

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following management's discussion and analysis should be read in conjunction with Coastal Contacts Inc.'s (the "Company") audited financial statements for the year ended October 31, 2003 and its Prospectus dated March 18, 2004. The Company prepares its financial statements in accordance with Canadian GAAP. This discussion of our business may include forward looking statements about our future operations, financial results and objectives. These statements are necessarily based on estimates and assumptions that are subject to risks and uncertainties. Our actual results could differ materially from those expressed or implied by such forward looking information due to a variety 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 regulatory authorities.

**Overview**

The Company is a direct marketer of replacement contact lenses. The Company was incorporated pursuant to the provisions of the *Canada Business Corporations Act* on December 14, 2000. Since its formation, the Company has experienced significant growth. The Company's revenue has grown from \$2.5 million in the eleven month period ended October 31, 2001 to \$8.9 million in fiscal 2002, an increase of 256%, and to \$20.1 million in fiscal 2003, an increase of 126%.

**Results of Operations*****Quarter Ended April 30, 2004***

Net sales for the second quarter ended April 30, 2004 were \$5,842,511. Total order volume shipped for the second quarter 2004 was 55,739 orders. The number of orders shipped to new customers during the second quarter ended April 30, 2004 was 40,708. Repeat orders from existing customers for the second quarter ended April 30, 2004 increased by approximately 7,241, or 93%, to approximately 15,031 from 7,790 for the second quarter ended April 30, 2003.

Gross profit for the second quarter ended April 30, 2004 was \$586,740. The company calculates gross profit by including the cost of purchases, freight, credit card charges, non management labour and bags and packaging as its cost of goods.

Selling, general and administrative expenses for the quarter ended April 30, 2004 were \$1,132,735. As a percentage of net sales, selling, general and administrative expenses decreased in the second quarter of 2004 to 19.4% of net sales as compared to 21.9% of net sales for the fiscal year ended October 31, 2003. In the second quarter of 2004, North American selling expenses decreased from 16% of gross sales for the fiscal year ended October 31, 2003 to 12.3% of gross sales for the period ended April 30, 2004.

During the quarter, the Company increased expenditures on European market development. The initial start up phase of marketing and other related expenses, such as freight and initial logistic expenses resulted in a lower yield than comparable North American based programs. A proportion of the expense was attributed to a "buy versus build" analysis of the European market, attempting to determine if the Company should build its presence in Europe or purchase an existing company. As a result of this investigation, the Company has reached a definitive agreement to purchase an on-line retailer in Europe. See "Subsequent Events" below. The Company also undertook the evaluation of several possible European partners, eventually selecting the company that management believes best suits its European growth objectives.

Loss before any income tax recoveries for the second quarter of 2004 was \$590,722. The loss was attributable to the factors outlined below.

In February, 2004, the *Fairness to Contact Lens Consumer Act* was implemented in the United States. Since the law went into effect, the Company has had to cancel a significant number of orders in accordance with the passive verification requirement laid out in the legislation. Although the cancellation rate remained consistent throughout the quarter, sales scaled from \$1.8 million in February to \$2 million in April.

The Company believes that the *Fairness to Contact Lens Consumer Act* will have the designed affect of increasing customers' choice in the market. The law requires that all eye care practioners provide their customers with a copy of their prescription after a contact lens fitting. With this information, the customer is in a more informed position and can include other value propositions such as price and convenience in their purchase decision. The on-line retailer segment of the market offers consumers an attractive alternative through significantly reduced pricing, much greater stock selection, and home delivery.

The Company signed a supply agreement with Johnson and Johnson eye care division effective May 2, 2004. Prior to this agreement the Company did not have access to manufacturer rebate coupons which act as purchase incentives to customers. During the second quarter the Company was at a disadvantage to some of the other retailers and online vendors in that it could not offer a \$40.00 manufacturer rebate to customers who bought Acuvue contact lenses. This resulted in higher than normal customer acquisition costs for customers of this product and reduced sales. The Company has now completed an agreement with Johnson and Johnson eye care which enables the Company to offer equivalent purchase incentives lowering acquisition costs.

### **Liquidity and Capital Resources**

The Company has historically funded its growth through a combination of funds generated from operations and borrowings. Working capital requirements generally precede the realization of sales on a monthly basis. The Company uses funds generated from operations and borrowings to increase inventory levels in anticipation of future sales realization. The Company's supply arrangements have historically required the Company to pay cash upon delivery of inventory. As a result, the Company is generally unable to rely on standard trade credit arrangements in purchasing its inventory, which would ordinarily permit the net amount due to be paid within 30 days of shipment of ordered merchandise. In addition, in order to help ensure sufficient supply, the Company generally carried a higher level of inventory than if it were able to purchase directly from contact lens manufacturers.

Net cash used in operating activities was \$ 1,227,054 in Quarter 2 of 2004.

Net cash provided by financing activities for Quarter 2 of 2004 was \$5,197,374.

Net cash used in investing activities, principally related to capital expenditures for infrastructure improvements, such as expanded operating facilities, and upgrades to telecommunications, computer and management information systems was approximately \$80,102 in Quarter 2 of 2004.

Between November 1, 2003 and December 15, 2003 the Company issued 710,000 common shares to non-related parties of the Company. 360,000 of the shares were issued for cash of \$315,000. The remaining 350,000 shares were issued in exchange for accounts payable. On December 23, 2003, the Company underwent a share subdivision issuing two new commons shares for every one issued and outstanding common share.

On March 29, 2004, the company undertook and Initial Public Offering (IPO), issuing 6,000,000 common shares for proceeds of \$6,000,000. There were a further 375,000 units consisting of shares and warrants issued to the underwriter as part of the underwriting fees. Share issue costs related to this financing amounted to \$872,605

On April 7 2004, certain insiders of the Company exercised options for 164,000 shares, for proceeds of \$132,480.

On April 23, 2004, the underwriter exercised part of its rights under the greenshoe option granted in the IPO and 164,000 common shares were issued for proceeds of \$151,700.

The Company believes that its available cash after this Offering, together with cash flow from operations, will be sufficient to support current operations and future growth at least through fiscal 2005. The Company may be required to 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.

Contractual Obligations				
	Total	Less than 1 year	1 – 3 years	4 to 5 years
Long Term Debt	\$494,670	\$159,654	\$319,499	\$15,517

### Accounting Policies

#### Stock Based Compensation:

Effective November 1, 2003, the company adopted the new accounting recommendations for stock based compensation issued by the Canadian Institute of Chartered Accountants which require prospective application to all stock options granted on or after the date of adoption.

Under this standard, fair value accounting is required for all stock options granted. Previously, stock options were not recognized in the financial statements.

#### Earnings per Share

Effective November 1, 2003, the Company adopted the new accounting recommendation for earnings per share issued by the Canadian Institute of Chartered Accountants. Under this standard, the Company calculates basic earnings per share using the weighted average number of common shares outstanding during the period. Diluted net earnings per share are calculated by the treasury stock method. Under the treasury stock method, the weighted average number of common shares outstanding for the calculation of diluted net earnings per share assumes that the proceeds to be received on the exercise of dilutive stock options and warrants are applied to repurchase common shares at the average market price for the period. Stock options are dilutive when the company has income from continuing operations and the average market price of the common shares during the period exceed the exercise price of the options.

### Subsequent Events

On May 2, 2004, the Company signed an agreement with Johnson and Johnson Eye care division, allowing the company to obtain credit terms and operate its inventory in a more efficient manner. It is expected that over time, the Company will be able to reduce its inventory levels as a result of the more just in time nature of the agreement with Johnson and Johnson eye care division. This agreement will also allow the company access to valuable purchase incentives which the Company believes will be important in securing customers in the future.

### Lensway

On June 24, 2004, the Company signed a definitive purchase agreement with Lensway AB and its shareholders and option holders to acquire all of the outstanding common shares and options of Lensway, a leading European-based online retailer and distributor of contact lenses.

The aggregate consideration for this acquisition will be cash consideration of \$5,655,000 and 13,195,000 common shares of Coastal Contacts which will be subject to voluntary pooling arrangements. The proposed acquisition is expected to close in or about the end of July, 2004.

This transaction is expected to be funded in part by a private placement of subscription receipts. In addition, the closing of the private placement is expected to occur on or before July 19, 2004, unless otherwise extended. The net proceeds of the offering will be held in escrow pending the successful completion of the acquisition.

Lensway is a leading European-based online retailer and distributor of contact lenses. Through its website, [www.lensway.com](http://www.lensway.com), Lensway offers a variety of brands of contact lenses. With a website customized to serve 16 countries within Europe, Lensway offers consumers an attractive alternative for obtaining replacement contact lenses across Europe. Lensway leverages the economies of the Internet to offer its customers competitive pricing, superior service and expedited delivery.