



HARDWOODS DISTRIBUTION
INCOME FUND

2006

Third Quarter Report
To Unitholders



About the Fund

Hardwoods Distribution Income Fund (the “Fund”) is an unincorporated open-ended limited purpose trust. The Fund was launched on March 23, 2004 with the completion of an initial public offering (IPO) of 14.4 million trust units (“Class A Units”) at \$10 per unit. Net proceeds of the IPO were used to acquire an 80% interest in a hardwoods lumber and sheet goods distribution business (“Hardwoods” or the “Business”) from the previous owners. The owners of the predecessor companies have retained a 20% interest in the Business in the form of Special Voting Units of the Fund and Class B Limited Partnership units of the Fund’s operating subsidiaries (“Class B Units”), which together are exchangeable into Class A Units provided that the Fund achieves certain objectives.

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund’s performance depends on the performance of the Business.

About the Business

Hardwoods has been providing quality lumber, hardwood plywood and specialty products to customers for over 45 years. People love hardwood and find many different ways to bring it into their lives. We sell hardwood lumber and sheet goods to industrial customers that use it to manufacture a wide variety of wood products. Whether in kitchen cabinets, doors and mouldings, furniture, or custom interior millwork, consumers place a higher value on products crafted from real wood. It’s a preference that doesn’t change with the whims of fashion. Demand for hardwood has remained remarkably stable decade after decade, in part because hardwood has no real substitute. There’s a warmth to the look and touch of hardwood that no other material can match.

Today, we are one of the largest distributors of hardwood lumber and sheet goods in North America. Headquartered in Langley, British Columbia, we operate a network of 37 distribution centers organized into nine regional clusters. With a proven track record of strong financial performance, Hardwoods plays a critical role linking suppliers and customers in a highly fragmented industry. The Business is diversified by geographic markets served, product mix, and customer type. Touching many areas of the economy, demand for hardwoods typically remains balanced through a range of economic conditions.

To Our Unitholders

Solid underlying sales activity, the successful rebuilding of our margins and a reduction in our distribution payout level contributed to improve our third quarter financial position. Despite the continued negative impact of a stronger Canadian dollar, we achieved solid EBITDA and distributable cash results, which enabled us to pay down our bank indebtedness, net of cash, by \$4.3 million or 9% during the third quarter. Overall, we ended the quarter better prepared to manage the impact of a slowing North American economy.

For the three months ended September 30, 2006, the Fund and its subsidiaries generated total distributable cash of \$4.9 million, or \$0.273 per unit, and distributions related to the period were \$2.9 million, or \$0.204 per unit, to our public unitholders (Class A Units). No distributions were declared on the 20% interest retained by Hardwood's previous owners (Class B Units), resulting in a 60% payout ratio for the quarter. On a year-to-date basis, we generated distributable cash of \$13.0 million, or \$0.724 per unit. Distributions related to the period were \$10.3 million to Class A Units (\$0.717 per Class A Unit) and no distributions were declared to Class B Units. This represents an overall payout ratio of 79% for the first nine months of 2006, and 87% in the previous twelve months of the Fund's operation.

On the sales front we achieved strong underlying sales growth in the U.S., where our investments in new facilities and personnel continue to bear fruit. To date, the decline in U.S. housing starts has had minimal impact on our U.S. branch activity, in part because the hardwood products used in new home construction are utilized during the finishing stages for items like mouldings, cabinetry and furniture. Accordingly, change in demand for hardwood typically lags the new construction market by up to six months. Diversification in our customer base and the sectors of the economy we serve has also helped to offset the impact of declining housing starts, and should have an ongoing positive impact on our sales activity.

In Canada, our third quarter sales were slightly weaker, primarily reflecting poor results from our Windsor branch, which was affected by the impact of cutbacks in the local manufacturing sector. Overall, the Canadian housing market was strong in the third quarter with residential housing starts at near historical highs, however a stronger Canadian dollar continued to have a negative impact on Canadian sales.

One of our most important achievements of the quarter was the improvement to our gross profit margin. At 18.9%, our gross profit margin exceeded historic levels during the third quarter.

Favourable purchase terms, a disciplined approach to selling, and the continued success of our import program were key factors in achieving this strong third quarter gross profit margin performance.

Moving into the seasonally slower fourth quarter, we anticipate challenges from reduced housing starts and a slowing economy. However, our business remains well diversified by geography, customer and end-use markets, and we expect this will lessen the impact on our business.

We remain focused on reducing our costs, continued discipline in the area of credit management, and prudent management of our leverage. The Fund's quarterly and year-to-date payout ratio is now significantly more conservative due to the distribution cut implemented at the beginning of the third quarter and the strength of our financial performance. We view the current distribution level as appropriate given our cautious market outlook, and believe it will give us the flexibility to respond effectively to changing business conditions.



Maurice E. Paquette

President and Chief Executive Officer

Management's Discussion and Analysis

October 30, 2006

This management's discussion and analysis ("MD&A") covers our unaudited interim consolidated financial statements as at and for the three and nine months ended September 30, 2006 ("Interim Financial Statements"). As well, it provides an update to the MD&A section contained in our 2005 Annual Report. The information below should be read in conjunction with the Interim Financial Statements and the audited consolidated financial statements for the year ended December 31, 2005. For additional information, readers should also refer to our Annual Information Form and other information filed on www.sedar.com. Dollar amounts are in Canadian dollars unless otherwise stated, and the consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

This MD&A includes the following sections:

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This MD&A may contain forward-looking statements. Such statements involve known and unknown risks, uncertainties and other factors outside of our control that could cause actual results to differ materially from those expressed in the forward-looking statements. Hardwoods Distribution Income Fund does not assume responsibility for the accuracy or completeness of the forward-looking statements and does not undertake any obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances.

References to “EBITDA” are to earnings before interest, income taxes, depreciation and amortization, mark-to-market adjustments on foreign currency contracts and the non-controlling interest in earnings. Management believes that, in addition to net income or loss, EBITDA is a useful supplemental measure of performance and cash available for distribution prior to debt service, changes in working capital, capital expenditures and income taxes.

EBITDA is not an earnings measure recognized by generally accepted accounting principles in Canada (“GAAP”) and does not have a standardized meaning prescribed by GAAP. Investors are cautioned that EBITDA should not replace net income or loss (as determined in accordance with GAAP) as an indicator of our performance, or to cash flows from operating, investing and financing activities or as a measure of our liquidity and cash flows. Our method of calculating EBITDA may differ from the methods used by other issuers. Therefore, our EBITDA may not be comparable to similar measures presented by other issuers. For a reconciliation between EBITDA and net income or loss as determined in accordance with GAAP, please refer to the discussion of Results of Operations described in section 3.0 of this report.

Distributable Cash of the Fund is a non-GAAP measure generally used by Canadian open-ended income funds as an indicator of financial performance. We define Distributable Cash as net earnings before depreciation, amortization, future income taxes, non-controlling interest, gains or losses on the sale of property, plant and equipment, and mark-to-market adjustments on foreign currency contracts, and after capital expenditures and contributions to any reserves that the Board of Trustees deem to be reasonable and necessary for the operation of the Fund.

Our Distributable Cash may differ from similar computations as reported by other similar entities and, accordingly, may not be comparable to distributable cash as reported by such entities. We believe that our Distributable Cash is a useful supplemental measure that may assist prospective investors in assessing the return on their investment in Class A Units. For a reconciliation between Distributable Cash and net cash provided by operating activities as determined in accordance with GAAP, please refer to the discussion of Distributable Cash and Cash Distributions described in section 4.1 of this report.

1.0 Overview

1.1 About the Fund

The Fund is an unincorporated open-ended limited purpose trust formed under the laws of the Province of British Columbia by a declaration of trust dated January 30, 2004. The Fund was launched on March 23, 2004 with the completion of an initial public offering (“IPO”) of 14,410,000 trust Voting Units (“Class A Units”). Net IPO proceeds of \$133.5 million, together with drawings on credit facilities totalling \$31.6 million, were used to acquire an 80% interest in the hardwood lumber and sheet goods distribution business (“Hardwoods” or the “Business”) from the previous owners.

The owners of the predecessor companies have retained a 20% interest in the Business in the form of Special Voting Units of the Fund and Class B Limited Partnership units of the Fund’s operating subsidiaries (“Class B Units”), which together are exchangeable into Class A Units provided that the Fund achieves certain objectives. Distributions by the Fund’s operating subsidiaries to the previous owners are subject to subordination arrangements until certain financial tests established at the time of the IPO and described in the Interim Financial Statements are met. As at September 30, 2006, the following units of the Fund were issued and outstanding:

Units	14,410,000
Special Voting Units	3,602,500

Hardwoods Distribution Income Fund units trade on the Toronto Stock Exchange under the symbol HWD.UN. The Fund’s performance depends on the performance of the Business.

1.2 About our Business and Industry

Hardwoods is one of North America’s largest distributors of high-grade hardwood lumber and specialty sheet goods to the cabinet, moulding, millwork, furniture and specialty wood products industries. At September 30, 2006 we operated from 37 distribution facilities organized into nine geographic regions throughout North America. In a highly fragmented but stable industry, we match products supplied from hundreds of mills to over 2,500 manufacturing customers.

Our product mix includes higher grades of hardwood lumber, as well as sheet goods, consisting primarily of hardwood plywood, as well as non-structural sheet goods such as medium density fiberboard, particleboard and melamine-coated stock. Our sheet goods are a key complementary product line as they are used by many purchasers of hardwood lumber in the manufacture of their end products.

Approximately 95% of the hardwood lumber distributed in North America is harvested from North American hardwood forests, located principally in the eastern United States. Imported hardwood lumber is largely limited to specialty species that generally do not compete with domestic hardwood lumber. Sheet goods are generally produced in North America by large manufacturers using domestic hardwoods and other materials, although imported hardwood plywood volumes have been increasing. Both domestic and imported hardwood lumber and plywood are distributed principally by third parties such as us. Historically, balanced supply and demand conditions have resulted in a stable pricing environment for hardwood lumber and hardwood plywood. Prices have generally kept pace with inflation over the long term.

The hardwood distribution industry is highly fragmented. While there are a number of hardwood distributors that operate from multiple locations, most are small, privately held companies serving discrete local markets.

2.0 Performance and Outlook

Market demand for Hardwood's products remained solid in the third quarter and we continued to benefit from our investments in new facilities and personnel. After adjusting for foreign exchange impacts and a difference in the number of selling days between the two periods, our U.S. sales grew by 13.4% in the third quarter of 2006 and by 14.0% on a year-to-date basis, compared to the same periods in 2005.

The continuing growth in our U.S. business, which accounts for approximately two-thirds of our sales, was achieved despite a marked slowdown in U.S. housing starts. It is important to note that hardwood products are used significantly in the finishing stages of new home construction. Accordingly, changes in demand for hardwood can lag the residential construction market by up to six months. We expect to experience more impact from the slowdown in the U.S. housing starts over the coming quarters. This may include reduced market pricing for some hardwood products, as we have seen recent price reductions in species we sell such as hard maple, cherry and red oak.

U.S. sales activity also benefited from diversification in our customer base. Customers use our products to manufacture a range of items such as cabinetry, furniture and custom millwork. While a significant portion of their output is used in new home construction, the renovation, non-residential construction and institutional markets are also key markets, and these sectors are performing well.

Demand in Canada, which accounts for approximately one third of our sales, was weaker than expected. After adjusting for a difference in the number of selling days between the two periods, underlying sales declined by 6.2% in the third quarter and by 2.7% on a year-to-date basis, compared to the same periods in 2005. The third quarter decline in sales was primarily due to a decrease in demand at our Windsor branch as a result of Southern Ontario's softening regional economy. A stronger Canadian dollar was also a factor, effectively reducing Canadian selling prices on our predominantly U.S.-sourced products, while also having a negative impact on Canadian customers' ability to sell into the U.S. market. We expect that conditions in the Canadian market will remain challenging in the near term.

An important third quarter achievement was rebuilding our gross profit margin following two quarters of weaker-than-normal results. Our third quarter gross profit margin was 18.9%, up from 17.7% in the first quarter and 18.2% in the second quarter of 2006. This achievement reflects favourable purchase terms, disciplined selling practices, as well as the continued success of our import program. Some quarter-to-quarter variations in our gross profit margin is considered normal for the business, with a typical range being 18% to 19%. Over the longer term gross profits should be in line with our historic average, which since inception of the Fund has been 18.5%.

We were also successful in reducing sales and administrative expenses during the third quarter, with personnel costs stabilizing for the first time since Q2 2005. The improvement was partially offset by an increase in bad debt expense as we prepare for a slowing economy.

Overall, the combination of higher gross profit margins and lower expenses balanced the quarter's negative foreign exchange impact. As a result, we were able to hold EBITDA at \$6.7 million, on par with third quarter 2005 levels. This is the best quarterly EBITDA result we have achieved in the past three quarters, and represents the first time in five quarters that EBITDA did not slip on a year-over-year basis. For the first nine months of 2006, EBITDA declined by 6.1% compared to the same period in 2005, reflecting weaker first half results. Net earnings were

lower in both the three and nine-month periods, reflecting reduced gains on foreign currency exchange contracts, higher interest expenses and higher income taxes.

While we are pleased with the results achieved in the third quarter, we are now moving into our seasonally slower fourth quarter, and we anticipate that underlying sales growth will begin to soften as a result of a slowdown in residential housing starts. The National Association of Homebuilders predicts a 12% decline in U.S. housing starts in 2006 and another 12% decline in 2007. In Canada, the Canadian Mortgage and Housing Corporation predicts stability in new housing starts for the balance of 2006, but anticipates an 8% decline in 2007. The impact of these changes should be partially offset by growth in the renovation and commercial construction markets and by our diversification across multiple sectors and end-use markets. Overall, excluding the impact of changes in foreign exchange, in the fourth quarter we expect underlying sales growth to be flat to moderate compared to the same period in the prior year, and gross profit margin to be in line with our historic performance level of 18.5%.

Strategically, we continue to focus on China as an emerging source of high quality, value-added products to introduce into our product mix. In addition to our established Dragon PlyTM hardwood plywood products, we are making progress in the introduction of our branded Rely-A-FormTM film faced plywood for use in the concrete forming industry. During the third quarter we appointed a full-time representative in China who is tasked with monitoring quality control on our import products and identifying new product opportunities. We are currently in the process of conducting product trials on a number of new products and expect to continue expanding our import program in the months ahead.

Another operational priority will be to maintain strict cost control. We continue to identify cost savings within our operations, and will closely manage selling and administrative costs and credit risks in preparation for a slowing economy.

As a result of the distribution cut implemented at the beginning of the third quarter and our solid financial performance, the Fund's payout ratio is currently 60% for the quarter and 79% on a year-to-date basis as calculated in section 4.1 of this report. We view the current distribution level as prudent given our cautious market outlook, and believe it will give Hardwoods the flexibility to respond to changing business conditions and to effectively manage its leverage.

3.0 Results of Operations

3.1 Three Months ended September 30, 2006 and September 30, 2005

Selected Unaudited Consolidated Financial Information (in thousands of Canadian dollars)

	For the three months Ended September 30, 2006	For the three months Ended September 30, 2005
Total sales	\$ 90,974	\$ 94,766
<i>Sales in the US (US\$)</i>	<i>57,714</i>	<i>54,092</i>
<i>Sales in Canada</i>	<i>26,213</i>	<i>29,692</i>
Gross profit	17,158	17,699
<i>Gross margin %</i>	<i>18.9%</i>	<i>18.7%</i>
Selling and administrative expenses	10,790	11,237
Realized gain on foreign currency contracts	(359)	(217)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 6,727	\$ 6,679
Add (deduct):		
Amortization	(525)	(507)
Interest	(932)	(614)
Mark-to-market adjustment on foreign currency contracts	(368)	1,224
Non-controlling interest	(981)	(1,357)
Income taxes	(1,265)	(828)
Net earnings for the period	\$ 2,656	\$ 4,597
Basic and fully diluted earnings per Class A Unit	\$ 0.184	\$ 0.319
Average Canadian dollar/US dollar exchange rate	1.1216	1.2031

Sales

For the three-month period ended September 30, 2006, we recorded sales of \$91.0 million, down 4.0% from \$94.8 million in the third quarter of 2005. The decrease in sales reflects a 4.9% reduction to sales revenues due to the negative impact of a strengthening Canadian dollar, partially offset by a 0.9% increase in underlying sales activity.

The 4.9% reduction in sales due to foreign exchange reflects that approximately two-thirds of Hardwoods sales are generated in the United States in U.S. dollars. Accordingly, a strengthening Canadian dollar has a negative top-line impact when we translate U.S. sales to Canadian dollars for reporting purposes. The average Canadian dollar exchange rate in the third quarter of 2006 was \$1.1216, compared to \$1.2031 in the third quarter of the prior year. Had exchange rates remained consistent with 2005 levels, total sales for the third quarter of 2006 would have been \$4.6 million higher, at \$95.6 million.

The 0.9% increase in underlying sales activity was achieved despite there being four fewer selling days in the third quarter of 2006 than in the same period in 2005. The difference in

selling days was caused by a change to the cutoff dates for our quarterly financial results. Currently, our financial results are calculated up to and including the final calendar day of each month, whereas previous practice was to cutoff results on the last Friday of the month. Having made this change, there will no longer be any difference in the number of selling days when comparing different quarters. To better understand the impact of the four fewer selling days, results from the U.S. and Canadian business are discussed separately below.

Sales in the United States, as measured in U.S. dollars, increased 6.7% to \$57.7 million, compared to \$54.1 million during the same quarter in 2005. Adjusting for the impact of the four fewer sales days, it is estimated that sales in the United States, as measured in U.S. dollars, increased by 13.4% in the three months ended September 30, 2006 compared to the same period in the prior year. All regions contributed positive sales increases in the third quarter after adjusting for the four fewer sales days. This was achieved despite the slowdown in the residential construction market discussed in the overview section 2.0 of this report.

Hardwoods' sales in Canada, as measured in Canadian dollars, declined by 11.7% to \$26.2 million, from \$29.7 million during the third quarter of 2005. After adjusting for the four fewer sales days, it is estimated that third quarter sales in Canada decreased 6.2% compared to the same period in the prior year. The majority of this decrease occurred at our Windsor branch, which experienced weaker demand with a regional slowdown in the manufacturing sector in southern Ontario.

Gross Profit

Gross profit for the three months ended September 30, 2006 was \$17.2 million, a decrease of \$0.5 million, or 3.1%, from \$17.7 million in the third quarter of 2005. The decrease in gross profit reflects the 4.0% decrease in sales, partially offset by a higher gross profit margin of 18.9%, compared to 18.7% in the third quarter of 2005. Favourable purchase terms, disciplined selling practices, and the positive impact of our import program contributed to the improvement in gross profit margin.

Selling and Administrative Expenses

For the three-month period ended September 30, 2006, selling and administrative (S&A) expenses were \$10.8 million, down \$0.4 million, or 4.0%, from \$11.2 million in the three-month period ended September 30, 2005. In the third quarter of 2006 the benefit of the stronger Canadian dollar on the conversion of S&A expenses at our U.S. operations reduced costs by \$0.7 million, compared to the same period in prior year. Costs were also \$0.5 million lower due to an

employee severance expense incurred in the third quarter of 2005 not repeated in the third quarter of 2006. Partly offsetting these cost savings were increases in other S&A costs totaling \$0.8 million, the most significant area being higher bad debt expense. Personnel costs, which was a primary source of cost pressure in the preceding three quarters, remained stable in the third quarter of 2006 compared to the same period in 2005. As a percentage of sales, third quarter S&A expenses were 11.9% in both the 2005 and 2006 periods.

Realized Gain on Foreign Currency Contracts

The Fund realized gains of \$0.4 million on maturing foreign currency contracts during the third quarter, up \$0.1 million from the same period in 2005. This improvement reflects the strengthening of the Canadian dollar in the third quarter of 2006, compared to the third quarter of 2005. The terms of our foreign currency contracts and the Fund's use of currency derivatives to mitigate the economic impact of fluctuations between the Canadian and U.S. dollar is described under Financial Instruments in section 5.0 of this report.

EBITDA

We reported EBITDA of \$6.7 million in the third quarter of 2006, which was unchanged from \$6.7 million in the same period in 2005. The \$0.5 million decrease in gross profit was fully offset by the \$0.4 million reduction in S&A expenses and the \$0.1 million increase in realized gains on foreign currency contracts.

Interest Expense

Interest expense for the three-month period ended September 30, 2006 was \$0.9 million, up \$0.3 million, or 51.8%, from \$0.6 million in Q3 2005. The increase in interest expense reflects higher average advances under operating lines of credit available to subsidiaries of the Fund, and increases in market borrowing rates. Further discussion of our borrowing arrangements can be found under Revolving Credit Facilities in section 4.4 of this report.

Other Income

The mark-to-market valuation of our outstanding foreign currency contracts resulted in an adjustment loss of \$0.4 million in the third quarter of 2006, compared to a \$1.2 million adjustment gain in the same period in 2005. As of September 30, 2006, our foreign currency contracts continued to be an asset to the Fund, having a fair value of \$2.6 million. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. Further

discussion of our foreign currency contracts can be found under Financial Instruments in section 5.0 of this report.

Income Taxes

Income taxes for the third quarter of 2006 were \$1.3 million, compared to \$0.8 million in the same period in 2005, an increase of \$0.5 million. The increase in income taxes relates to an increase in estimated taxable income to be allocated to the Fund for 2006 by the Fund's U.S. operating subsidiary. Although the Fund has an 80% indirect interest in its U.S. operating subsidiary, in 2006 it will be allocated 100% of the U.S. operating subsidiaries' taxable income, reflecting the fact that no distributions are expected to be paid on the Class B Units.

Subordination of the Class B Units is described in section 4.1 of this report.

Net Earnings

Net earnings for the three months ended September 30, 2006 were \$2.7 million, compared to \$4.6 million in the comparative period in 2005. The \$1.9 million decrease in net earnings primarily reflects a \$1.6 million decrease in mark-to-market adjustment gains on foreign currency contracts, a \$0.3 million increase in interest expense, a \$0.5 million increase in income taxes, partially offset by a \$0.4 million reduction in non-controlling interest as a result of lower profits during the third quarter.

3.2 Nine Months ended September 30, 2006 and September 30, 2005

Selected Unaudited Consolidated Financial Information (in thousands of Canadian dollars)

	For the nine months Ended September 30, 2006	For the nine months Ended September 30, 2005
Total sales	\$ 279,408	\$ 271,645
<i>Sales in the US (US\$)</i>	<i>172,007</i>	<i>150,929</i>
<i>Sales in Canada</i>	<i>84,558</i>	<i>86,939</i>
Gross profit	50,926	50,931
<i>Gross margin %</i>	<i>18.2%</i>	<i>18.7%</i>
Selling and administrative expenses	34,205	32,557
Realized gain on foreign currency contracts	(1,012)	(504)
Earnings before interest, taxes, depreciation and amortization and non-controlling interest ("EBITDA")	\$ 17,733	\$ 18,878
Add (deduct):		
Amortization	(1,573)	(1,657)
Interest	(2,463)	(1,519)
Mark-to-market adjustment on foreign currency contracts	(68)	541
Non-controlling interest	(2,726)	(3,249)
Income taxes	(2,440)	(2,013)
Net earnings for the period	\$ 8,463	\$ 10,981
Basic and fully diluted earnings per Class A Unit	\$ 0.587	\$ 0.762
Average Canadian dollar/US dollar exchange rate	1.1328	1.2238

Sales

Sales for the nine-month period ended September 30, 2006 were \$279.4 million, up 2.9% from \$271.6 million in the same period in 2005. The improvement in total sales reflects an 8.6% increase in underlying sales activity, partially offset by a 5.7% reduction to sales due to a negative foreign exchange impact.

The negative foreign exchange impact reflects a strengthening Canadian dollar, which had an average exchange value of \$1.1328 relative to the U.S. dollar during the nine months ended September 30, 2006, compared to \$1.2238 in the first nine months of 2005. Had exchange rates remained consistent with 2005 levels, total sales in the nine months ended September 30, 2006 would have been \$15.7 million higher at \$295.1 million.

The 8.6% increase in underlying sales activity reflects strong year-to-date sales growth in our U.S. business and a slight decline in our Canadian business. Sales in the United States, as measured in U.S. dollars, increased 14.0% to \$172.0 million in the first nine months of 2006, compared to \$150.9 million during the same period in 2005. Sales growth in our U.S. business has been aided by two new branches which opened late in 2005 in Minneapolis and Illinois, as well as growth in sales of import products in a number of our regions and the benefit of management continuity in certain operations following changes in 2005.

In Canada, year-to-date sales, as measured in Canadian dollars, were \$84.6 million, down 2.7% from \$86.9 million in the comparative period in 2005. Sales growth in Canada did not match that achieved in the United States, in part due to the strengthening Canadian dollar, and more recently due to weaker product demand at our Windsor branch due to a softening regional economy in southern Ontario. A stronger Canadian dollar affects our Canadian business on two fronts. First, for those hardwood products which are sourced from the United States in US dollars, a stronger Canadian dollar reduces the Canadian dollar purchase price that we pay to buy hardwood lumber from mills in the United States. When this product is resold to our Canadian customers, it is also at a lower Canadian dollar equivalent selling price, which effectively reduces our revenues in Canada. Second, the competitiveness of some of our customers comes under pressure with the continued strengthening of the Canadian dollar. To the extent our Canadian customers rely on selling their products into the US market, these customers see their revenues effectively reduced as the Canadian dollar gains strength.

Gross Profit

Gross profit for the nine-month period ending September 30, 2006 was \$50.9 million, unchanged from \$50.9 million in the first nine months of 2005. Gross profit reflects the benefit of a 2.9% increase in sales fully offset by a lower gross profit margin. Gross profit margin was 18.2% in the nine months ended September 30, 2006, compared to 18.7% in the same period in 2005. Efforts in the first quarter of 2006 to reduce inventory through lower selling prices at some locations contributed to the reduction in gross profit margin. Gross profit margin has steadily improved since that time, and in the third quarter of 2006 exceeded normal historic operating levels.

Selling and Administrative Expenses

For the nine months ended September 30, 2006, selling and administrative expenses were \$34.2 million, up \$1.6 million, or 5.1%, from \$32.6 million in the same period in 2005. The benefit of the stronger Canadian dollar on the conversion of S&A expenses at our U.S. operations reduced expenses by \$2.0 million. The three most significant areas of higher expenses in 2006 were personnel costs, bad debts, and premises expense. The increase in personnel costs has been driven by competitive wage pressures, as well as higher costs associated with delivery of our U.S. medical plan to employees. Increased bad debt expense reflects additional sales activity in 2006, as well as estimates regarding current and expected collection trends. Following a favourable bad debt experience in 2005, our year-to-date bad debt expense in 2006 is back within the normal historical operating range for the business of approximately 0.6% of sales. The third

area of notable cost increase, premises expense, primarily reflects rent increases in the ordinary course of business at our leased facility locations. As a percentage of sales, S&A expenses in the first nine months of 2006 were 12.2% of sales, compared to 12.0% in the comparative period in 2005.

Realized Gain on Foreign Currency Contracts

The Fund realized gains of \$1.0 million on foreign currency contracts which matured during the nine months ended September 30, 2006, compared to \$0.5 million in the comparative period in 2005. The higher gains on realized foreign currency contracts reflect the continued strengthening of the Canadian dollar in the first nine months of 2006 compared to the first nine months of 2005. The terms of our foreign currency contracts and the Fund's use of currency contracts to mitigate the economic impact of fluctuations between the Canadian and U.S. dollar is described under Financial Instruments in section 5.0 of this report.

EBITDA

We reported EBITDA of \$17.7 million for the nine-month period ended September 30, 2006, down \$1.1 million from \$18.9 million in the same period in 2005. The decrease in EBITDA reflects the \$1.6 million increase in S&A expenses, partially offset by the \$0.5 million increase in realized gains on foreign currency contracts.

Interest Expense

For the nine-months ended September 30, 2006, interest expense was \$2.5 million, up \$1.0 million from \$1.5 million in the comparative period in 2005. Higher average advances on operating lines of credit were the primary driver of increased interest expense, along with higher borrowing rates in the market. The increased draw on our operating lines of credit was used to finance higher sales activity and associated working capital growth. Further discussion of our borrowing arrangements can be found under Revolving Credit Facilities in section 4.4 of this report.

Other Income

The mark-to-market valuation of our outstanding foreign currency contracts resulted in an adjustment loss of \$0.1 million in the nine-months ended September 30, 2006, compared to a \$0.5 million adjustment gain in the same period in 2005. As of September 30, 2006, our foreign currency contracts continued to be an asset to the Fund, having a fair value of \$2.6 million. We continue to monitor our foreign currency contract policy to mitigate the impact of foreign exchange fluctuations on Canadian dollar distributions generated by our U.S. operations. Further

discussion of our foreign currency contracts can be found under Financial Instruments in section 5.0 of this report.

Net Earnings

Net earnings for the nine-months ended September 30, 2006 were \$8.5 million, compared to \$11.0 million in the comparative period in 2005. The \$2.5 million decrease in net earnings primarily reflects the \$1.1 million decrease in EBITDA, a \$1.0 million increase in interest expense, a \$0.5 million reduction in mark-to-market adjustment gains on foreign currency contracts, and a \$0.4 million increase in income taxes. This was partially offset by a \$0.5 million reduction in non-controlling interest as a result of lower profits during the first nine months of the year.

4.0 Liquidity and Capital Resources

4.1 Distributable Cash and Cash Distributions

	For the three months ended September 30, 2006	For the three months ended September 30, 2005	For the nine months ended September 30, 2006	For the nine months ended September 30, 2005
Net cash provided by operating activities	\$ 7,625	\$ (3,576)	\$ 9,679	\$ 5,958
Increase (decrease) in non-cash operating working capital	(2,658)	9,137	4,160	10,254
Cash flow from operations before changes in non-cash operating working capital	4,967	5,561	13,839	16,212
Capital expenditures	(46)	(368)	(805)	(823)
Distributable cash	<u>\$ 4,921</u>	<u>\$ 5,193</u>	<u>\$ 13,034</u>	<u>\$ 15,389</u>
Distributions relating to the period:				
Class A Units	2,940 ⁽¹⁾	3,891	10,325 ⁽²⁾	11,672
Class B Units	- ⁽³⁾	1,080	- ⁽³⁾	3,085
	<u>\$ 2,940</u>	<u>\$ 4,971</u>	<u>\$ 10,325</u>	<u>\$ 14,757</u>
Outstanding units and per unit amounts:				
Class A Units outstanding	14,410,000	14,410,000	14,410,000	14,410,000
Class B Units outstanding	3,602,500	3,602,500	3,602,500	3,602,500
Total Units outstanding	<u>18,012,500</u>	<u>18,012,500</u>	<u>18,012,500</u>	<u>18,012,500</u>
Distributable Cash per Unit	\$ 0.273	\$ 0.288	\$ 0.724	\$ 0.854
Distributions relating to the period:				
Class A Units	\$ 0.204 ⁽¹⁾	\$ 0.270	\$ 0.717 ⁽²⁾	\$ 0.810
Class B Units	\$ - ⁽³⁾	\$ 0.300	\$ - ⁽³⁾	\$ 0.856
Total Units	\$ 0.163	\$ 0.276	\$ 0.573	\$ 0.819
Payout ratio ⁽⁴⁾	59.7%	95.7%	79.2%	95.9%

¹ Includes the cash distributions of \$0.068 per Class A Unit per month which relate to the operations of the Fund for July, August, and September 2006.

² Includes the cash distributions of \$0.08542 per Class A Unit per month which relate to the operations of the Fund for the months January through June 2006, and distributions of \$0.068 per Class A Unit per month which relate to the operations of the Fund for July, August, and September 2006.

³ On January 10, 2006, Hardwoods Specialty Products LP and Hardwoods Specialty Products US LP, partnerships in which the Fund owns an 80% interest, announced that quarterly distributions were suspended on the subordinated units, represented by the Class B LP and Class B US LP units. The Class B LP units and Class B US LP units represent a 20% interest in the combined business of Hardwoods, which is subordinated to the Fund's ownership interest in the business. Accordingly, no distributions were declared payable relating to the fourth quarter of 2005, and the first, second, and third quarters of 2006 to the non-controlling interests and no current liability for distributions payable to the non-controlling interests is reflected in the September 30, 2006 balance sheet.

⁴ Payout ratio measures the ratio of distributions relating to the period to distributable cash in the period. Comparative distributable cash and payout ratio figures have been restated to conform with presentation adopted in the nine-month period ended September 30, 2006 as a result of the suspension of quarterly distributions on the Class B Units.

We pay distributions on Class A Units at the end of the month following the month in which the cash is earned. Distributions may also be made quarterly on Class B Units in an amount equivalent on an after-tax per-unit basis to distributions made on Class A Units, pursuant to the terms of a subordination agreement as outlined in the Fund's Annual Information Form dated March 20, 2006.

The Fund's subordination feature is designed to stay in place until the EBITDA and distributable cash tests established at the time of the IPO are met. The terms of these EBITDA and

distributable cash tests are described in note 5 to the accompanying financial statements of the Fund.

For the three months ended September 30, 2006, the Fund and its subsidiaries generated total distributable cash available to Class A and Class B Unitholders of \$4.9 million, or \$0.273 per unit. At the start of the third quarter of 2006, the Fund reduced its monthly distribution to \$0.068 per Class A Unit. Distributions relating to the period were \$2.9 million, or \$0.204 per unit to our public unitholders (Class A Units). For the nine months ended September 30, 2006, the Fund and its subsidiaries generated total distributable cash available to Class A and Class B Unitholders of \$13.0 million, or \$0.724 per unit, and declared distributions relating to the period of \$10.3 million, or \$0.717 per unit, to our public unitholders (Class A Units). In accordance with the terms of a subordination feature in place with the previous owners (Class B Units), no distributions were made to the previous owners in the nine months ended September 30, 2006. The Fund's subordination feature stays in place until EBITDA and distributable cash tests established at the time of the IPO have been met. These distributions represent an overall payout ratio of 60% for the third quarter, 79% for the first nine months of 2006, and 87% in the previous twelve months of the Fund's operation.

Cash distributions are dependent upon the financial performance achieved by the Fund, and are made monthly at the discretion of the Fund's independently elected Trustees based on current and future expected performance of the Business. Trustees have declared a distribution for October 2006 of \$0.068 per unit, to be paid on November 30, 2006 to unitholders of record as at November 20, 2006.

4.2 Capital Expenditures

Capital expenditures were \$0.1 million in the third quarter and \$0.8 million during the nine months ended September 30, 2006. As Hardwoods now leases all of its buildings and contracts out all freight delivery services, we have minimal capital requirements. We estimate that our full-year maintenance capital expenditures will not exceed \$1.0 million in 2006.

4.3 Utilization of Distributable Cash

Our utilization of distributable cash, and its relation to working capital use and bank line financing in the Business, is summarized below.

Selected Unaudited Consolidated Financial Information (in thousands of dollars except per unit amounts)

	For the three months ended September 30, <u>2006</u>	For the three months ended September 30, <u>2005</u>	For the nine months ended September 30, <u>2006</u>	For the nine months ended September 30, <u>2005</u>
Distributable Cash	\$ 4,921	\$ 5,193	\$ 13,034	\$ 15,389
Cash Distributions paid in the period	<u>(3,190)</u>	<u>(4,971)</u>	<u>(10,576)</u>	<u>(14,757)</u>
Distributable Cash Retained	\$ 1,731	\$ 222	\$ 2,458	\$ 632
Decrease (increase) in non-cash operating working capital	2,658	(9,137)	(4,160)	(10,254)
Decrease (increase) in long-term receivables	(73)	(540)	(84)	(749)
Proceeds from disposal of property, plant and equipment	<u>4</u>	<u>(25)</u>	<u>17</u>	<u>2,165</u>
Decrease (Increase) in bank indebtedness, net of cash	<u>\$ 4,320</u>	<u>\$ (9,480)</u>	<u>\$ (1,769)</u>	<u>\$ (8,206)</u>

For the three months ended September 30, 2006 the Fund generated distributable cash of \$4.9 million, paid cash distributions of \$3.2 million, and retained \$1.7 million of distributable cash. In the same period the Fund reduced its investment in non-cash working capital by \$2.7 million. The retained distributable cash, combined with the reduction in non-cash working capital, enabled the Fund to pay down its bank indebtedness (net of cash) by \$4.3 million in the third quarter of 2006.

For the nine-months ended September 30, 2006 the Fund generated distributable cash of \$13.0 million, paid cash distributions of \$10.6 million and retained \$2.5 million of distributable cash. In the same period the Fund increased its investment in non-cash working capital by \$4.2, which was financed by the \$2.5 million in retained distributable cash, and by an increase in bank indebtedness (net of cash) of \$1.8 million.

We believe that our credit facilities, combined with the retained portion of our distributable cash, are sufficient to meet our current working capital requirements. The terms of our revolving credit facilities are addressed below.

4.4 Revolving Credit Facilities

	<u>As at September 30, 2006</u>	<u>As at December 31, 2005</u>
Cash and cash equivalents	\$ (1,215)	\$ (2,203)
Bank Indebtedness	46,449	46,925
Net Debt	<u>\$ 45,234</u>	<u>\$ 44,722</u>
Unitholders' Equity	<u>\$ 118,042</u>	<u>\$ 124,298</u>
Total Capitalization	<u>\$ 163,276</u>	<u>\$ 169,020</u>
Net debt to total capitalization	27.7%	26.5%
Previous 12 months EBITDA	\$ 22,439	\$ 23,584
Net debt to previous 12 months EBITDA	2.02	1.90

We have independent credit facilities in each of Canada and the U.S. In Canada, the term of our three-year operating line extends to March 23, 2007 and comprises a maximum facility of \$22.0 million. The balance outstanding on the Canadian operating line as at September 30, 2006 was \$13.8 million. In the U.S., the term of our three-year operating line extends to March 31, 2007, comprises a maximum facility of U.S.\$35 million, and as at September 30, 2006 had a balance outstanding of \$32.5 million (U.S. \$29.0 million). The principal terms of the credit facilities available to Hardwoods LP and Hardwoods US LP are described in more detail in the Fund's Annual Information Form dated March 20, 2006.

For the nine months ended September 30, 2006, the Fund's net debt increased \$1.7 million, but was partly offset by a \$1.2 million benefit from a strengthening Canadian dollar on the conversion of U.S. dollar denominated net debt from our U.S. operations. This nets to a \$0.5 million increase in the Fund's net debt balance, from \$44.8 million at December 31, 2005 to \$45.2 million at September 30, 2006. Overall net debt compared to total capitalization stands at 27.7% as of September 30, 2006, up slightly from 26.5% as of December 31, 2005. The slight increase in net debt to total capitalization is considered normal given that September 30th completes the seasonally stronger third quarter sales period. This period has higher working capital requirements, and therefore involves increased bank financing needs compared to the December 31st year end measurement date when debt financing needs are diminished.

The ratio of net debt to EBITDA in the previous 12 months, an indicator of the Fund's financial leverage, increased to 2.02 times as of September 30, 2006 from 1.90 times as of December 31, 2005. The maximum ratio of net debt to EBITDA allowed under the Fund's Canadian and U.S.

credit facilities is 2.85 times. The Fund's operating subsidiaries were fully compliant with this ratio as at September 30, 2006.

4.5 Contractual Obligations

The table below sets forth contractual obligations of the Fund as at September 30, 2006. These obligations relate to operating leases on various premises and become due in the fiscal years indicated:

(in thousands of Canadian dollars)

<u>Total</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011 & thereafter</u>
\$ 25,612	\$ 1,614	\$ 6,465	\$ 6,048	\$ 5,211	\$ 3,411	\$ 2,863

4.6 Off-Balance Sheet Arrangements

The Fund has no off balance sheet arrangements. The foreign currency contracts discussed under Financial Instruments in section 5.0 of this report are marked-to-market at the end of each quarter, with the fair value recorded on the balance sheet.

5.0 Financial Instruments

The Fund uses currency contracts to assist in managing its exposure to fluctuations in exchange rates between the Canadian dollar and the United States dollar. The foreign currency contracts are recognized in the balance sheet and measured at their fair value, with changes in fair value recognized currently in the statement of operations. At September 30, 2006, a subsidiary of the Fund had 19 monthly foreign currency contracts to exchange U.S.\$675,000 into approximately Canadian \$878,000, reflecting an exchange rate of Cdn\$1.3001 to U.S.\$1.00, each month until April 2008. The subsidiary of the Fund also had an additional 12 monthly foreign currency contracts to exchange U.S.\$675,000 into approximately Canadian \$760,000 each month from May 2008 until April 2009, reflecting an exchange rate of \$1.1255. This means that the amount realized on settlement of foreign currency contracts will be approximately \$118,000 less per month in the period May 2008 to April 2009 than would otherwise be realized on a monthly basis by the Fund's current monthly currency contracts. Taken together, the fair value of the Fund's 31 remaining monthly currency contracts covering the period until April 2009 have been reflected in the financial statements and represent a current asset of \$1.5 million and a long term asset of \$1.1 million at September 30, 2006.

Based on the Fund's current monthly distribution of \$0.068 per unit to public unitholders, during the term of the monthly foreign currency contracts the principal value of the monthly foreign currency contracts is sufficient to fully cover the amount of expected US dollar denominated distributable cash which is necessary to be converted to Canadian dollars to pay distributions to Class A Unitholders.

6.0 Related Party Transactions

Related parties refers to affiliates of the previous owners of the Business who have retained a 20% interest in Hardwoods through ownership of Class B Hardwoods LP units and Class B Hardwoods USLP units, respectively. For the three months ended September 30, 2006, sales of \$0.3 million were made to related parties, and the subsidiaries of the Fund purchased \$11,000 from related parties. For the nine months ended September 30, 2006, sales of \$0.9 million were made to related parties, and the subsidiaries of the Fund purchased \$78,000 from related parties. These sales and purchases took place at prevailing market prices. Subsidiaries of the Fund also paid \$27,000 in the third quarter and \$81,000 in the nine months ended September 30, 2006 to related parties under the terms of an agreement to provide services for management information systems.

7.0 Critical Accounting Estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires that we make estimates and assumptions that can have a material impact on our results of operations as reported on a periodic basis. We base our estimates and assumptions on past experience and other factors that are deemed reasonable under the circumstances. Actual results could differ from these estimates. The critical estimates used in preparing our financial statements are:

Accounts Receivable Provision: Due to the nature of our business and the credit terms we provide to our customers, we anticipate that a certain portion of required customer payments will not be made, and we maintain an allowance for these doubtful accounts. The allowance is based on our estimate of the potential of recovering our accounts receivable, and incorporates current and expected collection trends.

Valuation of Inventories: We anticipate that the net realizable value of our inventory could be affected by market shifts or damage to our products. Our inventory is valued at the lower of cost and net realizable value.

Valuation of Other Intangible Assets and Goodwill: Other intangible assets represent customer relationships acquired at the time of our IPO, and are recorded at cost less accumulated amortization. Amortization is provided for on a straight line basis over 15 years. Goodwill is recorded at cost and is not amortized. Management reviews the carrying value of goodwill and of other intangible assets annually, or more frequently if events or changes in circumstances indicate that an asset may be impaired. An excess of carrying value over fair value will be charged to income in the period in which the impairment is determined.

8.0 Risks and Uncertainties

The Fund is exposed to a number of risks and uncertainties in the normal course of business that could have a negative effect on the Fund's financial condition or results of operations. We identified significant risks that we were aware of in our Annual Information Report dated March 20, 2006, which is available to readers at www.sedar.com.

As discussed in section 2.0 of this report, in the third quarter a number of economic measures indicated that a slowdown is underway in the US and Canadian housing sectors. We are diversified geographically, by customer and by the wide range of commercial and residential applications for hardwoods. However, significant erosion in levels of activity in any of these areas, including levels of commercial and new home construction or renovation, could have a negative impact on demand for the hardwood products we sell. The risk of bad debts also increased if some of our customers prove unable to stay in business during a period of reduced hardwood demand. To address these heightened risks, management is preparing action plans by operating region to control costs in the event that we do experience a downturn in the economy that reduces demand for our hardwood products. We are also proactively negotiating repayment plans and enhanced security where possible from customer accounts deemed to be most at risk from a credit perspective.

9.0 Quarterly Financial Information

(in thousands of dollars)	For the three	For the three	For the three	For the three	For the three	For the three	For the three	For the three	For the three
	months ended	months ended	months ended	months ended	months ended	months ended	months ended	months ended	months ended
	September 30,	June 30,	March 31,	December 31,	September 30,	June 30,	March 31,	December 31,	December 31,
	2006	2006	2006	2005	2005	2005	2005	2005	2004
Total sales	\$ 90,974	\$ 95,054	\$ 93,380	\$ 84,130	\$ 94,766	\$ 91,852	\$ 85,027	\$ 93,730	
Net earnings	\$ 2,656	\$ 3,939	\$ 1,868	\$ 2,370	\$ 4,597	\$ 3,442	\$ 2,942	\$ 5,568	
Basic and fully diluted earnings per Class A Unit	\$ 0.184	\$ 0.273	\$ 0.130	\$ 0.164	\$ 0.319	\$ 0.239	\$ 0.204	\$ 0.386	
EBITDA	\$ 6,727	\$ 6,427	\$ 4,579	\$ 4,706	\$ 6,679	\$ 6,691	\$ 5,508	\$ 6,422	
Distributable cash	\$ 4,921	\$ 4,716	\$ 3,397	\$ 3,324	\$ 5,193	\$ 5,473	\$ 4,723	\$ 5,645	
Total distributions to Class A and Class B Units	\$ 2,940	\$ 3,693	\$ 3,693	\$ 3,825	\$ 4,971	\$ 4,910	\$ 4,877	\$ 5,105	
Payout ratio	60%	78%	109%	115%	96%	90%	103%	90%	

The table above provides selected quarterly financial information for the eight most recently completed fiscal quarters of the Fund. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in our opinion, necessary to present a fair statement of the results of operations for the periods presented. Quarter-to-quarter comparisons of our financial results are not necessarily meaningful and should not be relied upon as indication of future performance. Historically, the first quarter and fourth quarter have been seasonally slower periods for our business. In addition, net earnings reported in each quarter will be impacted by changes to the foreign exchange rate of the Canadian and US dollar and gains or losses on foreign currency contracts, which are described under Financial Instruments in section 5.0 of this report.

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Balance Sheets
(Expressed in thousands of Canadian dollars)

	September 30, 2006	December 31, 2005
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,215	\$ 2,203
Accounts receivable	49,267	46,166
Income tax receivable	-	86
Inventory	44,880	47,666
Prepaid expenses	1,514	1,222
Foreign currency contracts (note 3)	1,490	1,134
	98,366	98,477
Long-term receivables	2,603	2,634
Property, plant and equipment	3,328	3,519
Deferred financing costs	30	77
Foreign currency contracts (note 3)	1,094	1,519
Other intangible assets	11,135	12,103
Goodwill	94,225	96,340
	\$ 210,781	\$ 214,669
Liabilities and Unitholders' Equity		
Current liabilities:		
Bank indebtedness (note 4)	\$ 46,449	\$ 46,925
Accounts payable and accrued liabilities	7,546	9,231
Income tax payable	452	-
Distributions payable to Unitholders	980	-
	55,427	56,156
Deferred gain on sale – leaseback of land and building	710	804
Non-controlling interests (note 5)	34,214	32,047
Future income taxes	2,388	1,364
Unitholders' equity:		
Fund Units	133,454	133,454
Retained earnings	(1,207)	1,886
Cumulative foreign currency translation account	(14,205)	(11,042)
	118,042	124,298
	\$ 210,781	\$ 214,669

Contingencies (note 11)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Trustees:

(Signed) LAWRENCE I. BELL Trustee

(Signed) TERRY M. HOLLAND Trustee

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Statements of Operations and Retained Earnings

(Unaudited)

(Expressed in thousands of Canadian dollars)

	Three month period ended September 30, 2006	Three month period ended September 30, 2005	Nine month period ended September 30, 2006	Nine month period ended September 30, 2005
Sales	\$ 90,974	\$ 94,766	\$ 279,408	\$ 271,645
Cost of sales	73,816	77,067	228,482	220,714
Gross profit	17,158	17,699	50,926	50,931
Expenses:				
Selling and administrative	10,790	11,237	34,205	32,557
Amortization:				
Plant and equipment	308	293	916	936
Deferred financing costs	15	16	46	48
Other intangible assets	223	233	674	708
Deferred gain on sale – leaseback of land and building	(21)	(35)	(63)	(35)
Interest	932	614	2,463	1,519
Realized gain on foreign currency contracts	(359)	(217)	(1,012)	(504)
Mark-to-market adjustment on foreign currency contracts (note 3)	368	(1,224)	68	(541)
	12,256	10,917	37,297	34,688
Earnings before non-controlling interests and income taxes	4,902	6,782	13,629	16,243
Non-controlling interests (note 5)	981	1,357	2,726	3,249
Earnings before income taxes	3,921	5,425	10,903	12,994
Income taxes:				
Current	825	460	1,351	1,057
Future	440	368	1,089	956
	1,265	828	2,440	2,013
Net earnings for the period	2,656	4,597	8,463	10,981
Retained earnings, beginning of period	307	1,404	1,886	2,801
Distributions declared to Unitholders	(4,170)	(3,891)	(11,556)	(11,672)
Retained earnings, end of period	\$ (1,207)	\$ 2,110	\$ (1,207)	\$ 2,110
Basic and diluted earnings per Unit	\$ 0.18	\$ 0.32	\$ 0.59	\$ 0.76
Weighted average number of Units outstanding	14,410,000	14,410,000	14,410,000	14,410,000

See accompanying notes to consolidated financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Consolidated Statements of Cash Flows
(Unaudited)
(Expressed in thousands of Canadian dollars)

	Three month period ended September 30, 2006	Three month period ended September 30, 2005	Nine month period ended September 30, 2006	Nine month period ended September 30, 2005
Cash flows provided by (used in)				
operating activities:				
Net earnings for the period	\$ 2,656	\$ 4,597	\$ 8,463	\$ 10,981
Items not involving cash:				
Amortization	525	507	1,573	1,657
Loss (gain) on sale of property, plant and equipment	(5)	20	(16)	(25)
Mark-to-market adjustment on foreign currency contracts	368	(1,224)	68	(541)
Non-controlling interests	981	1,357	2,726	3,249
Future income taxes	442	304	1,025	891
	4,967	5,561	13,839	16,212
Change in non-cash operating working capital (note 6)	2,658	(9,137)	(4,160)	(10,254)
Net cash provided by (used in) operating activities	7,625	(3,576)	9,679	5,958
Cash flows provided by (used in)				
investing activities:				
Additions to property, plant and equipment	(46)	(368)	(805)	(823)
Proceeds on disposal of property, plant and equipment	4	(25)	17	2,165
Increase in long-term receivables, net	(73)	(540)	(84)	(749)
Net cash provided by (used in) investing activities	(115)	(933)	(872)	593
Cash flows provided by (used in)				
financing activities:				
Increase (decrease) in bank indebtedness	(3,235)	9,480	781	8,206
Distributions paid to Unitholders	(3,190)	(3,891)	(10,576)	(11,672)
Distributions paid to non-controlling interests	-	(1,080)	-	(3,085)
Net cash provided by (used in) financing activities	(6,425)	4,509	(9,795)	(6,551)
Increase (decrease) in cash	1,085	-	(988)	-
Cash, beginning of period	130	-	2,203	-
Cash, end of period	\$ 1,215	\$ -	\$ 1,215	\$ -
Supplementary information (cash amounts):				
Interest paid	\$ 932	\$ 614	\$ 2,463	\$ 1,519
Income taxes paid	8	84	706	318

See accompanying notes to consolidated financial statements.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

For the periods ended September 30, 2006 and 2005

1. Nature of operations:

Hardwoods Distribution Income Fund (the "Fund") is an unincorporated, open ended, limited purpose trust established under the laws of the Province of British Columbia on January 30, 2004 by a Declaration of Trust. The Fund commenced operations on March 23, 2004 when it completed an initial public offering of Units and acquired an 80% interest in a hardwood lumber and sheet goods distribution business in North America (the "Business") from affiliates of Sauder Industries Limited ("SIL"). The Fund holds, indirectly, 80% of the outstanding limited partnership units of Hardwoods Specialty Products LP ("Hardwoods LP") and Hardwoods Specialty Products US LP ("Hardwoods USLP"), limited partnerships established under the laws of the Province of Manitoba and the state of Delaware, respectively.

2. Basis of presentation:

The Fund prepares its consolidated interim financial statements in accordance with Canadian generally accepted accounting principles on a basis consistent with those used and described in the annual consolidated financial statements for the year ended December 31, 2005. The disclosures contained in these consolidated interim financial statements do not include all the requirements of Canadian generally accepted accounting principles for annual financial statements, and accordingly, these consolidated interim financial statements should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2005. Certain comparative figures have been restated to conform to the current period's financial statement presentation.

3. Foreign currency contracts:

In order to manage the Fund's exposure to exchange rate fluctuations on United States dollar denominated distributable cash, a subsidiary of the Fund has entered into foreign currency contracts to exchange US\$675,000 each month for approximately \$878,000 until April 2008, reflecting an exchange rate of \$1.30. The subsidiary of the Fund has also entered into additional monthly foreign currency contracts which require the subsidiary to exchange, beginning in May 2008, US\$675,000 into approximately \$760,000 each month until April 2009, reflecting an exchange rate of \$1.1255. The fair value of the Fund's 31 remaining monthly foreign currency contracts at September 30, 2006 represent a cumulative current asset of \$1,490,000 and a cumulative long term asset of \$1,094,000.

4. Bank indebtedness:

	September 30, 2006	December 31, 2005
Checks issued in excess of funds on deposit	\$ 164	\$ 753
Credit facility, Hardwoods LP	13,835	13,201
Credit facility, Hardwoods USLP (September 30, 2006-US\$29,033; December 31, 2005-US\$28,350)	32,450	32,971
	\$ 46,449	\$ 46,925

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

For the periods ended September 30, 2006 and 2005

5. Non-controlling interests:

Balance, January 1, 2006	\$ 32,047
Interest in earnings for the period	2,726
Foreign currency translation adjustment of non-controlling interest in Hardwoods USLP	(559)
<hr/>	
Balance, end of period	\$ 34,214

The previous owners of the Business (note 1) have retained a 20% interest in Hardwoods LP and Hardwoods USLP through ownership of Class B Hardwoods LP units ("Class B LP Units") and Class B Hardwoods USLP units ("Class B USLP Units"), respectively. The Fund owns an indirect 80% interest in Hardwoods LP and Hardwoods USLP through ownership of all Class A Hardwoods LP units ("Class A LP Units") and Class A Hardwoods USLP units ("Class A USLP Units"), respectively.

The Class A LP Units and Class B LP Units and the Class A USLP Units and Class B USLP Units, respectively, have economic and voting rights that are equivalent in all material respects except distributions on the Class B LP Units and Class B USLP Units are subject to the subordination arrangements described below until the date (the "Subordination End Date") on which:

- the consolidated Adjusted EBITDA, as defined in the Subordination Agreement dated March 23, 2004, of the Fund for the 12 month period ending on the last day of the month immediately preceding such date is at least \$21,300,000; and
- cash distributions of at least \$29,540,000 (\$2.05 per Unit) have been paid on the Units and a combined amount of cash advances or distributions of at least \$7,385,000 has been paid on the Class B LP Units and Class B USLP Units, being \$2.05 per combined Class B LP and Class B USLP Units (as adjusted for issuances, redemptions and repurchases of Units, LP Units and USLP Units subsequently and by converting the cash distributions or advances by Hardwoods USLP on the USLP Units at the rate of exchange used by the Fund to convert funds received by it in US dollars into Canadian dollars) for the 24 month period ending on the last day of the month immediately preceding such date.

The Subordinated End Date had not occurred at September 30, 2006.

Prior to the Subordination End Date, advances and distributions on the LP Units and the USLP Units will be made in the following order of priority:

- At the end of each month, cash advances or distributions will be made to the holders of Class A LP Units and Class A USLP Units in a combined amount that is sufficient to provide available cash to the Fund to enable the Fund to make cash distributions upon the Units for such month at least equal to \$0.08542 per Unit or, if there is insufficient available cash to make distributions or advances in such amount, such lesser amount as is available as determined by the board of directors of the general partners;

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

For the periods ended September 30, 2006 and 2005

5. Non-controlling interests (continued):

- At the end of each fiscal quarter of Hardwoods LP and Hardwoods USLP, including the fiscal quarter ending on the fiscal year end, available cash of Hardwoods LP and Hardwoods USLP will be advanced or distributed in the following order of priority:
 - First, in payment of the monthly cash advance or distribution to the holders of Class A LP Units and Class A USLP Units as described above, for the month then ended;
 - Second, to the holders of Class A LP Units and Class A USLP Units, to the extent that the combined monthly cash advances or distributions in respect of the 12 month period then ended (and not, for greater certainty, in any previous 12 month period) on Class A LP Units and Class A USLP Units were not made or were made in amounts less than a combined amount at least equal to \$1.025 per Unit, the amount of any such deficiency. As of September 30, 2006, the amount of such deficiency was \$0.8 million;
 - Third, to the holders of Class B LP Units and Class B USLP Units in a combined amount for one Class B LP Unit and one Class B USLP Unit equal, on a pro-rated basis, to the combined amount advanced or distributed on one Class A LP Unit and one Class A USLP Unit during such fiscal quarter or, if there is insufficient available cash to make advances or distributions in such amount, such lesser amount as is available;
 - Fourth, to the holders of Class B LP Units and Class B USLP Units, to the extent only that combined advances or distributions in respect of any fiscal quarter(s) during the 12 month period then ended (and not, for greater certainty, in any previous 12 month period) on one Class B LP Unit and one Class B USLP Unit were not made, or were made in amounts less, on a pro-rated basis, that the combined amount advanced or distributed on one Class A LP Unit and one Class A USLP Unit during such 12 month period, the amount of such deficiency. As of September 30, 2006, the amount of such deficiency was \$3.6 million;
 - Fifth, to the extent of any excess, to the holders of the Class A LP Units and Class B LP Units and Class A USLP Units and Class B USLP Units, respectively, so that the combined advances or distributions on one Class A LP Unit and one Class A USLP Unit are the same as the combined advances or distribution on one Class B LP Unit and one Class B USLP Unit in respect of the 12 month period then ended (and not, for greater certainty, any previous 12 month period).

After the Subordination End Date, the holders of the Class B LP Units and Class B USLP Units will generally be entitled to effectively exchange all or a portion of their Class B LP Units and Class B USLP Units together for up to 3,602,500 Units of the Fund, representing 20% of the issued and outstanding Units of the Fund on a fully diluted basis. In the event the Fund enters into an agreement in respect of an acquisition or a take-over bid of the Fund, the holders of the Class B LP Units and Class B USLP Units will be entitled to exchange such units for Units of the Fund.

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

For the periods ended September 30, 2006 and 2005

6. Changes in non-cash operating working capital:

	Three month period ended September 30, 2006	Three month period ended September 30, 2005	Nine month period ended September 30, 2006	Nine month period ended September 30, 2005
Accounts receivable	\$ 1,653	\$ (2,028)	\$ (4,366)	\$ (4,483)
Income taxes receivable/payable	816	84	538	400
Inventory	706	(7,153)	1,467	(7,601)
Prepaid expenses	117	(92)	(324)	(467)
Accounts payable and accrued liabilities	(634)	220	(1,475)	1,897
	\$ 2,658	\$ (9,137)	\$ (4,160)	\$ (10,254)

7. Segment disclosure:

Information about geographic areas is as follows:

	Three month period ended September 30, 2006	Three month period ended September 30, 2005	Nine month period ended September 30, 2006	Nine month period ended September 30, 2005
Revenue from external customers:				
Canada	\$ 26,213	\$ 29,692	\$ 84,558	\$ 86,939
United States	64,761	65,074	194,850	184,706
	\$ 90,974	\$ 94,766	\$ 279,408	\$ 271,645

	September 30, 2006	December 31, 2005
Property, plant and equipment:		
Canada	\$ 1,261	\$ 1,559
United States	2,067	1,960
	\$ 3,328	\$ 3,519
Goodwill		
Canada	\$ 42,043	\$ 42,043
United States	52,182	54,297
	\$ 94,225	\$ 96,340

HARDWOODS DISTRIBUTION INCOME FUND

Notes to Consolidated Financial Statements

(Unaudited)

(Tabular amounts expressed in thousands of Canadian dollars)

For the periods ended September 30, 2006 and 2005

8. Pensions:

Hardwoods USLP maintains a defined contribution 401 (k) retirement savings plan (the "USLP Plan"). The assets of the USLP Plan are held and related investment transactions are executed by the Plan's Trustee, ING National Trust, and, accordingly, are not reflected in these consolidated financial statements. During the three months ended September 30, 2006, Hardwoods USLP contributed and expensed \$91,916 (US\$81,309) (2005 - \$89,581 (US\$74,459)) in relation to the USLP Plan. During the nine month period ended September 30, 2006, Hardwoods USLP contributed and expensed \$311,189 (US\$274,708) (2005 - \$326,803 (US\$267,040)) in relation to the USLP Plan.

Hardwoods LP does not maintain a pension plan. Hardwoods LP does, however, administer a group registered retirement savings plan ("LP Plan") that has a matching component whereby Hardwoods LP makes contributions to the LP Plan which match contributions made by employees up to a certain level. The assets of the LP Plan are held and related investment transactions are executed by LP Plan's Trustee, Sun Life Financial Trust Inc., and, accordingly, are not reflected in these consolidated financial statements. During the three months ended September 30, 2006, Hardwoods LP contributed and expensed \$53,996 (2005 - \$55,374) in relation to the LP Plan. During the nine month period ended September 30, 2006, Hardwoods LP contributed and expensed \$216,746 (2005 - \$215,822) in relation to the LP Plan.

9. Related party transactions:

For the three months ended September 30, 2006, sales of \$281,660 (2005 - \$423,326) were made to affiliates of SIL, and the Fund made purchases of \$10,655 (2005 - \$69,426) from affiliates of SIL. For the nine months ended September 30, 2006, sales of \$927,420 (2005 - \$1,779,567) were made to affiliates of SIL, and the Fund made purchases of \$77,880 (2005 - \$220,496) from affiliates of SIL. All these sales and purchases took place at prevailing market prices.

During the three months ended September 30, 2006, the Fund paid \$27,000 (2005 - \$31,704) to affiliates of SIL under the terms of an agreement to provide services for management information systems. During the nine months ended September 30, 2006, the Fund paid \$81,000 (2005 - \$90,680) to affiliates of SIL under the terms of an agreement to provide services for management information systems. This cost is included in the selling and administrative expense in the statement of operations.

10. Seasonality:

The Fund is subject to seasonal influences. Historically the first and fourth quarters are seasonally slower periods for construction activity and therefore demand for hardwood products.

11. Contingencies:

The Fund and its subsidiaries are subject to legal proceedings that arise in the ordinary course of its business. Management is of the opinion, based upon information presently available, that it is unlikely that any liability, to the extent not provided for through insurance or otherwise, would be material in relation to the Fund's consolidated financial statements.

Unitholder Information

Trustees

Lawrence I. Bell
Chair, British Columbia Hydro
& Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

Directors

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Chair, British Columbia Hydro
& Power Authority

Terry M. Holland
President, Krystal Financial Corp.

Graham M. Wilson
President, Grawil Consultants Inc.

E. Lawrence Sauder
Vice Chair, Sauder Industries

Richard N. McKerracher
President, Sauder Industries

Officers

Maurice E. Paquette
President & Chief Executive Officer

Robert J. Brown
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Trading under **HWD.UN**

Transfer Agent

Computershare Trust
Company of Canada

