

Management's Discussion and Analysis of Financial Condition and Results of Operations September 12, 2006

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 generally accepted accounting principles.

All statements made in the Quarterly Report, other than statements of historical fact, are forward-looking statements. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "would," "should," "guidance," "potential," "continue," "project," "forecast," "confident," "prospects," and similar expressions typically are used to identify forward-looking statements. 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. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or implied by these forward-looking statements due to a number 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 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. We expressly disclaim any intent or obligation to update these forward-looking statements, except as otherwise specifically stated by us.

Overview

With operation and distribution hubs in North America and Europe, the Company is among the largest and fastest growing vision care providers in the world. The Company has shipped over one and a half 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 streamline the value stream, bypassing middlemen to sell directly to the consumer, and achieve superior management of information and working capital. Management believes that by combining these efficiencies through multi-national operations, Coastal can maintain a competitive advantage in its market.

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 common shares. The net proceeds from the offering was used for financing further expansion, sales and marketing, and general corporate 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 \$21.1 million. On May 9, 2006, the Company's common shares began trading on the Toronto Stock Exchange.

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%.

We are focused on achieving consistent and sustainable growth through the continued development of our core businesses and carefully selected acquisitions. Our internal growth initiatives include the expansion into new markets through existing distribution hubs and the expansion of market share within existing markets. In the quarter, revenues were \$21.657 million – a new record for the Company. Our revenue growth in the third quarter of 2006 as compared to 2005, excluding the impact of currency was 16%.

The Company incurred a net loss before taxes of \$2.143 million in the third quarter of 2006. The third quarter was negatively impacted by costs associated with marketing, distribution and customer service costs for expansion into new markets, the costs of radio and catalogue campaigns in North America which should have a longer term impact on revenue growth and the impact of legal and accounting costs related to our TSX listing and proposed acquisitions that we decided not to pursue or were ongoing but not completed at the end of the quarter. These investments contributed to a loss in the operations of the North America distribution hub. Activities running through the distribution hub in Europe contributed \$1.3 million in income before income taxes on revenue of \$13.3 million.

Selected Quarterly Information (Unaudited)

Quarter Ended:	July 31, 2006	April 30, 2006	Jan. 31, 2006	Oct. 31, 2005	July 31, 2005	Apr. 30, 2005	Jan. 31, 2005	Oct. 31, 2004	July 31, 2004
Sales	\$21,657,030	\$17,603,271	\$18,409,548	\$20,820,006	\$19,817,514	\$14,854,904	\$12,036,729	\$11,726,733	\$6,996,983
Gross Profit	\$4,630,188	\$4,287,943	\$4,619,257	\$5,164,114	\$5,656,068	\$4,077,227	\$2,967,965	\$2,451,224	\$1,323,173
Net Income (loss)	(\$2,143,218)	\$100,244	\$237,198	\$216,514	\$1,200,180	\$436,374	\$243,006	\$276,220	(\$176,540)
Income tax (recovery) - current	\$194,827	\$153,803	\$88,939	(\$171,349)	\$519,271	\$55,105	\$71,569	(\$21,347)	\$ -
Income tax (recovery) - future	\$83,756	\$183,345	\$19,674	\$233,883	(\$313,899)	(\$10,409)	(\$3,278)	(\$38,045)	\$ -
Income (loss) before taxes	(\$1,864,635)	\$437,392	\$345,811	\$279,047	\$1,405,552	\$481,070	\$311,297	\$160,003	(\$119,715)
Amortization	\$331,823	\$289,919	\$260,615	\$257,377	\$228,831	\$172,225	\$174,398	\$151,689	\$14,774
Interest on long-term debt	\$3,510	\$13,814	\$15,998	\$17,797	\$22,516	\$22,984	\$35,704	\$27,678	\$15,702
Interest income	(\$303,543)	(\$285,279)	(\$86,121)	(\$80,266)	(\$76,713)	(\$44,948)	(\$5,003)	\$ -	\$ -
Stock based compensation	\$40,194	\$19,292	\$27,011	\$29,029	\$30,293	\$98,043	\$18,267	\$6,898	\$ -
EBITDA ⁽¹⁾	(\$1,792,651)	\$475,138	\$563,314	\$502,984	\$1,610,479	\$729,374	\$534,663	\$331,642	(\$146,081)

(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.

Results of Operations and Comparison of the three and nine months ended July 31, 2006 and July 31, 2005

Revenues increased 9% in the third quarter of 2006 to \$21.657 million from \$19.817 million in the third quarter of 2005. Excluding the \$1.4 million unfavourable impact of currency, the increase was \$3.2 million or 16%. This increase was due principally to core growth. Revenues increased 24% in the nine months ended July 31, 2006 to \$57.669 million from \$46.708 million in the nine months ended July 31, 2005. This increase was due to an increase of \$17.2 million or 37% from sales growth, offset, in part, by a decrease of \$6.0 million from currency.

Total order volume for the quarter was 262,719 orders, an increase of 50,648 orders or 24% over the third quarter of 2005. Orders for the nine months ended July 31, 2006 were 654,123, an increase of 162,268 or 33% over the prior year.

Gross margin declined to 21.4% in the third quarter of 2006 from 28.5% in the third quarter of 2005. Gross margin deteriorated to 23.5% in the nine months ended July 31, 2006 from 27.2% in the 2005. The deterioration was due primarily to pricing in North America, the impact of having a higher proportion of sales through more value conscious brands, the impact of expanding distribution and customer service capabilities to reflect the expansion of revenues into new markets and, to a lesser extent, the unfavourable impact of currency.

Selling, general and administrative expenses (SG&A) as a percentage of revenues increased to 30% and 25% in the third quarter and nine months ended July 31, 2006, respectively, compared with 20% and 21% in the third quarter and nine months ended July 31, 2005, respectively. This was due primarily to the costs of radio and catalogue campaigns launched in North America that should have a longer term impact on revenue growth, the impact of legal and accounting costs related to proposed acquisitions that we decided not to pursue or were ongoing but not completed at the end of the quarter, costs associated with marketing for expansion into new markets and, to a lesser extent, an increase in management salaries. During the quarter, a provision was set up in the amount of \$380,000 related to a dispute with a supplier that is now considered unlikely to be recovered.

Stock-based compensation represents a non cash expense resulting from the Company's issuance of stock options to employees and directors of the Company. We believe 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 July 31, 2006 was \$40,194 as compared to \$30,293 for the third quarter of the preceding year. Stock based compensation for the nine months ended July 31, 2006 was \$86,497 as compared to \$146,603 for the same period in the preceding year.

Earnings (loss) before interest, taxes, depreciation and amortization (EBITDA) for the third quarter and the nine months ended July 31, 2006 was (\$1.793) million and (\$0.754) million respectively, as compared to \$1.610 million and \$2.874 million for the same periods in 2005. Increased SG&A and the decline in the gross margin percentage as discussed above were only partially offset by higher gross profit derived from the higher sales revenue.

Amortization for the third quarter increased by \$102,992 from the third quarter of the previous year to \$331,823. This increase was due primarily to capital expenditures of \$384,322 on computer hardware, \$700,777 on computer software and website development and \$621,985 on leasehold improvements between May 1, 2005 and July 31, 2006. Amortization for the nine months ended July 31, 2006 was driven by the same factors and increased by \$306,903 from the previous year to \$882,357.

Interest expense declined in the third quarter and nine months ended July 31, 2006 primarily as a result of lower debt balances. Interest income increased from the previous year by \$226,830 to \$303,543 in the third quarter and by \$547,010 to \$674,943 in the nine months ended July 31,

2006 due almost entirely to higher average cash and marketable securities balances.

Notwithstanding the deterioration in earnings before taxes, the Company's tax expense increased to \$278,586 in the third quarter of 2006 from \$205,372 in 2005. For nine months ended July 31, 2006, tax expense increased to \$724,346 vs. \$318,359 in the comparative period 2005. During the quarter, the Company incurred losses in North America for which future income tax assets were not realized.

Net loss for the third quarter of 2006 was \$2.143 million versus net income of \$1.200 million in the third quarter of 2005. The change was due primarily to higher marketing and legal and accounting costs and gross margin deterioration. Net income for the nine months ended July 31, 2006 was \$1.806 million, versus income of \$1.880 for the same period in 2005, again due primarily to higher marketing and legal and accounting costs and margin pressures.

Liquidity and Capital Resources

Operating activities from operations used net cash of \$1.585 million during the third quarter of 2006 driven primarily by the loss from operations. Changes in our operating assets and liabilities during the third quarter of 2006 resulted in a net cash inflow of \$0.1 million, the most significant of which were an increase in accounts receivable and inventory of \$2.2 million offset by an increase in accounts payable of \$2.2 million and a decrease in prepaid expenses of \$0.5 million. The increase in accounts receivable reflects the higher revenues in this quarter versus the third quarter. The increase in inventory and payables reflect shipments of inventory received late in the quarter. The reduction in prepaid expenses includes the impact of the elimination of deposits with suppliers.

Operating activities from operations used net cash of \$4.381 million during the nine months ended July 31, 2006 driven by the loss from operations, an increase in accounts receivable as a result of the Invoice Me Later program and changes in operating assets. Changes in our operating assets and liabilities during the nine months ended July 31, 2006 resulted in a net cash outflow of \$3.8 million, the most significant of which were an increase in accounts receivable (\$1.8 million) and inventory (\$2.6 million).

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 results 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.

Cash received from financing activities were \$1.105 million and \$23.899 million in the third quarter and nine months ended July 31, 2006 respectively. Our financing activities from operations during the third quarter consisted primarily of a decrease in borrowings of \$0.375 million and proceeds on the issue of share capital of \$1.497 million. The share capital was primarily issued with the exercise of warrants and options and included \$0.503 million that was issued subsequent to the quarter end. Our financing activities from operations during the nine months ended July 31, 2006 consisted primarily to the issue of share capital for \$23.527 million including the proceeds of a private placement of \$21.070 million.

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 \$21.1 million. Each special warrant was exercised to acquire one

common share of the Company for no additional consideration. During the quarter, warrants related to previous placements were exercised for total proceeds of \$1.497 million.

Cash provided from investing activities was \$8.336 million for the third quarter and cash used in investing activities was \$11.397 million the first nine months of 2006. Our investing activities from operations during quarter and the nine months ended July 31, 2006 consisted primarily of capital expenditures of \$.690 million and \$1.992 million respectively. In the third quarter, the Company had proceeds of \$9.086 million on investments of which were either held in cash at the end of the quarter in part in expectation of the completion of an acquisition near the end of the quarter or re-invested shortly after the quarter end. In the nine months ended July 31, 2006, investments increased \$9.304 million as some of the proceeds from the private placement have been invested in short term investments.

We believe that available cash, together with cash flow from operations and the 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.

Common Shares

As at September 1, 2006, the Company had 73,410,503 common shares, 1,131,796 options and 229,781 warrants issued and outstanding. Of these securities, 3,964,522 common shares and 443,780 options remain in escrow, are subject to a voluntary pooling agreement or have not yet vested as of September 1, 2006.

Earnings per Share (Unaudited)

Quarter Ended:	July 31, 2006	April 30, 2006	Jan. 31, 2006	Oct. 31, 2005	July 31, 2005	Apr. 30, 2005	Jan. 31, 2005	Oct. 31, 2004	July 31, 2004
Net Income (loss)	(\$2,143,218)	\$100,244	\$237,198	\$216,514	\$1,200,180	\$436,374	\$243,006	\$276,220	(\$176,540)
Weighted Average # of shares - Basic	69,704,510	63,681,865	58,034,604	50,573,011	50,044,222	43,123,319	35,777,134	33,874,960	21,235,996
Weighted Average # of shares - Fully Diluted	69,704,510	65,204,309	60,264,972	60,983,391	60,251,874	52,959,221	46,562,596	44,519,450	21,235,996
Basic Earnings (Loss) per share	(\$0.03)	\$0.00	\$0.00	\$0.00	\$0.02	\$0.01	\$0.01	\$0.01	(\$0.01)
Diluted Earnings (Loss) per share	(\$0.03)	\$0.00	\$0.00	\$0.00	\$0.02	\$0.01	\$0.01	\$0.01	(\$0.01)

Critical Accounting Estimates

The Company 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 Lenslogistics 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 be performed in the fourth quarter.

Contractual Obligations

As of July 31, 2006, the Company was obligated to make payments under longer term contractual obligations as summarized below.

Nature of Obligation	Aug 1-Oct 31, 2006	Year ended Oct 31, 2007	Year ended Oct 31, 2008	Year ended Oct 31, 2009	Year ended Oct 31, 2010	After Oct 31, 2010	Total
Long Term Debt	18,503	-	-	-	-	-	18,503
Operating Leases	189,587	758,347	855,501	456,582	316,296	105,432	2,681,745
Other Obligations	15,372	49,533	13,688	10,251	-	-	88,844
Total	223,462	807,880	869,189	466,833	316,296	105,432	2,789,092

Related Party Transactions

As at July 31, 2006, the Company had the following amounts due from related parties

	\$
Promissory notes receivable	243,700
Advances to officers	214,154
CMP Medical Inc.	39,691
	<u>497,545</u>

The amounts due from related parties includes: (1) promissory notes from six members of management. These loans are payable on demand and bear interest at 5% per annum; (2) Other advances to officers of the Company in the amount of \$214,154. These advances are non interest bearing with no fixed terms of repayment; and (3) \$39,691 from CMP Medical Inc., a company controlled by an officer and shareholder of the Company.

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
Total consideration	<u>1,060,225</u>
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)
Net assets acquired	<u>878,654</u>
Goodwill	<u>181,571</u>

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

Subsequent event

On August 12, 2006, the Company acquired the leading on-line distributor of contact lenses and optical products in the Netherlands. The acquisition three companies all organized under the laws in The Netherlands. The companies operate primarily through the web portal www.MyLenses.nl.

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.