

**IN THE SUPREME COURT OF BRITISH COLUMBIA**  
**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985,**  
**c. C-36, AS AMENDED**

**AND**

**IN THE MATTER OF THE *CANADA BUSINESS CORPORATIONS ACT*,**  
**R.S.C. 1985, c. C-44**

**AND**

**IN THE MATTER OF STERLING SHOES INC. and STERLING SHOES GP INC.**

**THIRD REPORT OF THE MONITOR**  
**ALVAREZ & MARSAL CANADA INC.**

**FEBRUARY 15, 2012**

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## 1.0 INTRODUCTION

- 1.1 Alvarez & Marsal Canada Inc. ("**A&M**" or the "**Monitor**") was appointed as Monitor pursuant to the order (the "**Initial Order**") pronounced by this Honourable Court on October 21, 2011 (the "**Order Date**") on the application of Sterling Shoes Inc. ("**Sterling**") and Sterling Shoes GP Inc. ("**Sterling GP**") (together, the "**Petitioners**") under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "**CCAA**"). The proceedings brought by the Petitioners under the CCAA will be referred to herein as the "**CCAA Proceedings**". The Petitioners and Sterling Shoes Limited Partnership (the "**Partnership**") will be referred to herein as the "**Petitioner Parties**" or the "**Company**".
- 1.2 The Initial Order granted a stay of proceedings (the "**Stay of Proceedings**") against or in respect of the Petitioner Parties and their assets until November 18, 2011. The Stay of Proceedings was subsequently extended by the order dated November 18, 2011 to December 30, 2011.
- 1.3 On December 9, 2011, the Petitioner Parties sought and obtained an order (the "**December 9 Order**") from this Honourable Court approving, among other things:
- a) an agency agreement (the "**Agency Agreement**") between the Partnership and Century Services LP ("**Century**") as well as Sale Guidelines relating to a liquidation of inventory at 53 separate retail store locations;
  - b) an extension of the forbearance agreement (the "**Forbearance Agreement**") between the Company and its primary operating lender, Bank of Montreal ("**BMO**"), to March 31, 2012;
  - c) a sale and investment solicitation process ("**SISP**");
  - d) a key employee incentive plan ("**KEIP**"); and
  - e) an extension of the Stay of Proceedings to April 2, 2012.
- 1.4 The Initial Order together with select motion material and other documentation filed in the CCAA, are posted on the Monitor's website at [www.alvarezandmarsal.com/sterling](http://www.alvarezandmarsal.com/sterling) (the "**Monitor's Website**").

## 2.0 PURPOSE OF REPORT

- 2.1 This is the Monitor's third report (the "**Third Report**") and has been prepared as a limited purpose report to provide this Honourable Court and the Company's stakeholders with an update on various aspects of the operations of the Company including its cash receipts and disbursements

for the period ended January 28, 2012 as well as an update on the progress and status of certain of the Company's restructuring efforts.

### 3.0 **TERMS OF REFERENCE**

- 3.1 In preparing this Third Report, A&M has necessarily relied upon unaudited financial and other information supplied, and representations made to us, by certain senior management of the Company ("**Management**"). Although this information has been subject to review, A&M has not conducted an audit nor otherwise verified the accuracy or completeness of any of the information prepared by Management or otherwise provided by the Petitioner Parties. Accordingly, A&M expresses no opinion and does not provide any other form of assurance on the accuracy of any information contained in this report, or otherwise used to prepare this Third Report.
- 3.2 Certain of the information referred to in this Third Report consists of financial forecasts and/or projections prepared by Management. An examination or review of financial forecasts and projections and procedures, as outlined by the Canadian Institute of Chartered Accountants, has not been performed. Readers are cautioned that since financial forecasts and/or projections are based upon assumptions about future events and conditions that are not ascertainable, actual results will vary from the projections and the variations could be material.
- 3.3 Unless otherwise stated, all monetary amounts contained in this Third Report are expressed in Canadian dollars.

### 4.0 **CASH FLOW STATEMENT AND VARIANCE ANALYSIS**

- 4.1 The Company previously filed with this Honourable Court a weekly cash flow forecast for the period ending March 31, 2012 (the "**Revised Cash Flow Statement**") which was reviewed by A&M in its capacity as Monitor of the Petitioner Parties. A&M's comments with respect to the Revised Cash Flow Statement and its review are included in the Monitor's Second Report and are not repeated herein.
- 4.2 As part of the Monitor's ongoing oversight and monitoring of the business and financial affairs of the Company, the Monitor has undertaken weekly reviews of the Company's actual cash flow in comparison with that forecast by Management and contained in the Revised Cash Flow Statement. The Company's actual cash receipts and disbursements as compared to the Revised

Cash Flow Statement for the 15 week period October 16, 2011<sup>1</sup> through January 28, 2012 is summarized in the table below:

Sterling Shoes Inc. et al. Actual Consolidated Cash Flow Compared to Revised Cash Flow Statement (Note 1) For the 15 Week Period from October 16, 2011 to January 28, 2012			
	October 16, 2011 to January 28, 2012 (Cumulative)		
(\$000's)	Actual	Forecast	Variance
Gross Sales Receipts	\$ 32,464	\$ 33,249	\$ (785)
Cash received on behalf of Century (Note 2)	8,785	-	8,785
Inventory Liquidation	8,620	7,572	1,048
<b>Receipts (incl. taxes)</b>	<b>49,869</b>	<b>40,821</b>	<b>9,048</b>
<b>Disbursements</b>			
Vendors	(7,367)	(7,411)	44
Payroll	(6,758)	(6,747)	(11)
Rent	(4,117)	(4,109)	(8)
Sales tax	(946)	(1,100)	154
Deposits	(89)	(312)	222
Pre-filing related payments	(1,113)	(1,106)	(7)
Other	(3,101)	(4,189)	1,088
Amounts paid to Century (Note 2)	(7,862)	-	(7,862)
	<b>(31,354)</b>	<b>(24,974)</b>	<b>(6,380)</b>
<b>Cash Flow from Operations</b>	<b>18,515</b>	<b>15,847</b>	<b>2,667</b>
CAPEX	-	(120)	120
Professional fees	(1,505)	(2,718)	1,213
Interest / Forbearance fee	(464)	(305)	(159)
<b>Net Cash Flow</b>	<b>16,546</b>	<b>12,704</b>	<b>3,841</b>
<b>Bank Position</b>			
Opening Bank Exposure (Note 3)	(14,270)	(14,443)	173
<b>Closing Bank Position</b>	<b>2,276</b>	<b>(1,739)</b>	<b>4,014</b>
Opening balance	\$ (2,344)	\$ (2,344)	\$ -
(Opened) / Cancelled	(637)	(1,473)	835
Drawn	2,647	2,899	(252)
<b>LCs (Spring orders)</b>	<b>(334)</b>	<b>(917)</b>	<b>583</b>
<b>Total Bank Position</b>	<b>\$ 1,942</b>	<b>\$ (2,656)</b>	<b>\$ 4,598</b>
<b>Notes:</b>			
(1)	"Revised Cash Flow Forecast" as defined in and attached to the Second Report of the Monitor		
(2)	Cash received on behalf of Century and Amounts paid to Century relate to credit card receipts for stores being liquidated by Century services under an agency agreement.		
(3)	Adjustments to opening balances previously reported include cancellation of certain outstanding cheques during the post filing period.		

<sup>1</sup> The date of the Initial Order was October 21, 2011; however, the first week of the Revised Cash Flow Statement includes a forecast for the week of October 16<sup>th</sup> through 22<sup>nd</sup>, 2011 which captures the date of the Initial Order.

4.3 In summary, the Company has experienced a net favourable cash flow variance of approximately \$4.6 million for the 15 week period ended January 28, 2012. The principal components of the net favourable variance are described below:

- a) sales receipts – the negative variance of \$785,000 relates primarily to lower than expected sales receipts during the 2011 holiday season;
- b) cash received on behalf of Century – the positive variance of \$8.8 million relates to cash received from credit card and debit card transactions at the Closing Stores that are received in the Company's bank account and then disbursed to Century net of certain withholdings. The Company has paid Century \$7.9 million as at January 28, 2012 and owes a further \$163,000 after adjustments for rent and other expenses paid by the Company on behalf of Century;
- c) inventory liquidation – the positive variance of approximately \$1 million relates to receipt of the balance of the net guaranteed minimum owed to the Company by Century under the term of the Agency Agreement;
- d) sales tax – the positive variance of \$154,000 primarily relates to timing differences with respect to sales tax remittances;
- e) deposits – the positive variance of \$222,000 relates to timing differences as well as fewer vendors requiring deposits than expected;
- f) other – the favourable variance of \$776,000 is due to timing differences as well as lower than expected costs for marketing, information technology, supplies and other sales, general and administrative expenses;
- g) professional fees – the favourable variance of \$1.2 million relates primarily to lower than estimated professional fees being incurred; and
- h) interest and forbearance fees – the unfavourable variance of \$159,000 relates to higher than expected fees payable under the Forbearance Agreement.

## 5.0 **UPDATE ON THE COMPANY'S RESTRUCTURING EFFORTS**

5.1 The Company has undertaken a number of strategic operational and financial restructuring activities pursuant to the terms of the December 9 Order, including:

## **Store Closures and Liquidation**

- a) As at the date of this Third Report the Company has nearly completed the liquidation of stock in 53 retail store locations (the “**Closing Stores**”). To date, net proceeds of \$8.6 million arising from the liquidation have been paid to the Company pursuant to the terms of the Agency Agreement with Century.
- b) Notices of Disclaimer or Resiliation (“**NOD**”) of leases relating to the Closing Stores have been dispatched to 36 landlords with the remaining 17 leases subject to either term expiry or mutually agreed surrenders and/or assignment of leases. To date, no objections to the NOD’s have been received by the Company or the Monitor.
- c) The Monitor is advised that Century will be vacating the final Closing Stores by February 29, 2012 in accordance with the terms of the Agency Agreement. Century appears to be in compliance with the commercial terms of the Agency Agreement.

## **Employees**

- d) As a result of the store closures, approximately 370 full-time and part-time store personnel have been made redundant. Management also restructured its head office or corporate management team in January 2012 which resulted in the termination of the employment of an additional 20 employees.

## **Sale and Investment Solicitation Process**

- e) The background to the engagement of Capital West Partners (“CapWest”) by a special committee of Sterling’s Board of Directors (the “**Special Committee**”) is set out in the Monitor’s Second Report.
- f) Since December 9, 2011, CapWest has continued with its engagement and has approached and held discussions with various potential investors and interested parties regarding a potential equity investment and/or purchase of the Company’s business and assets. Specifically, CapWest has:
  - i. contacted 72 prospective purchasers/investors, including both strategic and financial investors from Canada, the U.S. and Europe;
  - ii. received 23 executed non-disclosure agreements from interested parties and these interested parties have been given access to the electronic data room;
  - iii. received and responded to specific enquiries from interested parties;

- iv. held individual management presentations with a select number of potential purchasers/investors during January and February 2012; and
  - v. issued bid instruction letters to a select number of purchasers/investors inviting them to submit non-binding first round offers in a prescribed format by February 10, 2012. Letters of intent and/or expressions of interest have been received and are currently being reviewed by the Company and its advisors.
- g) During the period since its Second Report, the Monitor has overseen the SISP. This has involved receiving copies of all material transaction documents in advance of their release to interested parties, obtaining regular updates from CapWest on the sales process, being invited to all material external meetings with interested parties and receiving copies of all correspondence with interested parties.
- h) The SISP is progressing according to timelines set out in the Monitor's Second Report and the Monitor understands that the Company remains optimistic that it will be in a position to close a transaction in the March-April 2012 period subject to Court approval.

## **6.0 CONCLUDING COMMENTS**

- 6.1 It is the Monitor's view that the Company continues to act in good faith and with due diligence and has made significant progress with its restructuring efforts in the period of time since the commencement of the CCAA Proceedings.
- 6.2 Since the date of the Initial Order, the Company appears to have met its obligations in the normal course including payment of amounts due on account of the salaries and wages of its employees, statutory remittances for employee withholdings and exigible sales taxes, realty lease payments and trade vendor payments, a significant portion of which have been on a cash in advance basis.
- 6.3 The Monitor is not aware of any material variances from the Revised Cash Flow Statement that have not been sufficiently explained and/or are not reasonable in the circumstances. In addition, the Company remains in compliance with the terms of the Forbearance Agreement with BMO.
- 6.4 The Company and its financial advisor, CapWest, have progressed the SISP to a stage where indicative bids have now been received from a number of interested parties. The SISP appears to be tracking to the timelines referenced in the Monitor's Second Report (refer to Appendix C). The Monitor is satisfied that the SISP has been undertaken fairly and in accordance with the agreed processes as outlined by CapWest.



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All of which is respectfully submitted to this Honourable Court this 15th day of February, 2012.

**Alvarez & Marsal Canada Inc.,  
in its capacity as Monitor of Sterling Shoes Inc.  
and Sterling Shoes GP Inc.**

A handwritten signature in black ink, appearing to read 'Todd M. Martin', with a stylized flourish at the end.

Todd M. Martin  
Senior Vice President