May 4, 2005 and the remaining fifty percent held in escrow, payable eighteen months from such date.

The acquisition was accounted for using the purchase method whereby assets acquired and liabilities assumed were recorded at their fair market values as of the date of the acquisition.

The following sets forth the purchase price and its allocation to the tangible and intangible assets acquired.

	\$
Cash	949,032
Direct acquisition costs	111,193
<b>Total consideration</b>	<b>1,060,225</b>
Cash	33,988
Other current assets	240,942
Property and equipment	5,865
Yourlenses customer list	735,000
Yourlenses trade name	514,500
Website development	134,750
Current liabilities	(313,440)
Long-term debt	(85,361)
Future income tax liability	(387,590)
<b>Net assets acquired</b>	<b>878,654</b>
<b>Goodwill</b>	<b>181,571</b>

Goodwill has been allocated to the Swedish reporting unit and is not deductible for income tax purposes.

### **Forward-looking statements**

In addition to historical information, this report and the reports and documents incorporated by reference in this report contain statements that could relate to future events and the Company's future results. Although the Company believes the assumptions underlying these forward looking statements are reasonable, any of these assumptions could prove to be inaccurate and, as a result, the forward-looking statements made based on these assumptions could be incorrect. Investors are cautioned that all forward-looking statements involve risks and uncertainties including, without limitation, those relating to changes in the market, potential downturns in economic conditions, limited suppliers, inventory risk, disruption in our distribution facilities, foreign exchange, fluctuations, regulatory requirements, demand for contact lenses, competition and dependence on the internet. These risks, as well as others, could cause actual results and events to vary significantly.

### **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).