

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

**Consolidated Financial Statements**

**For the years ended December 31, 2001 and 2000**

**To the Unitholders of Royal Host Real Estate Investment Trust**

We have audited the consolidated balance sheets of Royal Host Real Estate Investment Trust (“Royal Host”) as at December 31, 2001 and 2000 and the consolidated statement of net earnings and cash available for distribution and cash flows for the years then ended. These consolidated financial statements are the responsibility of Royal Host’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, there consolidated financial statements, present fairly, in all material respects, the financial position of Royal Host as at December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

Signed

***“Deloitte and Touche LLP”***

Chartered Accountants  
Calgary, Canada  
March 15, 2002

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Consolidated Balance Sheets**  
*\$000*

	As At	
	December 31, 2001	December 31, 2000
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and short-term investments <i>(Note 3)</i>	12,201	6,799
Accounts and notes receivable	8,348	12,320
Deposits and prepaid expenses	2,781	2,603
Inventories	3,471	2,903
Future income tax	255	1,470
	<b>27,056</b>	<b>26,095</b>
<b>Capital Assets <i>(Note 6)</i></b>	<b>327,250</b>	<b>332,916</b>
<b>Long-term Notes Receivable and Other Assets</b>	<b>3,730</b>	<b>4,604</b>
	<b>358,036</b>	<b>363,615</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued liabilities	15,595	15,936
Current portion of mortgages and other debt <i>(Note 7)</i>	68,724	51,802
Current portion of capital leases <i>(Note 8)</i>	1,273	928
Distributions payable	1,636	1,874
Other current liabilities	2,140	2,013
	<b>89,368</b>	<b>72,553</b>
<b>Mortgages and Other Debt <i>(Note 7)</i></b>	<b>83,582</b>	<b>107,051</b>
<b>Capital Leases <i>(Note 8)</i></b>	<b>2,225</b>	<b>2,205</b>
<b>Future Income Taxes</b>	<b>1,138</b>	<b>1,885</b>
<b>Deferred Revenue</b>	<b>1,235</b>	<b>2,145</b>
<b>Equity <i>(Note 9)</i></b>	<b>180,488</b>	<b>177,776</b>
	<b>358,036</b>	<b>363,615</b>

*See accompanying Notes to Consolidated Financial Statements*

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Consolidated Statements of Net Earnings and Cash Available for Distribution**  
**For the years ended December 31, 2001 and 2000**  
*\$000*

	Years Ended	
	December 31, 2001	December 31, 2000
<b>Hospitality Revenues</b>		
Rooms	89,969	89,989
Food and beverage	23,045	23,023
Other hospitality revenues	24,068	27,867
	<u>137,082</u>	<u>140,879</u>
<b>Hospitality Expenses</b>	<u>94,829</u>	<u>96,144</u>
<b>Operating Income</b>	<u>42,253</u>	<u>44,735</u>
<b>Other (Income) and Expenses</b>		
Interest income	(362)	(112)
Interest on mortgages and other debt	14,262	14,912
Trust administration	1,687	1,968
Capital and future income taxes	735	(837)
Depreciation and amortization	18,877	21,932
	<u>35,199</u>	<u>37,863</u>
<b>Net Earnings (Note 4)</b>	<b>7,054</b>	<b>6,872</b>
Add: Depreciation and amortization of capital assets	17,694	21,001
Add: Amortization of deferred financing fees	1,183	931
Add (deduct): Future income tax expense (recovery)	468	(620)
	<u>26,399</u>	<u>28,184</u>
<b>Cash Available for Distribution</b>	<b>26,399</b>	<b>28,184</b>
<b>Per Unit Cash Available for Distribution</b>		
- basic (Note 4)	<b>0.94</b>	<b>1.15</b>
- diluted (Note 4)	<b>0.93</b>	<b>1.10</b>

*See accompanying Notes to Consolidated Financial Statements*

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31, 2001 and 2000**  
*\$000*

	Years Ended	
	December 31, 2001	December 31, 2000
<b>CASH PROVIDED BY (USED IN)</b>		
<b>Operating Activities</b>		
Net earnings	7,054	6,872
Items not affecting cash:		
Depreciation and amortization of capital assets	17,694	21,001
Future income tax expense (recovery)	468	(620)
Funds from operations	<u>25,216</u>	<u>27,253</u>
<b>Change in non-working capital:</b>		
Decrease (increase) in accounts and notes receivable	3,972	(4,265)
Increase in deposits and prepaid expenses	(178)	(1,589)
Increase in inventories	(568)	(197)
(Decrease) increase in accounts payable and accrued liabilities	(341)	3,124
Increase (decrease) in other current liabilities	127	(1,490)
	<u>28,228</u>	<u>22,836</u>
<b>Financing Activities</b>		
Additions to mortgages and other debt	15,206	69,355
Principal repayments on mortgages and other debt	(22,773)	(65,666)
Issuance of trust units	22,559	-
Issuance of trust units under distribution reinvestment plan	144	-
Unit issue costs	(1,409)	-
	<u>13,727</u>	<u>3,689</u>
<b>Investing Activities</b>		
Capital expenditures	(10,643)	(4,924)
Decrease (increase) in long-term notes receivable and other assets	874	(424)
(Decrease) increase in deferred revenue	(910)	699
	<u>(10,679)</u>	<u>(4,649)</u>
<b>Equity Distributions</b>	<u>(25,874)</u>	<u>(22,368)</u>
<b>Net Increase (Decrease) in Cash and Short-term Investments</b>	<b>5,402</b>	<b>(492)</b>
<b>Cash and Short-term Investments, beginning of year</b>	<u>6,799</u>	<u>7,291</u>
<b>Cash and Short-term Investments, end of year</b>	<u>12,201</u>	<u>6,799</u>

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

**1. GENERAL INFORMATION**

Royal Host Real Estate Investment Trust (“Royal Host”) was created pursuant to the Declaration of Trust dated August 27, 1997. Royal Host is an unincorporated closed-end mutual fund trust established for the purpose of investing in hotel properties and hospitality businesses, under specified guidelines as defined under the Declaration of Trust.

**2. SIGNIFICANT ACCOUNTING POLICIES**

**a) Basis of Accounting**

The Royal Host accounting policies and standards of financial disclosure are in accordance with Canadian generally accepted accounting principles (“GAAP”) as prescribed by the Canadian Institute of Chartered Accountants (“CICA”) and industry specific accounting principles as published by the Canadian Institute of Public and Private Real Estate Companies (“CIPPREC”).

**b) Use of Estimates**

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and revenue and expenses for the reported period. Actual results could differ from those estimates.

**c) Principles of Consolidation**

These consolidated financial statements include the accounts of Royal Host and its wholly-owned subsidiaries and the accounts of all partnerships and co-tenancy to the extent of the Royal Host proportionate interest in their respective assets, liabilities, revenues, expenses and cash flows. All inter-company transactions and balances have been eliminated.

**d) Revenue Recognition**

Revenue is recognized upon performance of hotel and related services and delivery of food and beverages. Revenue from prepaid vacations is recorded when the purchaser has complied with all major conditions of the sale, including the payment of the full purchase price or the arrangement of appropriate financing. Ongoing credit evaluations are performed and an allowance for potential credit losses is provided against the portion of accounts receivable which is estimated to be uncollectible. Certain portions of revenue from prepaid vacations are deferred until earned by Royal Host.

**e) Capital Assets**

Hotel properties are recorded at the lower of net book value or net recoverable amount. The net recoverable amount represents the undiscounted projected future net cash flow generated from the property throughout its useful life, including its residual value, and is intended to determine recovery of an investment and is not an expression of a property’s fair market value.

Hotel properties are depreciated using the straight-line method over their estimated useful lives of between 25 and 40 years. Hotel construction, condition and location characteristics are evaluated on a periodic basis by management and useful life estimates are revised accordingly, as may be necessary from time to time.

Maintenance and repair costs are expensed against operations as incurred, while significant improvements, replacements and major renovations are capitalized to hotel properties. Furniture, equipment and certain improvements are depreciated on a straight-line basis over periods of up to ten years.

## **ROYAL HOST REAL ESTATE INVESTMENT TRUST**

### **Notes to Consolidated Financial Statements**

#### **As at December 31, 2001 and 2000**

Properties under development consist of properties under construction and are recorded at the lower of cost, including pre-development expenditures, and their net recoverable amount.

Goodwill comprises the unamortized balance of the excess of the Royal Host acquisition cost over the fair value of the identifiable net assets of Royco Hotels & Resorts ("Royco") and R.V.I. Holiday Limited Partnership ("RVI"). To December 31, 2001, goodwill has been amortized on a straight-line basis over periods between five and 15 years.

Goodwill is regularly evaluated by comparing estimated future net cash flows against the net book value of goodwill to assess the recoverability of goodwill. Any permanent impairment would be written down in the period identified and charged against earnings.

Effective January 1, 2002, Royal Host will adopt the recommendations of the CICA Handbook Section 3062 regarding Goodwill and Other Intangible Assets, which requires for years beginning after January 1, 2002, non-amortization of goodwill. Goodwill will be assessed quarterly for impairment, which will be measured as the difference between the book value of the goodwill and its fair value. Goodwill will be written down in the period if an impairment loss has been identified.

#### **f) Capitalized Costs**

Costs associated with the acquisition of the hotel properties are capitalized to the respective hotel property. These costs typically include realty agent commissions, property transfer taxes, legal fees, environmental studies, engineering and other direct expenses.

The cost of hotel properties under development includes all expenditures incurred in connection with the activities of acquiring, developing and constructing these properties. These expenditures consist of all direct costs including debt interest and an appropriate allocation of general and administrative costs incurred.

#### **g) Inventory**

Inventory consists of food, beverages, china, silverware, glassware, linen and general supplies. These items are recorded at lower of cost or net replacement value and are determined on a first-in, first-out basis.

#### **h) Financing Costs**

Debt financing costs are deferred and amortized on a straight-line basis over the terms of the related loans.

#### **i) Income Taxes**

Royal Host is taxed as a "mutual fund trust" for income tax purposes. Pursuant to the Declaration of Trust, the Trustees intend to distribute all taxable income directly earned by Royal Host to its Unitholders and to deduct such distributions and designations for income tax purposes.

Effective January 1, 2000, Royal Host adopted the recommendations of Abstract 107 of the Emerging Issues Committee of the CICA regarding future income taxes, which requires recording a future tax amount for temporary differences existing in subsidiaries of the Trust. This accounting change has been applied retroactively without restatement. The impact of the change was to record a future tax liability and a charge to Unitholders' equity at January 1, 2000 of \$1,035,000. Temporary differences consist primarily of loss carry-forwards and book versus tax values of capital assets.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

**j) Unit Option Plan**

Royal Host has a unit option plan as described in Note 9(d). No compensation expense is recognized for the plan when options are granted. Consideration received on exercise of options is credited to Unitholders' equity.

**3. RESERVED CASH**

Included in cash is an amount of \$3,194,000 (2000 - \$3,727,000) of reserved cash representing funds on deposit with lenders for future planned capital expenditures within the next 12 months.

**4. PER UNIT COMPUTATIONS**

There were 24,115,846 trust units outstanding as at December 31, 2001 (2000 - 20,267,412). Per unit computations are based on the weighted average number of trust units outstanding for the year, after adjusting the net earnings and cash available for distribution for payments on the convertible debenture of \$1,760,000 (2000 - \$1,760,000) and payments on the redeemable partnership units of \$2,836,000 (2000 - \$3,025,000).

For the twelve months ended:	December 31, 2001			December 31, 2000		
	(\$000's)	Weighted Average Units (000's)	Per Unit	(\$000's)	Weighted Average Units (000's)	Per Unit
<b>Earnings per unit</b>						
Net earnings	7,054			6,872		
Less:						
Interest on convertible debenture	(1,760)			(1,760)		
Distributions on redeemable partnership units	(2,836)			(3,025)		
<b>Basic and diluted earnings per unit</b>	<b>2,458</b>	<b>23,172</b>	<b>0.11</b>	<b>2,087</b>	<b>20,267</b>	<b>0.10</b>
<b>Cash available for distribution</b>						
Net earnings	7,054			6,872		
Add (deduct):						
Depreciation and amortization of capital assets	17,694			21,001		
Amortization of deferred financing fees	1,183			931		
Future income tax expense (recovery)	468			(620)		
Distributions on redeemable partnership units	(2,836)			(3,025)		
Interest on convertible debenture	(1,760)			(1,760)		
<b>Basic cash available for distribution per unit</b>	<b>21,803</b>	<b>23,172</b>	<b>0.94</b>	<b>23,399</b>	<b>20,267</b>	<b>1.15</b>
Add back:						
Distributions on redeemable partnership units	2,836	3,151		3,025	3,151	
Interest on convertible debenture	1,760	2,000		1,760	2,127	
<b>Diluted cash available for distribution per unit</b>	<b>26,399</b>	<b>28,323</b>	<b>0.93</b>	<b>28,184</b>	<b>25,545</b>	<b>1.10</b>

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

Under the Royal Host capital replacement reserve policy, 3% of total hotel revenue is deducted from cash available for distribution to allow for the upkeep and renovation of the hotel properties. This policy may be amended from time to time at the discretion of the Trustees. On this basis, the reserve provided for the year ended December 31, 2001 would have been \$3,641,000 (2000 - \$3,671,000). As Royal Host spent \$10.6 million excluding capital leases in 2001 (2000 - \$4.9 million) to renovate and reposition the hotel properties, the Trustees have determined that no reserve would be provided for in 2001 and 2000.

Royal Host has complied with the new requirements of the Canadian Institute of Chartered Accountants ("CICA") with respect to the calculation of earnings and diluted earnings per unit. Comparative figures have been restated to conform to these new accounting standards.

**5. RELATED PARTY TRANSACTIONS**

During 2001, Royal Host transferred a portion of its accounts receivable, aggregating \$2,761,000, to a company of which certain officers of Royal Host hold, in aggregate, a 45% interest. No gain or loss was recognized, and this transaction was conducted at amounts approximating fair market value.

**6. CAPITAL ASSETS**

	<i>(in \$000's)</i>		
	<b>Gross Book Value</b>	<b>Accumulated Depreciation and Amortization</b>	<b>Net Book Value</b>
<b>2001</b>			
Land	37,303	-	37,303
Buildings	276,435	35,142	241,293
Furniture, fixtures and equipment	37,586	20,712	16,874
Paving and other	1,195	152	1,043
	<b>352,519</b>	<b>56,006</b>	<b>296,513</b>
Properties under development	9,008	-	9,008
Goodwill	34,276	12,547	21,729
	<b>395,803</b>	<b>68,553</b>	<b>327,250</b>
<b>2000</b>			
Land	37,303	-	37,303
Buildings	274,227	28,171	246,056
Furniture, fixtures and equipment	35,745	14,311	21,434
Paving and other	1,173	108	1,065
	<b>348,448</b>	<b>42,590</b>	<b>305,858</b>
Properties under development	1,457	-	1,457
Goodwill	34,276	8,675	25,601
	<b>384,181</b>	<b>51,265</b>	<b>332,916</b>

Royal Host re-evaluated the useful lives of its properties for depreciation purposes. The result was to extend the estimated useful lives of hotel and resort buildings from 25 years to between 25 and 40 years, commencing January 1, 2001. Had the previous estimates been used, depreciation and amortization expense would have been \$21,814,000 for the year ended December 31, 2001.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

All hotel properties are wholly-owned by Royal Host, except one hotel property representing less than 5% of total capital assets, which is jointly owned by Royal Host and the vendor. Pursuant to the Exchange Agreement dated September 11, 1998, the vendor has an option to exchange its 50% ownership interest for units of Royal Host. The valuation of such exchange is to be determined based on a specified capitalization rate and the units of Royal Host are to be priced based on a 20 day weighted average trading price per unit. This calculation has been taken into consideration in the diluted per unit calculations in Note 4 and determined to be anti-dilutive.

For discussion of capital replacement reserves in 2001 and 2000, see Note 4.

Properties under development include interest expense capitalized of \$Nil in 2001 (2000 - \$66,000). The Royal Host commitment to complete properties under development in 2001 is estimated at \$2,307,000 (2000 - \$747,000).

**7. MORTGAGES AND OTHER DEBT**

	<i>(in \$000's)</i>	
	<b>December 31, 2001</b>	<b>December 31, 2000</b>
Mortgages and other debt secured by hotel properties	152,306	158,853
Less current portion	68,724	51,802
<b>Long-term obligations</b>	<b>83,582</b>	<b>107,051</b>
Years ended December 31 <i>(in 000's)</i>		
2002	68,724	
2003	3,316	
2004	2,349	
2005	2,567	
2006	2,776	
Subsequent	72,574	
	<b>152,306</b>	
<b>Supplementary Information:</b>	<b>December 31, 2001</b>	<b>December 31, 2000</b>
Cash interest paid in the year	13,753	13,949

Mortgages and other debt bear interest at rates ranging from 4.75% to 12.0% (2000 – 8.0% to 12.0%) with a weighted average year-end rate of 9.02% (2000 - 9.24%) and mature between 2002 and 2018. The mortgages and other debt are secured by fixed charges over specified hotel properties. Monthly principal and interest payments pursuant to the indebtedness are \$1,488,000 at December 31, 2001 (2000 - \$1,541,000).

Financing charges are deferred and amortized over the term of the related debt. In 2001, \$1,183,000 was included in amortization (2000 - \$931,000).

In 2001, there was a net reduction of \$6.6 million of long term debt. Royal Host intends to use approximately \$18.5 million of the estimated net proceeds of the 9.25% Convertible Unsecured Subordinated Debentures issued in February 2002 to reduce its outstanding current bank indebtedness (see Note 17).

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

**8. OBLIGATIONS UNDER CAPITAL LEASES**

The company has entered into various capital lease obligations to acquire computers and hotel furniture, fixtures and equipment. The present values of minimum lease payments under capital lease as of December 31, 2001 are as follows:

	<i>(in \$000's)</i>	
	<b>December 31, 2001</b>	<b>December 31, 2000</b>
Present value of future minimum lease payments	3,498	3,133
Less current portion	1,273	928
<b>Long-term obligations</b>	<b>2,225</b>	<b>2,205</b>

For the years ending December 31 *(in 000's)*

2002	1,563
2003	1,343
2004	675
2005	321
2006	111
Subsequent	34
Future minimum lease payments	4,047
Amounts representing interest	549
Present value of future minimum lease payments	<b>3,498</b>

**9. EQUITY**

	<i>(in \$000's)</i>	
	<b>December 31, 2001</b>	<b>December 31, 2000</b>
<b>Balance, beginning of year</b>	<b>128,276</b>	<b>146,681</b>
Adjustment for future income taxes <i>(Note 2(i))</i>	-	(1,035)
<b>As restated</b>	<b>128,276</b>	<b>145,646</b>
Net earnings	7,054	6,872
Issuance of trust units - public offering	22,559	-
Issuance of trust units - distribution reinvestment plan	144	-
Unit issue costs	(1,409)	-
Equity distributions on:		
Trust units	(21,040)	(19,457)
Redeemable partnership units	(2,836)	(3,025)
Interest paid on convertible debentures	(1,760)	(1,760)
	<b>130,988</b>	<b>128,276</b>
<b>Convertible Equity</b>		
Redeemable partnership units	27,500	27,500
Convertible debenture	22,000	22,000
	<b>49,500</b>	<b>49,500</b>
<b>Balance, end of year</b>	<b>180,488</b>	<b>177,776</b>

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2001 and 2000**

**a) Unit Capital**

	<u>Number of units</u>	<u>(in \$000's)</u>
<b>Balance, December 31, 1998</b>	<b>18,829,487</b>	<b>187,142</b>
Issuance of trust units under private placement	1,435,530	10,006
Issuance of trust units under distribution reinvestment plan	2,395	17
<b>Balance, December 31, 2000 and 1999</b>	<b>20,267,412</b>	<b>197,165</b>
Issuance of trust units under public offering		
March 27, 2001	3,390,000	20,001
April 23, 2001	433,600	2,558
Issuance of trust units under distribution reinvestment plan	24,834	144
<b>Balance December 31, 2001</b>	<b>24,115,846</b>	<b>219,868</b>

On March 27, 2001, pursuant to a prospectus, Royal Host issued 3,390,000 units at a unit price of \$5.90 for total gross proceeds of \$20,001,000. On April 23, 2001, Royal Host issued 433,600 units at a unit price of \$5.90 for total gross proceeds of \$2,558,000 pertaining to the over-allotment option granted in the March 27, 2001 prospectus.

**b) Distributions to Unitholders**

Cash available for distribution for the year ended December 31, 2001 was \$26,399,000 (2000 - \$28,184,000) and distributions declared to Unitholders, excluding distributions on redeemable partnership units, aggregated \$21,040,000 (2000 - \$19,457,000) for the same period.

**c) Distribution Reinvestment Plan**

Royal Host has established a Distribution Reinvestment Plan ("DRIP") that is administered by its transfer agent and has reserved 500,000 units for issue under this Plan. For the period January 2001 to July 2001, the transfer agent purchased DRIP units on the open market. Subsequent to July 2001, the company has issued new units for DRIP participants out of the previously authorized reserved units.

**d) Unit Options**

Royal Host has reserved 1,883,000 units under its unit option plan. As at December 31, 2001, Royal Host has unit options outstanding to certain directors, employees and consultants to purchase an aggregated total of 907,500 units (2000 - 990,000 units), ranging from \$10.00 to \$10.50 per unit (in 2001 and 2000, the weighted average exercise price is \$10.03). These options expire on October 31, 2007 and on March 23, 2008. During 2001, no options were issued or exercised, but 82,500 units expired.

**e) Redeemable Partnership Units**

Holder of redeemable partnership units ("Holder") is entitled to receive distributions indirectly from Royal Host equivalent to the distributions paid by Royal Host to its Unitholders, commencing on January 1, 1999. Each partnership unit is redeemable by the Holder after January 1, 2000 at a cash price equal to the market value of a Royal Host unit, or at the option of Royal Host and subject to regulatory approval, one Royal Host unit or a combination thereof.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
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Under certain circumstances, including a change of control (“Trigger Event”), the Holders have the right to redeem the partnership units for cash proceeds of \$27.5 million. If the Trigger Event occurs after the issuance of redeemable units but prior to January 1, 2004, then the Holders may redeem the then outstanding redeemable partnership units for cash, at the greater of \$9.00 per unit or the market price of the Royal Host units. Change in control is defined as ownership by any one entity or a group of related entities of more than 20% of the outstanding units of Royal Host.

For accounting purposes, the redeemable partnership units have equity characteristics and accordingly, they are classified as equity instruments.

**f) Convertible Debentures**

The convertible debentures bear interest at 8% per annum and are payable monthly, at Royal Host's option, in either cash or Royal Host units of an equivalent value. In addition, upon maturity in 2003, Royal Host has the option to repay the debentures in either cash or in equivalent units of Royal Host.

Based on certain conditions, the debentures are convertible at \$11.00 per trust unit for the period from October 1, 2001 to September 30, 2003.

For accounting purposes, the convertible debentures have equity characteristics and accordingly, they are classified as equity instruments.

**g) Employee Unit Purchase Program**

During 2000, Trustees approved the issue of up to 400,000 units from treasury for an employee unit purchase program. Under this program, certain Royal Host employees will be eligible to finance the purchase of units from treasury at \$5.80 per unit. To date, no units have been issued under the plan.

**10. COMMITMENTS**

**a) Energy Contracts**

Royal Host has entered into long-term supply arrangements with two electrical utility companies and two natural gas providers to supply electricity and natural gas requirements for certain Alberta and Ontario properties. The electricity contracts are for a term of five years at a blended rate of approximately 6.09 cents per kilowatt-hour for annual usage of approximately 33.7 million kilowatt-hours in 2002 (2001 - 9.23 cents per kilowatt-hour for 5.7 million kilowatt hours). The natural gas contracts are for terms of two, three, and five years, at a blended rate of approximately 19.45 cents per cubic meter, excluding delivery, on annual usage of approximately 4.74 million cubic meters for 2002 (2001 – 28.85 cents per cubic meter for 3.60 million cubic meters). Royal Host is not required to guarantee usage levels for any contracts.

**b) Vacation Club Transactions**

Effective December 18, 2001 Royal Host management, acting in its capacity as authorized officers of a unincorporated vacation club society (“Society”) entered into a lease agreement with a party to secure, on behalf of the Society, the right to use a vacation property. The lease agreement temporarily obligates a Royal Host subsidiary to lease the particular vacation property for three successive 15-year terms followed by a final 5-year term. The renewal terms are automatic and substantially obligate the lessee to renew the lease for a full term of 50 years.

Management intends to fully transfer the entitlements and obligations associated with this lease agreement to the Society, and the Society has agreed to accept the entitlements and obligations associated with the lease agreement pending finalization of legal and contractual documentation pertaining to the transfer of the lease entitlements and obligations to the Society.

It is anticipated that the finalization of such transfer of lease entitlements and obligations will occur in the near future. Should matters arise that result, for whatever reason, in the entitlements and obligations of the lease

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agreement not transferring to the Society, Royal Host may record such entitlements and obligations in its consolidated financial statements at that time. The current estimated fair value of each of the future entitlements and of the obligations at December 31, 2001 is \$3.2 million.

**11. OTHER HOSPITALITY REVENUES**

Other hospitality revenues include rental income from one hotel property that is leased to the previous owner for a fixed fee of \$2,015,000 per annum. The lease is renewable at the option of the tenant for a further three additional 5-year terms, commencing October 31, 2002, at an amount equal to the base lease adjusted by the consumer price index. The lease may be terminated if the property is sold by Royal Host, upon due notice, along with payment of a penalty calculated in accordance with the lease agreement.

**12. FRANCHISE AGREEMENTS**

Under the terms of the hotel franchise agreements expiring at various dates commencing October 31, 2007 through to December 12, 2021, annual payments for franchise expenses (including fees, reservation and advertising services) are due to external parties for 33 of the 36 hotels owned by Royal Host (2000 - 33 of the 36 hotels). In 2001, a hotel property in which Royal Host is a 50% co-tenant was converted to the Travelodge brand, of which Royal Host is the master franchisor in Canada. There were no Royal Host owned hotels converted to the Travelodge brand in 2000. The franchise royalties to external parties are computed based upon percentages of defined revenues and amounted to \$2,061,000 for the year (2000 - \$1,931,000).

**13. OPERATING LEASES**

Certain property and equipment are leased under operating lease agreements expiring at varying intervals. The following is a five-year schedule for future minimum rental payments required under these leases as at December 31, 2001:

**Year ending December 31 (\$000's)**

2002	1,296
2003	764
2004	498
2005	226
2006	110
Total future minimum rental payments	<u>2,894</u>

**14. RISK MANAGEMENT**

Royal Host's key financial risk exposures include credit risks arising from receivables from corporate accounts and amounts owed by purchasers of prepaid vacations, commodity price risk on utilities and interest rate risk arising from fluctuations in interest rates.

Credit risks are minimized, as amounts due from any one debtor are not significant and routine credit assessments are carried out prior to credit being granted. The accounts receivable from prepaid vacation owners are secured by the prepaid vacations purchased.

Commodity price risk is managed through the use of fixed price contracts for the stable supply of natural gas and electricity in the jurisdictions where such commodities have been de-regulated.

Interest rate risk is continually monitored and managed through limiting the amount of variable rate debt as well as the total amount of debt. The amount of variable rate debt aggregated \$21,332,000 or 14% of the Royal Host total debt portfolio as at December 31, 2001 (\$40,060,000 or 25% of the Royal Host total debt portfolio as at December 31, 2000). Variable rates ranged from prime plus 3/4% to prime plus 2% for 2001 and 2000.

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**15. FAIR VALUES**

Current assets and liabilities approximate their carrying values at December 31, 2001, due to their short-term nature. The fair values of the non-current portion of mortgages and other debt and convertible equity instruments are as follows:

	<i>(\$000's)</i>	
	<b>Carrying values</b>	<b>Fair values</b>
Mortgages and other debt	83,582	84,053
Capital leases	2,225	1,998
Redeemable partnership units and convertible debenture	49,500	46,321

Fair value estimates are made at a specific point in time based on relevant market information. These are estimates and involve uncertainties and matters of significant judgment and cannot be determined with precision. Changes in assumptions and estimates could significantly affect fair values.

**16. COMPARATIVE FIGURES**

Certain prior year's figures have been reclassified to conform with the presentation adopted for 2001; also certain of the 2000 figures have been restated to reflect the adoption of future income taxes and the new accounting standards for per unit computations. There was no material change to the consolidated statement of net earnings.

**17. SUBSEQUENT EVENTS**

On February 21, 2002, pursuant to a prospectus, Royal Host issued \$40,000,000 of 9.25% Convertible Unsecured Subordinated Debentures due 2007 for net proceeds of \$38,100,000. Royal Host intends to use approximately \$18.5 million of the estimated net proceeds of the Debentures to reduce its outstanding bank indebtedness and the balance to reduce other indebtedness, upgrade and reposition its existing properties, for working capital and general trust purposes including acquisitions.