

## **Management's Discussion and Analysis of Financial Condition and Results of Operations for the three and nine months ended July 31, 2010**

**September 13, 2010**

This "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) is dated as of September 13, 2010 and should be read in conjunction with Coastal Contacts Inc.'s (the "Company", "our", "we", "us", "Coastal" or "Coastal Contacts") unaudited interim consolidated financial statements and notes thereto for the three and nine months ended July 31, 2010. 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. Examples of such forward-looking statements within this document include statements relating to: our perception of the contact lens and eyeglasses industry or market and anticipated trends in that market in any of the countries in which we do business; our anticipated ability to procure products, or the terms under which we may procure our products; our anticipated business operations, inventory levels, ability to handle specific order and call volumes, ability to fill and timely ship orders, ability to achieve greater marketing efficiency or similar statements; our ability to increase production; our plans for capital expenditure plans; our relationships with suppliers, our anticipated results of operations, including but not limited to anticipated sales, revenues, earnings, tax benefits or similar matters; the effects of seasonality; sufficiency of cash flows; the expected outcome of ongoing litigation; and our perceptions regarding volatility in and impact of foreign currency exchange rates.

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. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties and assumptions which are difficult to predict. Assumptions underlying our expectations regarding forward-looking statements or information contained in this MD&A include, among others: that we will maintain our position in the markets we operate in and expand into other markets in a favourable manner; that we will have sufficient capital to continue making investments in advertising, inventory, equipment and personnel to support our business and new product lines, including our eyeglass business; that we will be able to generate and maintain sufficient cash flows to support our operations; that we will be successful in complying with regulatory requirements in British Columbia, Canada, North America, Europe, Asia Pacific and other world wide jurisdictions; that we will successfully defend any legal action brought against us; that we will be able to establish and/or maintain necessary relationships with suppliers; and that we will retain key personnel. The foregoing list of assumptions is not exhaustive.

Persons reading this MD&A are cautioned that forward-looking statements or information are only predictions, and that our actual future results or performance may be materially different due to a number of factors. These factors include, but are 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 currency exchange rate fluctuations; regulatory requirements; demand for products we sell; competition and dependence on the internet and other risks detailed in our filings with the Canadian and Swedish securities regulatory authorities. Reference should be made to the section entitled "Risk Factors" contained in our most recently filed Annual Information Form dated January 29, 2010 and our listing prospectus, dated October 14, 2009 and filed with the Swedish Regulatory Agency, both of which are available on SEDAR at [www.sedar.com](http://www.sedar.com), 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. Accordingly, readers should not place undue reliance on forward-looking statements and information, which are qualified in their entirety by this cautionary statement. These forward-looking statements are made as of the date of this MD&A and we expressly disclaim any intent or obligation to update these forward-looking statements, unless we specifically state otherwise and except as required by applicable law.

## **Overview**

Coastal Contacts is the leading worldwide online retailer of contact lenses, eyeglasses, sunglasses and vision care accessories. We service our international customers through our distribution facilities in North America and Europe.

We launched our business in the year 2000 selling contact lenses online. In 2004, after a successful start up phase, we completed an initial public offering of our common shares in Canada. From 2004 to 2008 we targeted a significant portion of our investments in various international markets and acquired several businesses in Europe and Asia as part of our strategy to establish a globally diversified business platform.

We have built a diversified international base of more than 2 million vision corrected customers and have the largest market share of any online optical retailer in many of our markets.

During the third quarter of fiscal 2010 sales increased 5% (12% excluding the effects of foreign exchange), when compared to the same period in 2009. We shipped a total of 428,563 orders, approximately 28% of which were to new customers with the remaining amount representing reorders. Eyeglasses sales in the quarter totaled \$5.0 million, an 84% increase over the same period last year. In our North American market, sales of eyeglasses grew 108% year over year for the periods referenced. Shipped orders and reorders are non-GAAP measures that do not have a standardized meaning prescribed by Canadian GAAP and are therefore unlikely to be comparable to similar measures presented by other companies. Refer to *Supplemental Non-GAAP Measures* below for further information.

During the third quarter of fiscal 2010, we continued to make progress on the management changes in our European business unit that we commenced in the second quarter of 2010. We have replaced some key management, marketing and operations personnel and expect to fine tune this initiative in the coming quarters. We are satisfied with our progress to date.

Also during the third quarter of 2010, we added personnel to support our eyeglasses business, continued investing in our information technology infrastructure, expanded our eyeglasses manufacturing facilities and capacity, primarily in North America, and we continued to broaden our selection of eyeglass frames.

On July 7, 2010, the former managing director of our European division resigned from our Board of Directors and was replaced by Mr. Tushar Shah on July 16, 2010. Mr. Shah is a Managing Partner of Kinderhook Partners, a US based investment partnership.

**Results of Operations – three and nine months ended July 31, 2010 compared to the three and nine months ended July 31, 2009**

(CAD\$000's)	For the three months ended July 31,		For the nine months ended July 31,	
	2010	2009	2010	2009
<b>Sales</b>	39,455	37,511	112,681	102,154
<b>Gross profit</b>	11,377	11,179	31,944	31,075
<b>Earnings before taxes</b>	609	922	1,789	2,915
<b>Net earnings</b>	529	603	1,661	2,099
<b>Adjusted EBITDA <sup>1</sup></b>	1,400	1,967	4,578	5,177

Sales increased by \$2.0 million, or 5%, in the third quarter of 2010 to \$39.5 million from \$37.5 million in the third quarter of 2009. We shipped 428,563 orders in the third quarter of 2010, a 16% increase over the 370,882 orders we shipped in the same period last year. This growth largely reflects the growth of shipments of eyeglasses and contacts lenses in the North American market. Eyeglasses sales in the quarter totaled \$5.0 million, an 84% increase over the same period last year. Largely as a result of this new product growth and promotion of our eyeglasses business, which is currently characterized by lower average order sizes, our total average revenue per order declined in the quarter by 4%. Relative to the prior year, our third quarter 2010 sales were impacted negatively by 7% as a result of foreign exchange rate fluctuations, primarily as a result of a year over year decline in the value of the Swedish Krona relative to the Canadian Dollar, and the Euro relative to the Swedish Krona.

Sales increased by \$10.5 million over the first nine months of 2010 to \$112.7 million from \$102.2 million in the first nine months of 2009. This represents a 10% sales growth, resulting from a 17% increase in shipped orders, again, largely as a result of growth of shipments of eyeglasses and contacts lenses in the North American market. This was offset by a decrease of 3% in average revenue per order and a negative 4% impact as a result of foreign exchange rate fluctuations.

Our gross profit margin as a percentage of sales, or gross margin, in the three months ended July 31, 2010 was 29%, compared to 30% during the three months ended July 31, 2009. For the nine months ended July 31, 2010, our gross margin was at 28%, compared to 30% in the same period in 2009.

<sup>1</sup> Adjusted EBITDA, shipped orders, reorders and reorder rate(s) are non-GAAP measures that do not have a standardized meaning prescribed by Canadian GAAP and are therefore unlikely to be comparable to similar measures presented by other companies. Refer to Supplemental Non-GAAP measures on page 6 and 7 for further information and a reconciliation of net earnings to adjusted EBITDA.

Gross margin improvements in North America, including positive contributions from our eyeglasses business, partly offset gross margin declines in Europe, with the latter being negatively impacted by retail pricing declines in certain regions and the Euro to Swedish Krona foreign currency exchange rate fluctuations.

Advertising expenses decreased to \$4.9 million (12% of sales) in the third quarter of fiscal 2010, compared to \$5.0 million (13% of sales) during the same period in 2009. During the nine months ended July 31, 2010, advertising expenses decreased to \$12.8 million (11% of sales), compared to \$13.4 million (13% of sales) during the same period in 2009. During the third quarter of 2010 we maintained a conservative approach to advertising expenditures in our European operation while we undertook our management transition. Additionally, we continued to use alternative promotional methods to gain customers and encourage the online adoption of the eyeglasses model, which resulted in lower advertising spending relative to our historical patterns.

Selling, general and administrative (“SG&A”) expenses increased to \$5.1 million, or 13% of sales, for the three months ending July 31, 2010 compared to \$4.2 million, or 11% of sales for the same period in 2009. SG&A expenses increased to \$14.5 million, or 13% of sales, in the nine months ended July 31, 2010 compared to \$12.5 million, or 12% of sales, in the same period last year. With respect to both comparative periods, in 2010 we increased our investments in personnel and operating premises to support our growing operations. Additionally, we incurred additional costs related to management changes in Europe, including approximately \$0.5 million in related professional fees, during the third quarter of fiscal 2010.

Amortization for the quarter ended July 31, 2010 increased by \$0.1 million from the same quarter of the previous year to \$0.7 million. Amortization increased by \$0.2 million in the nine months ended July 31, 2010 compared to the same period in 2009 due to an increase in expenditures on eyeglasses equipment, information technology infrastructure and tenant improvements to support our growing eyeglasses business.

Adjusted EBITDA was \$1.4 million in the third quarter of fiscal 2010, compared to \$2.0 million in the same period in 2009.

Our income tax expense decreased to \$0.1 million in the third quarter of fiscal 2010 compared to \$0.3 million in the same period of fiscal 2009. Certain operations generate taxable income, while in certain other jurisdictions we have incurred losses historically that can be applied against current and future taxable earnings to reduce our tax liability on those earnings. When we generate a proportionately larger amount of taxable income, in regions where we have tax losses available to carry forward, our overall tax rate decreases as a percentage of our earnings.

### **Liquidity and Capital Resources**

At July 31, 2010 we had cash and cash equivalents of \$20.8 million, as compared to \$11.5 million at October 31, 2009.

Cash provided by operations was \$10.5 million during the third quarter of fiscal 2010 compared to cash provided by operating activities of \$0.2 million during the same period in fiscal 2009. We generated \$1.2 million from earnings after adjustments for non-cash items during the quarter, and \$9.3 million from changes in non-cash working capital items by reductions in inventory and prepaid

expenses, and an increase in our accounts payable and accrued liabilities balances. Over the past few fiscal quarters, we have undertaken a number of efforts, including leveraging our significant buying power with suppliers, trimming inventory balances and establishing financing facilities, which have improved our cash and liquidity position and enhanced our ability to take advantage of future opportunities.

Cash provided by investing activities was \$0.3 million for the third quarter of fiscal 2010, compared to cash used of \$0.3 million during the same period in fiscal 2009. During the three months ended July 31, 2010, we invested \$1.5 million in eyeglasses production facilities and our information technology infrastructure and we generated \$1.8 million by entering into a capital lease financing facility at an interest rate of 4.73% per annum. This financing released the cash tied up in our existing capital asset base, including eyeglasses manufacturing equipment, a significant portion of which was purchased while the financing was being negotiated in the earlier part of fiscal 2010.

As a minor offset we expended \$0.1 million in both the third quarter of 2010 and 2009 by purchasing and cancelling our common shares under the current Normal Course Issuer Bid, or NCIB. At the end of the third quarter of 2010, we had under the approved NCIB the ability to purchase, expiring on December 30, 2010, up to a remaining 3.7 million common shares.

As at July 31, 2010, we had readily available approximately \$10.5 million of additional approved bank financing from multiple lenders, which includes approximately \$8.5 million from two separate working capital facilities and approximately \$2 million from a capital financing facility.

We believe that existing available cash and cash equivalents, operating and capital financing facilities, and operational cash flow will be sufficient to support our capital expansion plans, NCIB stock purchases and operations through to the end of fiscal 2011. We are actively expanding our product offerings, assessing capital financing alternatives, assessing strategic opportunities, and considering strategic acquisitions. We expect cash flows from changes in working capital to vary in the future due to the timing of receipts, inventory shipments and supplier payments. We may seek additional sources of funds to support our capital expansion or for accelerated growth, acquisitions of companies or assets or other activities, and there can be no assurance that such funds will be available on satisfactory terms or at all. Failure to obtain such financing could delay or prevent our planned growth, which could adversely affect our business, financial condition and results of operations.

### Quarterly Financial Information

(in CAD\$000's, except per share amounts)

Quarter ended	July 31, 2010	Apr. 30, 2010	Jan. 31, 2010	Oct. 31, 2009	July 31, 2009	Apr. 30, 2009	Jan. 31, 2009	Oct. 31, 2008
<b>Sales</b>	39,455	37,318	35,908	37,716	37,511	33,301	31,342	32,027
<b>Adjusted EBITDA<sup>1</sup></b>	1,400	1,500	1,678	2,828	1,967	1,387	1,823	1,664
<b>Foreign exchange (gain) loss</b>	(5)	293	(18)	(121)	252	(39)	(202)	361
<b>Net Earnings</b>	529	382	750	648	603	528	968	397
<b>Weighted average # of shares - basic</b>	56,982	56,962	56,902	56,902	57,057	57,975	58,318	58,451
<b>Weighted average # of shares - diluted</b>	57,964	58,324	58,502	57,705	57,374	57,988	58,320	58,605
<b>Basic earnings per share</b>	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.01
<b>Diluted earnings per share</b>	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.01

Seasonality may impact our revenue distribution throughout the year. Our sales have historically been stronger during the spring, summer and fall months.

### Supplemental Non-GAAP Measures

Our reorder rate is defined as the percentage of orders in the quarter shipped to customers that we

estimate have ordered from us in the past.

We report our results in accordance with Canadian GAAP, however, we present adjusted EBITDA as we believe that our investors may use these figures to make more informed 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 earnings, primarily because it does not include interest, income taxes, amortization, share-based compensation expense and foreign exchange gains and losses.

The following table provides a reconciliation of net income to Adjusted EBITDA:

(CAD\$000's)	For the three months ended July 31,		For the nine months ended July 31,	
	2010	2009	2010	2009
<b>Net earnings</b>	<b>529</b>	<b>603</b>	<b>1,661</b>	<b>2,099</b>
Amortization	672	616	2,030	1,834
Share-based compensation	109	189	459	485
Interest expense (income), net	15	(12)	30	(68)
Foreign exchange (gain) loss	(5)	252	270	11
Income tax expense	80	319	128	816
<b>Adjusted EBITDA</b>	<b>1,400</b>	<b>1,967</b>	<b>4,578</b>	<b>5,177</b>

### Critical Accounting Estimates

Coastal prepares its consolidated financial statements in accordance with Canadian 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 sales 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 sales 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.

#### *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.

#### *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 \$15.5 million and \$17.3 million at July 31, 2010 and October 31, 2009, 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 at July 31, 2010 was \$0.8 million.

#### *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.

### **Future Accounting Policies**

#### *Transition to International Financial Reporting Standards*

In accordance with the Canadian Institute of Chartered Accountants Accounting Standards Board (AcSB), Canadian publicly accountable enterprises will be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS). This changeover to IFRS from Canadian GAAP will apply to the Coastal's financial statements for the year beginning on November 1, 2011. Coastal will undertake the appropriate measures to ensure compliance with these new standards by the prescribed adoption date. Coastal is currently assessing the implications of these standards on the consolidated financial statements.

IFRS consists of a conceptual framework similar to Canadian GAAP and therefore differences in accounting policies will have to be addressed. In order to meet the requirement to transition to IFRS, the Company is currently undertaking a project to ensure compliance with the new standards by the adoption date. The Company's IFRS project plan is comprised of four stages: awareness, assessment, design and implementation. The company is currently in the assessment stage which includes an analysis of the difference between IFRS and Canadian GAAP and an evaluation of the potential impact on financial reporting, accounting policies, systems and internal controls over financial reporting.

### **Common Shares**

As at July 31, 2010, we had 56,913,546 common shares and 4,477,500 share purchase options outstanding.

### **Related Party Balances**

As at July 31, 2010, four promissory notes owing from Coastal employees were outstanding, totaling \$0.2 million, of which \$0.04 million represented accumulated interest. These loans are payable on demand, bear interest at a rate of 5% per annum, and the debtors are personally liable for the amounts owed. Coastal did not have any loans outstanding to its Chief Executive Officer ("CEO"), its Chief Financial Officer ("CFO") or any of its directors as at July 31, 2010.

### **Contingent Liabilities**

Coastal is engaged in certain legal actions in the ordinary course of our business and believes that the ultimate outcome of these actions will not have a material adverse effect on our operating results, liquidity or financial position.

### **Off-Balance Sheet Arrangements**

Coastal does not have any off-balance sheet arrangements as defined by applicable securities regulations in Canada at July 31, 2010 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 currently purchase significant amounts of inventory from a limited number of major suppliers. We believe that alternative suppliers are available should those suppliers refuse or be unable to provide us with products.

### **Disclosure Controls and Procedures**

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the CEO and CFO, on a timely basis so that appropriate decisions can be made regarding public disclosure. As of July 31, 2010, an evaluation of the design of Coastal's disclosure controls and procedures as defined in National Instrument 52-109 was carried out. Based on that evaluation, the CEO and CFO concluded that the design and operation of those disclosure controls and procedures were effective.

### **Internal Controls over Financial Reporting**

Management is responsible for certifying the design of Coastal's internal control over financial reporting as required by National Instrument 52-109.

Our internal control over financial reporting is intended to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with applicable generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management, including the CEO and CFO, carried out an evaluation of the design of our internal controls over financial reporting as at July 31, 2010. Management believes the design, based upon the Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, to be effective for the nature and size of Coastal's business, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles. During the third quarter of 2010, management did not make changes to its system of internal controls that materially affect internal controls over financial reporting.

**Additional Information**

Additional information relating to Coastal, including Coastal's most recently filed annual information form, dated January 29, 2010, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).