

## 6. Liquidity and Capital Resources

### 6.1 Cash Flows

#### Major Cash Flow Components

(\$ millions)	2006 (52 weeks)	2005 (52 weeks)	Change
Cash flows from (used in):			
Operating activities	\$ 1,180	\$ 1,489	\$ (309)
Investing activities	\$ (1,308)	\$ (903)	\$ (405)
Financing activities	\$ (120)	\$ (208)	\$ 88

### Cash Flows from Operating Activities

2006 cash flows from operating activities decreased to \$1.2 billion compared to \$1.5 billion in 2005. The change in cash flows from operating activities for the year is mainly due to the decrease in operating income.

### Cash Flows used in Investing Activities

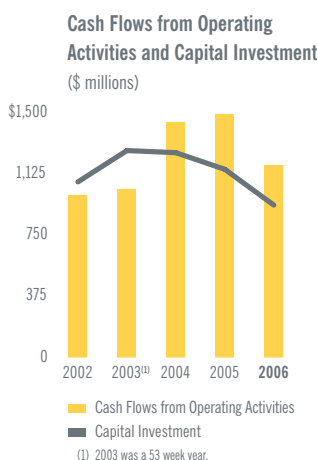
2006 cash flows used in investing activities were \$1.3 billion compared to \$0.9 billion in 2005. During 2005, proceeds were received from the sale of a portfolio of third-party long term loans receivable as described in the Related Party Transactions section of this MD&A. In addition, capital expenditures declined \$219 million and the longer term to maturity profile of the Company's short term investments portfolio resulted in a shift to short term investments from cash and cash equivalents.

Capital investment amounted to \$0.9 billion (2005 – \$1.2 billion) for the year as the Company continued to maintain and renew its asset base and invest for growth. Approximately 79% (2005 – 82%) of the capital investment was for new stores, renovations or expansions. The continued capital investment activity benefited all regions in varying degrees and strengthened the existing store base. Some of the new, larger stores replaced older, smaller, less efficient stores that did not offer the broad range of products and services demanded by today's consumer. The remaining 21% (2005 – 18%) of the capital investment was for the warehouse and distribution network, information systems and other infrastructure required to support store growth. Levels of capital investment in 2007 are expected to be lower than in previous years as a result of the Company's desire to fully prove store format economics before building new stores.

The 2006 corporate and franchised store capital investment program, which includes the impact of store openings and closures, resulted in an increase in net retail square footage of 2.5% over 2005. During 2006, 37 (2005 – 69) new corporate and franchised stores were opened and 147 (2005 – 77) underwent renovation or minor expansion. The 37 new stores, net of 33 (2005 – 57) store closures, added 1.2 million square feet of retail space (2005 – 2.8 million). The 2006 average corporate store size increased 2.3% to 57,400 square feet (2005 – 56,100) and the average franchised store size increased 1.1% to 27,400 square feet (2005 – 27,100).

At year end 2006, the Company had committed approximately \$153 million (2005 – \$264 million) with respect to capital investment projects such as the construction, expansion and renovation of buildings and the purchase of real property.

During 2006, the Company also generated \$99 million (2005 – \$109 million) from fixed asset sales.



## Management's Discussion and Analysis

### Capital Investment and Store Activity

	2006 (52 weeks)	2005 (52 weeks)	Change
Capital investment (\$ millions)	\$ 937	\$ 1,156	\$ (219)
Retail square footage (in millions)	49.7	48.5	2.5%
Average store size (sq. ft.)			
Corporate	57,400	56,100	2.3%
Franchised	27,400	27,100	1.1%

### Cash Flows used in Financing Activities

Cash flows used in financing activities decreased to \$120 million in 2006 compared to \$208 million in 2005 mainly due to the 2006 fourth quarter dividend payment occurring after year end.

During the second quarter of 2006, the Company repaid its \$125 million of 8.70% Series 1996 Provigo Inc. Debenture as it matured.

During 2005, the Company's 2003 Base Shelf Prospectus expired and a new Base Shelf Prospectus was filed allowing for the issue of up to \$1.0 billion of aggregate Medium Term Notes ("MTN"), all of which remains available.

The Company intends to renew its Normal Course Issuer Bid ("NCIB") to purchase on the Toronto Stock Exchange or enter into equity derivatives to purchase up to 5% of its common shares outstanding. No shares were purchased for cancellation in 2006 under the NCIB (2005 – 226,100).

### 6.2 Sources of Liquidity

The Company can obtain its short term financing through a combination of cash generated from operating activities, cash, cash equivalents, short term investments, bank indebtedness and its commercial paper program. The Company's cash, cash equivalents and short term investments, as well as \$845 million in uncommitted operating lines of credit extended by several banks, support its \$1.2 billion commercial paper program. The Company's commercial paper borrowings generally mature less than three months from the date of issuance although the terms can be up to 364 days.

Securitization of credit card receivables provides *President's Choice Bank* ("PC Bank"), a wholly owned subsidiary of the Company, with an additional source of funds for the operation of its business. Under PC Bank's securitization program, a portion of the total interest in the credit card receivables is sold to independent trusts. In 2006, PC Bank restructured its credit card securitization program and Eagle Credit Card Trust ("Eagle"), a previously established independent trust, issued \$500 million of five year senior notes and subordinated notes due 2011 at a weighted average rate of 4.5%. The restructuring of the portfolio yielded a nominal net loss. PC Bank securitized an aggregate \$240 million of credit card receivables during 2006 (2005 – \$225 million). Information on PC Bank's credit card receivables and securitization is provided in Notes 1 and 11 to the consolidated financial statements and in the Off-Balance Sheet Arrangements section of this MD&A.

The Company obtains its long term financing through its MTN program. The Company plans to refinance existing long term debt as it matures.

In the normal course of business, the Company establishes standby letters of credit used in connection with certain obligations related to the financing program for its independent franchisees, securitization of *PC Bank*'s credit card receivables, real estate transactions and benefit programs. At year end, the aggregate gross potential liability related to the Company's standby letters of credit was approximately \$333 million (2005 – \$276 million) against which the Company had \$371 million (2005 – \$316 million) in credit facilities available to draw on.

It is the intention of the Company to enter into a committed credit facility expected to be extended by several banks in the amount of \$500 million for general corporate purposes and to support the Company's commercial paper program.

The Company has the following sources from which it can fund its 2007 cash requirements:

- cash flows generated from operating activities;
- cash, cash equivalents, and short term investments;
- commercial paper program;
- MTN program; and
- additional credit card receivable securitizations from future growth in the *PC Bank* credit card operations.

During the third quarter of 2006, the Company's MTN and debentures were downgraded by Dominion Bond Rating Service ("DBRS") to "A" from "A (high)" and the commercial paper rating was confirmed at "R-1 (low)". In both cases, the trend was changed to "stable" from "negative". During the fourth quarter of 2006, the Company's long term corporate credit and commercial paper ratings were downgraded by Standard & Poor's ("S&P") to "A-" from "A" and to "A-1 (low)" from "A-1 (mid)", respectively. The Company was removed from CreditWatch with negative implications and the outlook was changed to "stable".

Subsequent to year end, DBRS placed the Company's MTN and debentures Under Review with Negative Implications and at the same time, confirmed the Company's commercial paper rating at its current level with a "stable" trend; and S&P placed the Company's long term corporate credit and commercial paper ratings on CreditWatch with negative implications. Although a further rating decline will increase borrowing costs, the Company anticipates no difficulty in obtaining external financing based on past experience and the expectation of stable market conditions.

The Company's current credit ratings are outlined in the table below:

Credit Ratings (Canadian Standards)

	Dominion Bond Rating Service	Standard & Poor's
Commercial paper	R-1 (low)	A-1 (low)
Medium term notes	A	A-
Other notes and debentures	A	A-

The rating organizations listed above base their credit ratings on quantitative and qualitative considerations. These credit ratings are intended to give an indication of the risk that the Company will not fulfill its obligations in a timely manner.

### 6.3 Contractual Obligations

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at December 30, 2006:

#### Summary of Contractual Obligations

(\$ millions)	Payments due by year						Total
	2007	2008	2009	2010	2011	Thereafter	
Long term debt (including capital lease obligations)	\$ 27	\$ 420	\$ 148	\$ 319	\$ 369	\$ 2,956	\$ 4,239
Operating leases <sup>(1)</sup>	190	178	156	134	114	720	1,492
Contracts for purchases of real property and capital investment projects <sup>(2)</sup>	145	4	4				153
Purchase obligations <sup>(3)</sup>	735	660	562	562	561	358	3,438
<b>Total contractual obligations</b>	<b>\$ 1,097</b>	<b>\$ 1,262</b>	<b>\$ 870</b>	<b>\$ 1,015</b>	<b>\$ 1,044</b>	<b>\$ 4,034</b>	<b>\$ 9,322</b>

(1) Represents the minimum or base rents payable. Amounts are not offset by any expected sub-lease income.

(2) These obligations include agreements for the purchase of real property. These agreements may contain conditions that may or may not be satisfied. If the conditions are not satisfied, it is possible the Company will no longer have the obligation to proceed with the transaction. These obligations also include commitments with respect to capital investment projects, such as the construction, expansion and renovation of buildings.

(3) These include material contractual obligations to purchase goods or services where the contract prescribes fixed or minimum volumes to be purchased or payments to be made within a fixed period of time for a set or variable price. These are estimates of anticipated financial commitments and the amount of actual payments may vary. The purchase obligations do not include purchase orders issued in the ordinary course of business for goods which are meant for resale, nor do they include any contracts which may be terminated on relatively short notice or with insignificant cost or liability to the Company. Also excluded are purchase obligations related to commodities or commodity-like goods for which a market for resale exists. The Company believes such excluded contracts do not have a material impact on its liquidity.

At year end, the Company had other long term liabilities which included accrued benefit plan liability, future income taxes liability and stock-based compensation liability. These long term liabilities have not been included in the table for the following reasons:

- future payments of accrued benefit plan liability, principally post-retirement benefits, depend on when and if retirees submit claims;
- future payments of income taxes depend on the levels of taxable earnings and income tax rates;
- future payments of the share appreciation value on employee stock options depend on whether employees exercise their stock options, the market price of the Company's common shares on the exercise date and the manner in which they exercise those stock options; and
- future payments of restricted share units depend on the market price of the Company's common shares.

### 6.4 Off-Balance Sheet Arrangements

In the normal course of business, the Company enters into the following off-balance sheet arrangements:

- standby letters of credit used in connection with certain obligations mainly related to real estate transactions, and benefit programs, the aggregate gross potential liability of which is approximately \$221 million (2005 – \$143 million);
- guarantees;
- the securitization of a portion of PC Bank's credit card receivables through independent trusts;
- a standby letter of credit to an independent funding trust which provides loans to the Company's independent franchisees for their purchase of inventory and fixed assets; and
- financial derivative instruments in the form of interest rate swaps.

## Guarantees

The Company has entered into various guarantee agreements including standby letters of credit in relation to the securitization of *PC Bank's* credit card receivables and in relation to third-party financing made available to the Company's independent franchisees and obligations to indemnify third parties in connection with leases, business dispositions and other transactions in the normal course of the Company's business. For a detailed description of the Company's guarantees, see Note 21 to the consolidated financial statements.

## Securitization of Credit Card Receivables

The Company, through its wholly owned subsidiary *PC Bank*, securitizes credit card receivables through an independent trust administered by a major Canadian chartered bank and through Eagle, also an independent trust. In these securitizations, *PC Bank* sells a portion of its credit card receivables to the trusts in exchange for cash. The trusts fund these purchases by issuing debt securities in the form of asset-backed commercial paper ("ABCP") and asset-backed term notes respectively, to third-party investors. The securitizations are accounted for as asset sales only when *PC Bank* transfers control of the transferred assets and receives consideration other than beneficial interests in the transferred assets. All transactions between the trusts and *PC Bank* have been, and are expected to continue to be, accounted for as sales as contemplated by Canadian GAAP, specifically Accounting Guideline ("AcG") 12, "*Transfers of Receivables*". As *PC Bank* does not control or exercise any measure of influence over the trusts, the financial results of the trusts have not been included in the Company's consolidated financial statements.

When *PC Bank* sells credit card receivables to the trusts, it no longer has access to the receivables but continues to maintain credit card customer account relationships and servicing obligations. *PC Bank* does not receive a servicing fee from the trusts for its servicing obligations and accordingly, a servicing obligation is recorded. When a sale occurs, *PC Bank* retains rights to future cash flows after obligations to the investors in the trusts have been met, which is considered to be a retained interest. The ABCP issuing trust's recourse to *PC Bank's* assets is limited to *PC Bank's* retained interests and is further supported through a standby letter of credit provided by a major Canadian chartered bank for 9% (2005 – 9%) of the securitized amount. This standby letter of credit could be drawn upon in the event of a major decline in the income flow from or in the value of the securitized credit card receivables. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. The Company believes that the likelihood of this occurrence is remote. The subordinated notes issued by Eagle provide credit support to those notes which are more senior. The carrying value of the retained interests is periodically reviewed and when a decline in value is identified that is other than temporary, the carrying value is written down to fair value.

As at December 30, 2006, the total amount of securitized credit card receivables outstanding which *PC Bank* continues to service was \$1.25 billion (2005 – \$1.01 billion) and the associated retained interests amounted to \$5 million (2005 – \$5 million). The standby letter of credit supporting a portion of these securitized receivables amounted to approximately \$68 million (2005 – \$91 million). During 2006, *PC Bank* received income of \$116 million (2005 – \$106 million) in securitization revenue from the independent trusts relating to the securitized credit card receivables. In the absence of securitization, the Company would be required to raise alternative financing by issuing debt or equity instruments. Further disclosure regarding this arrangement is provided in Notes 11 and 21 to the consolidated financial statements.

## Independent Funding Trust

Independent franchisees of the Company may obtain financing through a structure involving independent trusts which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixturing and equipment. These trusts are administered by a major Canadian chartered bank. The independent funding trust within the structure finances its activities through the issuance of ABCP to third-party investors. The total amount of loans issued to the Company's independent franchisees outstanding as of December 30, 2006 was \$419 million (2005 – \$420 million) including \$124 million (2005 – \$126 million) of loans payable of VIEs consolidated by the Company in 2006. Based on a formula, the Company has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, \$44 million (2005 – \$42 million) as of December 30, 2006. This credit enhancement allows the independent funding trust to provide favourable financing terms to the Company's independent franchisees. In the event that

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an independent franchisee defaults on its loan and the Company has not, within a specified time period, assumed the loan or the default is not otherwise remedied, the independent funding trust may assign the loan to the Company and draw upon this standby letter of credit. The Company has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. No amount has ever been drawn on the standby letter of credit. The Company believes it would be able to fully recover from the independent franchisee any amounts it had reimbursed to the issuing bank. Neither the independent funding trust nor the Company can voluntarily terminate the agreement prior to December 2009, and following that date only upon six months' prior notice. Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required including a credit rating downgrade of the Company below a long term credit rating of A (low) issued by DBRS. If the arrangement is terminated, the independent franchisees would be required to replace the loans provided by the independent funding trust with alternative financing. The Company is under no contractual obligation to provide funding to independent franchisees under such circumstances. In accordance with Canadian GAAP, the financial statements of the independent funding trust are not consolidated with those of the Company.

### **Financial Derivative Instruments**

The Company uses off-balance sheet financial derivative instruments to manage its exposure to changes in interest rates. For a detailed description of the Company's off-balance sheet financial derivative instruments and the related accounting policies, see Notes 1 and 20 to the consolidated financial statements.