

No. S-
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985,

c. C36, 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.

REPORT OF THE PROPOSED MONITOR

ALVAREZ & MARSAL CANADA INC.

OCTOBER 21, 2011

**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985,
c. C36, 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.**

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1.0 INTRODUCTION

- 1.1 Alvarez & Marsal Canada Inc. ("**A&M**") has been advised that Sterling Shoes, Inc. ("**Sterling**") and Sterling Shoes GP Inc. ("**Sterling GP**") (together, the "**Petitioners**") intend to bring an application before this Honourable Court seeking certain relief under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "**CCAA**") granting, *inter alia*, a stay of proceedings against or in respect of the Petitioners (and Sterling Shoes Limited Partnership ("**Sterling LP**")) until November 18, 2011 and appointing A&M as Monitor. Sterling, Sterling GP and Sterling LP will be collectively referred to herein as the "**Company**". The proceedings to be commenced by the Petitioners under the CCAA will be referred to herein as the "**CCAA Proceedings**".
- 1.2 An overview of the Company's business, its financial position including its assets and liabilities, the causes and nature of its financial difficulties and insolvency and the need for relief under the CCAA are as outlined in the Petition to Court dated October 21, 2011 (the "**Petition**") and the affidavit of Daniel Gumprich sworn October 20, 2011 (the "**Gumprich Affidavit #1**") filed in these proceedings (both of which A&M has reviewed) and are not repeated herein.

2.0 PURPOSE OF REPORT

- 2.1 The purpose of this report is to provide this Honourable Court with select information in respect of the CCAA Proceedings including certain provisions of the draft form of Order (the "**Initial Order**") attached to the Petition brought by the Petitioners as well as other related matters including:
- a) Appointment of Monitor;
 - b) Terms of reference;
 - c) Cash flow forecast;
 - d) Existing credit agreement and forbearance agreement; and
 - e) Proposed court ordered charges.

3.0 APPOINTMENT OF MONITOR

- 3.1 A&M was engaged by the Company on September 30, 2011 to provide consulting services to Sterling management and the Special Committee of Sterling's Board of Directors in connection with the Company's assessment of its strategic and restructuring alternatives. A&M has also provided assistance to the Company in preparing for its filing under the CCAA.
- 3.2 A&M is a trustee within the definition of subsection 2(1) of the *Bankruptcy and Insolvency Act (Canada)* (the "**BIA**") and accordingly, A&M meets the requirements of section 11.7 of the CCAA. In addition, A&M confirms that it is not restricted from acting as Monitor in the CCAA Proceedings by section 11.7(2) of the CCAA as neither A&M nor any of its affiliates, officers and directors have at any time in the two preceding years, been the auditor or a director, officer or

employee of the Petitioners, and A&M is not otherwise related to the Petitioners or to any director or officer of the Petitioners or a trustee under a trust indenture issued by any of the Petitioners or any person related to the Petitioners.

- 3.3 A&M has consented to act as Monitor in the CCAA Proceedings should this Honourable Court grant the Petitioners' request for relief under the CCAA.

4.0 TERMS OF REFERENCE

- 4.1 In preparing this report, A&M has necessarily relied upon unaudited financial and other information supplied, and representations made to it, 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 attempted to verify the accuracy or completeness of any of the information prepared by Management or otherwise provided by the Company. 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 report.
- 4.2 Certain of the information referred to in this 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 those forecasts and/or projections, even if the assumptions materialize, and the variations could be significant.
- 4.3 Capitalized terms not defined in this report are as defined in the Gumprich Affidavit #1 filed in support of the Petitioners' application for relief under the CCAA.
- 4.4 Unless otherwise stated, all monetary amounts contained in this report are expressed in Canadian dollars.

5.0 CASH FLOW FORECAST

- 5.1 In accordance with section 10(2) of the CCAA, the Company has prepared a weekly cash flow forecast of its receipts and disbursements for the eleven week period ending December 31, 2011 (the "**Cash Flow Statement**"). In preparing the Cash Flow Statement, Management has adopted the probable and hypothetical assumptions set out in accompanying notes to the Cash Flow Statement.
- 5.2 A copy of the Cash Flow Statement and accompanying notes thereto as well as a copy of the signed letter from the Company to A&M containing the prescribed representations of the Company regarding the preparation of the Cash Flow Statement, are attached hereto as Appendix "**A**".

5.3 In summary and as indicated in the Cash Flow Statement:

- a) Total cash receipts forecast from the sales of inventory (including applicable sales taxes) during the eleven week period ending December 31, 2011 (the “**Forecast Period**”) are approximately \$30.6 million;
- b) Total payments to trade vendors are forecast to be approximately \$4.4 million for the Forecast Period and it is assumed that a number of trade vendors will insist on more restrictive trade terms including in some cases, COD terms;
- c) Payroll and payroll remittances (for both store and corporate employees) and store rent is forecast to be consistent with historical levels and will be approximately \$4.6 million and \$3.4 million, respectively, for the Forecast Period;
- d) Statutory sales tax remittances are forecast to be maintained on a current basis throughout the Forecast Period and pre-filing liabilities for sales taxes will be paid during the Forecast Period in accordance with paragraph 8(b) of the Initial Order;
- e) Forecast deposits and pre-filing related payments total approximately \$200,000 and \$854,000, respectively, and relate to potential pre-payments that may be required after the commencement of the CCAA Proceedings and accrued customs brokerage fees and certain freight charges, respectively;
- f) Other operating expenses of \$4.2 million relate to general overhead costs as well as a draw down of a stand-by letter of credit in the amount of \$1.5 million which secures the supply of certain trade vendors and expires December 31, 2011;
- g) Net cash flow from operations estimated for the Forecast Period is approximately \$11.7 million before anticipated professional fees, restructuring costs and interest; and
- h) Forecast bank indebtedness including outstanding letters of credit is expected to be reduced by approximately \$8.7 million during the Forecast Period with a forecast balance at December 31, 2011 of approximately \$8.0 million.

5.4 While not reflected on the Cash Flow Statement, the net book value of the Company’s inventories during the Forecast Period are estimated to reduce from approximately \$39.9 million as at October 16, 2011 to approximately \$29.8 million as at December 31, 2011.

5.5 A&M has undertaken a review of the Cash Flow Statement in our capacity as proposed Monitor of the Company. The Cash Flow Statement has been prepared by Management for the purpose described in the Initial Order, using the probable and hypothetical assumptions set out in notes attached as Appendix A.

5.6 A&M’s review consisted of inquiries, analytical procedures and discussions related to information supplied to us by certain Management and employees of the Company. Since hypothetical assumptions need not be supported, our procedures with respect to them were

limited to evaluating whether they were consistent with the purpose of the Cash Flow Statement. We have also reviewed the information and documents provided by Management of the Company in support of the probable assumptions, as well as the preparation and presentation of the Cash Flow Statement.

- 5.7 Based on our review, nothing has come to our attention that causes us to believe that, in all material respects:
- a) the hypothetical assumptions are not consistent with the purpose of the Cash Flow Statement;
 - b) as at the date of this report, the probable assumptions developed by Management are not suitably supported and consistent with the plans of the Company or do not provide a reasonable basis for the Cash Flow Statement, given the hypothetical assumptions; or
 - c) the Cash Flow Statement does not reflect the probable and hypothetical assumptions.

5.8 Since the Cash Flow Statement is based on assumptions regarding future events, actual results will vary from the information presented even if the hypothetical assumptions occur, and the variations may be material. Accordingly, A&M expresses no assurance as to whether the Cash Flow Statement will be achieved.

5.9 The Cash Flow Statement has been prepared solely for purposes described in Note 1 of the Cash Flow Statement and readers are cautioned that it may not be appropriate for any other purpose.

6.0 EXISTING CREDIT AGREEMENT AND FORBEARANCE AGREEMENT

- 6.1 The Company's principal senior secured lender is Bank of Montreal ("BMO"), which have extended to Sterling LP as borrower, and Sterling GP and Sterling as guarantors, a secured credit facility, as amended, which provides a maximum aggregate availability of \$20.0 million (the "**Existing Credit Agreement**"). The Existing Credit Agreement is more fully described in the Petition.
- 6.2 As described in the Petition, on October 20, 2011, the Company and BMO concluded negotiations as to the terms and conditions of a forbearance agreement (the "**Forbearance Agreement**"). Pursuant to the Forbearance Agreement, BMO will continue to provide availability under the Existing Credit Agreement to Sterling LP, including an overadvance limit of up to \$2.5 million, on the terms and conditions set out in the Existing Credit Agreement, as amended by the Forbearance Agreement.
- 6.3 The Forbearance Agreement expires on December 31, 2011 (or such earlier time as provided in the Forbearance Agreement). A&M is advised that BMO and the Company intend to continue discussions and commence negotiations on extending the availability beyond December 31, 2011 based on revised cash flow forecasts to be prepared by the Company and various operational restructuring plans currently being formulated by Management.

- 6.4 Under the Forbearance Agreement, BMO's consent is required with respect to a number of operating matters including any future disclaimers of realty leases by the Company and any operational restructuring plans developed by the Company.
- 6.5 The Forbearance Agreement includes *inter alia*, provisions that BMO would be an unaffected creditor in the CCAA Proceedings and any plan of compromise or arrangement and that the borrower and guarantors do not dispute the validity and enforceability of the security underlying the Existing Credit Agreement. In addition, the Forbearance Agreement includes a confirmation and acknowledgement by the Company that they have agreed to a waiver of the requirement of a notice of intention to enforce security issued under section 244 of the BIA and that BMO can enforce all of its rights under its security underlying the Existing Credit Agreement upon five (5) days written notice to the Company upon the occurrence or existence of a 'Terminating Event' (as defined in the Forbearance Agreement").
- 6.6 A&M's legal counsel have undertaken a review of the BMO security supporting the Existing Credit Agreement and provided an opinion that subject to customary assumptions and provisos, the security is valid and enforceable in all jurisdictions in Canada where secured assets are located and constitutes a valid charge on those assets. In most instances, it is the only registered charge of any significance and where it is not, it would only be subject to the interests of creditors holding purchase money security interests in specific equipment.

7.0 PROPOSED COURT ORDERED CHARGES

- 7.1 The draft Initial Order provides for an Administration Charge and a Directors' and Officers' Charge of \$500,000 and \$1.5 million, respectively. BMO has consented to the quantum and the priority (refer to comments in paragraph 7.7 below) of the proposed Court ordered charges.

Administration Charge

- 7.2 The Petitioners have proposed that the Monitor, counsel to the Monitor, counsel to the Petitioners and the Petitioners' financial advisors shall be entitled to the benefit of a charge ("**Administration Charge**") on the property of the Company up to the aggregate amount of \$500,000 as security for such parties' fees and disbursements both before and after the making of the Initial Order. The Administration Charge is in addition to retainers that have already been provided to the aforementioned parties.
- 7.3 The amount of the Administration Charge sought by the Petitioners was determined after consideration by the Petitioners and their legal and financial advisors of the particular circumstances surrounding the Company's planned restructuring under the CCAA and experience with other restructurings of similar scale and complexity. BMO has made it a condition of the Forbearance Agreement and the Company has agreed that \$150,000 of the total Administration Charge of \$500,000 be subordinate to their security. A&M is of the view that the amount of the Administration Charge and the priority sought for such charge are appropriate and reasonable in the circumstances.

Directors' and Officers' Charge

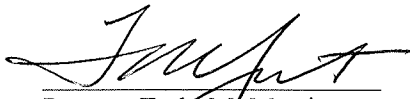
- 7.4 It is also proposed by the Petitioners that its Directors and Officers be granted a charge ("**D&O Charge**") on the property of the Company up to an amount of \$1.5 million as security for the Company's obligation to indemnify its Directors and Officers for any obligations and liabilities they may incur after the commencement of the CCAA Proceedings except to the extent such obligation or liability was incurred as a result of gross negligence or wilful misconduct.
- 7.5 A&M has been advised that the Company holds an insurance policy in respect of potential claims against its Directors and Officers ("**D&O Insurance**"). Legal counsel for A&M has reviewed the policy of insurance obtained by the Company, and it appears that while the D&O Insurance provides coverage in respect of statutory and other liabilities that might arise in the CCAA Proceedings, there are a number of exclusions that create at least some degree of uncertainty as to whether there is coverage for all such liabilities. In particular, the D&O Insurance is based on certain representations and coverage is excluded if those representations whether innocently made or not, are untrue. Accordingly, A&M is satisfied that additional protection through a D&O Charge is appropriate.
- 7.6 The amount of the D&O Charge was estimated by Management after taking into account potential claims for unpaid wages and salaries, employee benefits, vacation pay, severance payments (should any arise) and sales taxes. BMO has made it a condition of the Forbearance Agreement, and the Company has agreed, that \$1.0 million of the total D&O Charge of \$1.5 million be subordinate to their security. A&M is of the view that the amount of the D&O Charge and the priority sought for such charges are appropriate and reasonable in the circumstances.


Priority of Proposed Court Ordered Charges

- 7.7 The Petitioners propose that the relative priority of the Administration Charge and the D&O Charge be as follows:
- a) First – Administration Charge to the maximum of \$350,000,
 - b) Second – D&O Charge to a maximum of \$500,000,
 - c) Third – Any existing liens, charges, security interests or other encumbrances securing the obligations of the Company to BMO under the Existing Credit Agreement and/or Forbearance Agreement,
 - d) Fourth – Administration Charge to a maximum of \$150,000, and
 - e) Fifth – D&O Charge to maximum of \$1.0 million.
- 7.8 A&M is of the view that the relative priorities of the Court ordered charges should they be granted by this Honourable Court, are appropriate and reasonable in the circumstances.

All of which is respectfully submitted to this Honourable Court this 21st day of October, 2011.

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


Per: Todd M. Martin
Senior Vice President


Per: Pam K. Boparai
Vice President

APPENDIX A

Sterling Shoes Inc., Sterling Shoes GP Inc. and Sterling Shoes Limited Partnership
Consolidated Cash Flow Forecast
For the Eleven Week Period from October 16 to December 31, 2011
(CDN \$000's)

Week	1	2	3	4	5	6	7	8	9	10	11	1-11	TOTAL		
For the Week ending	15-Oct	22-Oct	29-Oct	5-Nov	12-Nov	19-Nov	26-Nov	3-Dec	10-Dec	17-Dec	24-Dec	31-Dec	Total (incl. Actual)		
Total Sales Receipts (incl. HST)	2	\$ 2,816	\$ 2,660	\$ 2,648	\$ 2,286	\$ 2,232	\$ 2,587	\$ 2,886	\$ 2,726	\$ 2,542	\$ 2,693	\$ 3,062	\$ 4,302	\$ 30,624	\$ 33,440
Disbursements															
Vendors	3	(400)	(547)	(921)	(631)	(387)	(184)	(242)	(90)	(349)	(559)	(153)	(377)	(4,440)	(4,840)
Payroll	4	(296)	-	(602)	(166)	(810)	(263)	(600)	(165)	(857)	(237)	(753)	(168)	(4,621)	(4,917)
Rent	5	-	-	(1,650)	(75)	-	-	-	(1,650)	(75)	-	(3,450)	-	(3,450)	(3,450)
Sales tax	6	-	-	-	(100)	-	-	-	(430)	-	-	(625)	-	(1,155)	(1,155)
Deposits	7	-	-	(200)	(513)	(341)	-	-	-	-	-	(200)	-	(200)	(200)
Pre-filing related payments	8	-	-	(513)	(341)	-	-	-	-	-	-	-	-	-	(854)
Other / Drawdown of accord LC	9	(303)	(131)	(182)	(288)	(183)	(238)	(182)	(232)	(209)	(293)	(293)	(1,952)	(4,183)	(4,486)
Total Disbursements		(999)	(678)	(2,418)	(3,176)	(1,455)	(685)	(1,024)	(2,567)	(1,490)	(1,089)	(1,199)	(3,122)	(18,903)	(19,902)
Cash Flow from Operations		1,817	1,982	230	(890)	777	1,902	1,862	159	1,052	1,604	1,863	1,180	11,721	13,538
Professional fees	10	(114)	(326)	(332)	(315)	(233)	(171)	(166)	(144)	(138)	(116)	(111)	(133)	(2,185)	(2,299)
Interest / Forbearance fee	11	-	(75)	(84)	-	-	-	(82)	-	-	-	-	(66)	(307)	(307)
Term Loan		-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Cash Flow		1,703	1,581	(186)	(1,205)	544	1,731	1,614	15	914	1,488	1,752	981	9,229	10,932
Bank Position															
Opening Bank Exposure		(16,146)	(14,443)	(12,862)	(13,048)	(14,253)	(13,709)	(11,978)	(10,364)	(10,349)	(9,435)	(7,947)	(6,195)	(14,443)	(16,146)
Closing Bank Position		(14,443)	(12,862)	(13,048)	(14,253)	(13,709)	(11,978)	(10,364)	(10,349)	(9,435)	(7,947)	(6,195)	(5,214)	(5,214)	(5,214)
Letters of Credit															
Opening balance	12	\$ (2,411)	\$ (2,344)	\$ (2,344)	\$ (2,344)	\$ (2,344)	\$ (2,344)	\$ (2,344)	\$ (2,344)	\$ (3,094)	\$ (3,844)	\$ (3,844)	\$ (4,344)	\$ (2,344)	(2,411)
Opened	12	-	(130)	(130)	(130)	(130)	(130)	(130)	(881)	(750)	-	(500)	-	(2,911)	(2,911)
Drawn	12	67	130	130	130	130	130	130	131	-	-	1,500	-	2,411	2,478
Closing Letters of Credit		(2,344)	(2,344)	(2,344)	(2,344)	(2,344)	(2,344)	(2,344)	(3,094)	(3,844)	(3,844)	(4,344)	(2,844)	(2,844)	(2,844)
Total Bank Position		\$ (16,787)	\$ (15,206)	\$ (15,392)	\$ (16,597)	\$ (16,053)	\$ (14,322)	\$ (12,708)	\$ (13,443)	\$ (13,279)	\$ (11,791)	\$ (10,539)	\$ (8,058)	\$ (8,058)	(8,058)

Daniel Camptrich
Daniel Camptrich
Chief Financial Officer

October 30, 2011
Date

Notes:
See following page

Sterling Shoes Inc, Sterling Shoes GP Inc. and Sterling Shoes Limited Partnership
Consolidated Cash Flow Forecast
For the Eleven Week Period from October 16 to December 31, 2011

Notes:

- 1 The purpose of this Cash Flow Statement is to set out the liquidity requirements of Sterling Shoes Inc, Sterling Shoes GP Inc. and Sterling Shoes Limited Partnership during the CCAA Proceedings. Since projections are based on assumptions regarding future events, actual results will vary from the information presented, and the variations may be material.
- 2 Cash receipts are based on estimated sales for the remainder of 2011. These estimates were calculated using actual weekly sales for 2010 with appropriate adjustments to reflect the recent sales activities at the Company's stores and the sale of excess inventory which took place in October 2010. Cash receipts also assume that the Company will continue to purchase inventory throughout the period. Cash receipts include HST collected.
- 3 Payments to vendors are based on the expected delivery dates for purchase orders currently open.
- 4 Payroll payments are based on recent payroll expenses with appropriate adjustments for the expected increased sales activity during the December 2011 holiday season. These amounts include payroll withholding taxes and other employee related expenses.
- 5 Rent payments are based on ongoing monthly lease obligations to landlords. The above noted forecast assumes that all stores remain open during the 11 week period.
- 6 Sales tax payments are based on the sales tax collected and net of input tax credits based on an 11% effective HST/GST rate across all provinces in which the Company operates.
- 7 Deposits include additional security deposits for suppliers of utility services.
- 8 Pre-filing payments include among other things, customs brokerage and freight payments to suppliers which are expected to be paid in order that goods can be released.
- 9 Other expenses include selling, general and administrative expenses. These expenses include travel, recurring professional fees (audit and tax), head office rent and communication expenses and insurance. These estimates have been forecast based on recent levels of monthly expenses and assumed to be spread evenly across each month and paid each week. The week of December 31 includes the drawdown of a \$1.5m standby letter of credit which expires on 31 December 2011.
- 10 Professional fees relating to the filing are based on estimates provided by advisors of the Company and the secured lender for consulting and legal services as well as those of the monitor.
- 11 Interest and forbearance fees include bank interest and fees relating to the forbearance agreement recently entered into with Bank of Montreal.
- 12 Letters of credit are based on those currently open and as well as new letters of credit which may be required to place future orders.



October 20, 2011

Alvarez & Marsal Canada Inc.
Suite 1680, 400 Burrard Street
Commerce Place
Vancouver, BC

Attention: Todd M. Martin

Dear Sirs

**Re: Proceedings under the *Companies' Creditors Arrangement Act* ("CCAA")
Responsibilities/Obligations and Disclosure with Respect to Cash Flow
Projections**

In connection with the application by Sterling Shoes Inc and Sterling Shoes GP Inc. ("**Sterling**") for the commencement of proceedings under the CCAA in respect of Sterling, including a stay of all proceedings against Sterling Shoes Limited Partnership ("**LP**"), the management of Sterling and LP (collectively the "**Company**") have prepared the attached Cash-Flow Statement and the assumptions on which the Cash-Flow Statement is based.

The Company confirms that:

1. the Cash-Flow Statement and the underlying assumptions are the responsibility of the Company;
2. all material information relevant to the Cash-Flow Statement and to the underlying assumptions has been made available to Alvarez & Marsal Canada Inc. in its capacity as proposed Monitor or Monitor; and
3. Management of the Company has taken all actions that it considers necessary to ensure:
 - a. That the individual assumptions underlying the Cash-Flow Statement are appropriate in the circumstances; and
 - b. That the individual assumptions underlying the Cash-Flow Statement, taken as a whole, are appropriate in the circumstances.

Yours Truly,

A handwritten signature in dark ink, appearing to read "Daniel Gumprich", written over a horizontal line.

Daniel Gumprich
Chief Financial Officer

(Authorized director or officer of Sterling Shoes Inc., Sterling Shoes GP Inc. and Sterling Shoes Limited Partnership)