

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

**Consolidated Financial Statements**

**For the years ended December 31, 2004 and December 31, 2003**

## AUDITORS' REPORT

To the Unitholders of  
Royal Host Real Estate Investment Trust

We have audited the consolidated balance sheets of Royal Host Real Estate Investment Trust (the "Trust") as at December 31, 2004 and 2003 and the consolidated statements of net earnings and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Trust'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, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2004 and 2003 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

signed "Deloitte and Touche LLP"

Chartered Accountants  
Calgary, Alberta  
February 25, 2005

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

	As At	
	December 31, 2004	December 31, 2003 (Restated - Note 11)
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and short-term investments (Note 2(l))	9,375	5,183
Accounts and notes receivable	10,053	8,609
Deposits and prepaid expenses	3,719	3,453
Inventories	3,131	3,739
Property held for sale (Notes 3 and 4)	2,704	-
Property under development (Note 5)	6,870	2,068
Future income tax (Note 11)	1,004	583
	<b>36,856</b>	<b>23,635</b>
<b>Restricted Cash (Note 6)</b>	<b>5,677</b>	<b>4,247</b>
<b>Capital Assets (Note 7)</b>	<b>330,602</b>	<b>344,701</b>
<b>Long-term Notes Receivable and Other Assets (Note 8)</b>	<b>3,276</b>	<b>3,297</b>
	<b>376,411</b>	<b>375,880</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued liabilities	22,670	18,330
Current portion of mortgages and other debt (Note 9)	39,083	39,515
Current portion of capital leases (Note 10)	563	864
Distributions payable	561	558
Other current liabilities	2,304	1,929
	<b>65,181</b>	<b>61,196</b>
<b>Mortgages and Other Debt (Note 9)</b>	<b>117,896</b>	<b>121,650</b>
<b>Capital Leases (Note 10)</b>	<b>961</b>	<b>1,490</b>
<b>Future Income Taxes (Note 11)</b>	<b>8,329</b>	<b>7,715</b>
<b>Deferred Revenue</b>	<b>688</b>	<b>963</b>
<b>Equity (Note 12)</b>	<b>183,356</b>	<b>182,866</b>
	<b>376,411</b>	<b>375,880</b>

See accompanying Notes to Consolidated Financial Statements

Approved on behalf of the Board of Trustees:

As signed by  
 "Ron Ghitter, Q.C."  
 Chairman of the Board

As signed by  
 "Alvin G. Poettcker"  
 Chairman of the Audit Committee

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Consolidated Statements of Net Earnings**  
**For the years ended December 31, 2004 and December 31, 2003**  
*\$000's*

	Years Ended	
	December 31, 2004	December 31, 2003
<b>Hospitality Revenues</b>		
Rooms	99,692	96,004
Food and beverage	25,876	25,353
Other hospitality revenues	16,987	16,664
	<b>142,555</b>	<b>138,021</b>
<b>Hospitality Expenses</b>	<b>105,857</b>	<b>103,414</b>
<b>Gross Margin</b>	<b>36,698</b>	<b>34,607</b>
<b>Other Expenses and (Income)</b>		
Amortization	16,567	17,368
Interest on mortgages and other debt	13,825	13,618
Trust administration	3,600	2,125
Property impairment provision (Note 4)	734	-
Future income tax	442	745
Capital and other taxes	228	484
Loss on foreign currency translation	131	158
Interest income	(66)	(29)
	<b>35,461</b>	<b>34,469</b>
<b>Earnings from continuing operations (Note 13)</b>	<b>1,237</b>	<b>138</b>
<b>Earnings (loss) from discontinued operations, net of tax (Notes 4 and 13)</b>	<b>320</b>	<b>(119)</b>
<b>Net earnings</b>	<b>1,557</b>	<b>19</b>
<b>Basic per unit net (loss) earnings</b>		
- from continuing operations	(0.23)	(0.28)
- from discontinued operations	0.01	-
<b>Basic per unit net loss (Note 13)</b>	<b>(0.22)</b>	<b>(0.28)</b>
<b>Diluted per unit net (loss) earnings</b>		
- from continuing operations	(0.23)	(0.29)
- from discontinued operations	0.01	-
<b>Diluted per unit net loss (Note 13)</b>	<b>(0.22)</b>	<b>(0.29)</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, 2004 and December 31, 2003**  
*\$000's*

	Years Ended	
	December 31, 2004	December 31, 2003
<b>CASH PROVIDED BY (USED IN)</b>		
<b>Operating Activities</b>		
Net earnings	1,557	19
Less: (earnings) loss from discontinued operations <i>(Note 4)</i>	(320)	119
Items not affecting cash:		
Amortization of capital assets	15,973	16,708
Future income tax expense	442	745
Property impairment provision	734	-
	<u>18,386</u>	<u>17,591</u>
<b>Change in non-cash working capital:</b>		
(Increase) decrease in accounts and notes receivable	(1,444)	563
(Increase) decrease in deposits and prepaid expenses	(177)	330
Decrease in inventories	608	146
Increase (decrease) in accounts payable and accrued liabilities	4,340	(802)
Increase (decrease) in other current liabilities and deferred revenue	100	(704)
Amortization of deferred finance costs	594	660
<b>Cash flows from continuing operations</b>	<u>22,407</u>	<u>17,784</u>
<b>Funds from discontinued operations</b>	<u>13</u>	<u>218</u>
<b>Net non-cash change in properties held for sale</b>	<u>(406)</u>	<u>-</u>
<b>Cash flows from operating activities</b>	<u>22,014</u>	<u>18,002</u>
<b>Financing Activities</b>		
Additions to mortgages and other debt	32,750	32,240
Principal repayments on mortgages and other debt and capital leases	(38,055)	(13,816)
Issuance of trust units plan under employee unit purchase	17	8
Contributed surplus <i>(Note 12(g))</i>	-	89
Issuance of convertible debentures, net of retirements <i>(Note 12 (f)(iii))</i>	13,000	-
Equity financing issue costs	(1,607)	-
Equity distributions <i>(Note 12(b))</i>	(12,475)	(19,120)
	<u>(6,370)</u>	<u>(599)</u>
<b>Investing Activities</b>		
Restricted cash <i>(Note 6)</i>	(1,430)	(88)
Capital expenditures	(6,426)	(26,115)
Property under development	(4,802)	(1,728)
Net cash from sale of properties	1,779	-
Increase in long-term notes receivable and other assets	(573)	(395)
	<u>(11,452)</u>	<u>(28,326)</u>
<b>Net Change in Cash and Short-term Investments</b>	<u>4,192</u>	<u>(10,923)</u>
<b>Cash and Short-term Investments, beginning of year</b>	<u>5,183</u>	<u>16,106</u>
<b>Cash and Short-term Investments, end of year</b>	<u>9,375</u>	<u>5,183</u>

*See accompanying Notes to Consolidated Financial Statements*

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**1. GENERAL INFORMATION**

Royal Host Real Estate Investment Trust ("Royal Host" or the "Trust") was created pursuant to the Declaration of Trust dated August 27, 1997. Royal Host is an unincorporated open-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. Royal Host's Declaration of Trust permits the development of new facilities on property adjacent to its existing properties.

**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").

**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 periods. 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, joint ventures and co-tenancies 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**

Revenues consisting of rooms, food and beverage and other hospitality revenues are recognized when services are provided and collection is reasonably assured. Other hospitality revenues include management fees, franchise royalties, parking, tenant leases, health club and spa, timeshare maintenance fees and sales and other. 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.

Timeshare revenues are 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. Certain portions of timeshare revenue are deferred until earned by Royal Host.

**e) Capital Assets**

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

Hotel properties are amortized using the straight-line method over their estimated useful lives ranging between 25 and 40 years. Each individual property is evaluated quarterly and a useful life is estimated based on certain factors including construction materials used, location, condition of the property and the particular capital maintenance program and requirements of the property.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

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 amortized on a straight-line basis over periods of up to ten years.

Intangible assets are amortized using the straight-line method based on their estimated useful lives over the following periods:

- i) Franchise rights and management contracts – 3-10 years,
- ii) Customer lists and intellectual and human capital – 1-7 years.

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

**f) Impairment of Long-Lived Assets**

Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment loss is recognized when their carrying value exceeds the total undiscounted cash flows expected from their use and eventual disposition. The amount of the impairment loss is determined as the excess of the carrying value of the asset over its fair value.

**g) Capitalized Costs**

Costs associated with the acquisition of 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 interest on debt and an appropriate allocation of general and administrative costs incurred.

**h) 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.

**i) Financing Costs**

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

**j) 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.

Royal Host utilizes the future income tax asset and liability method of accounting for future income taxes. This method requires recording a future income tax amount for the Trust's subsidiaries based on differences between the carrying amounts of balance sheet items and their corresponding tax basis. In addition, the future tax benefits of income tax assets, including unused tax losses, are recognized to the extent that it is more likely than not that such losses will be ultimately utilized by the Trust's subsidiaries. Future income tax assets and liabilities are measured using the enacted tax rates and laws that are expected to apply when the tax assets or liabilities are to be either realized or settled.

**k) Unit Option Plan**

Royal Host has a unit option plan as described in Note 12(d). No compensation expense is recognized for the plan when options are granted. Consideration received on exercise of options is credited to Unitholders' equity.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**l) Cash and Cash Equivalents**

Cash and short-term investments include all cash and highly liquid investments with an original maturity of less than three months and exclude restricted cash.

**m) Foreign Currency Translation**

The Trust's foreign operations are conducted through integrated subsidiaries and financial statements are translated using the temporal method. Accordingly, monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated financial statements. Non-monetary assets, liabilities and other items recorded in the net earnings arising from transactions denominated in foreign currencies are translated at rates of exchange in effect at the date of the transaction. The Trust discloses exchange gains and losses as part of net earnings.

**3. CHANGES IN ACCOUNTING POLICIES**

**a) Disposal of Long-Lived Assets**

Effective January 1, 2004, the Trust adopted the new CICA Handbook Section 3475, Disposal of Long-Lived Assets and Discontinued Operations. The recommendations of this section require that disposals of long-lived assets be classified as held for sale, and the results of operations and cash flows associated with the assets disposed and held for sale be reported separately as discontinued operations, net of applicable income taxes. A long-lived asset is classified by the Trust as an asset held for sale at the point in time when it is available for immediate sale, management has committed to a plan to sell the asset and is actively locating a buyer for the asset at a sales price that is reasonable in relation to the current fair value of the asset, and the sale is probable and expected to be completed within a one-year period. For unsolicited interest in a long-lived asset, the asset is classified as held for sale if all the conditions of the purchase and sale agreement have been met, a sufficient purchaser deposit has been received and the sale is probable and expected to be completed shortly after the end of the current period. The impact of adopting the new recommendations for disposals of long-lived assets is disclosed in Note 4.

**b) Impairment of Long-Lived Assets**

Effective January 1, 2004, the Trust prospectively adopted the recommendations of CICA Handbook Section 3063, Impairment of Long-Lived Assets. The recommendations of this section require that an impairment loss on long-lived assets to be held and used be recognized when their carrying value exceeds the total undiscounted cash flows expected from their use and eventual disposition. The amount of the impairment loss is determined as the excess of the carrying value of the asset over its fair value. The impact of adopting the new recommendations has been reflected in the consolidated statements of net earnings as a property impairment provision.

**4. PROPERTY HELD FOR SALE, DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS**

During the second quarter of 2004, the Trust decided to sell certain hotel properties and had pending sales to two separate, unrelated buyers. The first pending sale involved an offer to purchase of \$5.8 million in net consideration for three properties with a total of 190 rooms in Western Canada, two of which were conditional on mortgage lender approval. On November 26, 2004 the Trust completed the sale of one of these hotel properties located in North Battleford, Saskatchewan for \$1.2 million. The pending sale of the two remaining properties was cancelled as the Trust was unable, as at December 31, 2004, to remove the two properties from a pool of assets securing a debenture. As a result, these properties were reclassified from property held for sale to capital assets at reduced values, after taking a property impairment provision of \$734,000.

The second pending sale involves an offer to purchase of \$2.7 million in net consideration for one property with 95 rooms in Ontario, which is conditional on a rezoning application. The expected completion date of the remaining transaction is prior to June 30, 2005.

On May 28, 2004 the Trust completed the sale of a marina and recreational vehicle facility in Oklahoma, USA for \$1.2 million.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

The following table sets forth the results of operations associated with the above noted long-lived assets, separately reported as discontinued operations for the current and prior years.

	<b>Year Ended</b>	
	<b>December 31,</b>	<b>December 31,</b>
	<b>2004</b>	<b>2003</b>
	<b>(\$000's)</b>	<b>(\$000's)</b>
<b>Hospitality Revenues</b>		
Rooms	1,365	1,786
Food and beverage	154	1,170
Other hospitality revenues	168	567
	<u>1,687</u>	<u>3,523</u>
<b>Hospitality Expenses</b>	<u>1,701</u>	<u>3,241</u>
<b>Gross Margin</b>	<u>(14)</u>	<u>282</u>
<b>Other Expenses</b>		
Interest on mortgages and other debt	6	4
Capital and other taxes	8	4
Amortization	94	411
Property impairment provision	406	-
(Gain) loss on foreign currency translation	(39)	56
	<u>475</u>	<u>475</u>
<b>Operating loss from discontinued operations before income taxes</b>	<b>(489)</b>	<b>(193)</b>
Future income tax recovery	(250)	(74)
<b>Operating earnings (loss) from discontinued operations</b>	<b>(239)</b>	<b>(119)</b>
Gain on disposition	559	-
<b>Net earnings (loss) from discontinued operations</b>	<b>320</b>	<b>(119)</b>

**5. PROPERTY UNDER DEVELOPMENT**

A subsidiary of Royal Host is participating in a joint venture to develop a portion of the property at the Grand Okanagan Lakefront Resort and Conference Center in Kelowna, British Columbia for resale. Property under development reflects Royal Host's proportionate share of the costs incurred to date to develop the property. Construction of the first phase of the project, a parkade, commenced January 2004 and was completed in October 2004. Construction on the residence units commenced May 2004. Revenue from the sale of land or property is recorded on closing or, where sold by way of an agreement of purchase and sale, when the agreement is duly executed and delivered. Profit from the sale of land or property is recorded on closing or, where sold by way of an agreement of purchase and sale, when the collection of the sale proceeds is reasonably assured and all other material conditions are met.

Royal Host accounts for its subsidiary's interest in the above joint venture on a proportionate consolidation basis. Accordingly, these financial statements reflect Royal Host's undivided interest in the assets, liabilities, revenues and expenses in the joint venture. As a joint venture participant, Royal Host is subject to the normal development risks associated with property development activity.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

The following table sets out Royal Host's proportionate share of the assets, liabilities, revenues and expenses in the joint venture:

	<i>(in \$000's)</i>	
	<b>Year Ended</b>	
	<b>December 31, 2004</b>	<b>December 31, 2003</b>
<b>Assets</b>		
Current	100	265
Work in progress	6,870	2,068
Other	146	146
	<u>7,116</u>	<u>2,479</u>
<b>Liabilities</b>		
Current	1,102	235
Long-term	-	-
Joint Venturer's Equity	6,014	2,244
	<u>7,116</u>	<u>2,479</u>

As the project is still in the development phase during fiscal 2004, no revenue has been recognized and all costs incurred have been capitalized to work in progress.

In February 2005, Royal Host, along with its joint venture partner, entered into a non-revolving \$28.0 million financing arrangement consisting of a \$20.0 million construction loan and an \$8.0 million mezzanine loan. The loan proceeds will be used to complete the project.

**6. RESTRICTED CASH**

Restricted cash is \$5,677,000 (2003 - \$4,247,000) representing funds on deposit with lenders pursuant to financing arrangements for future planned capital expenditures within the next twelve months.

**7. CAPITAL ASSETS**

	<i>(in \$000's)</i>		
	<b>Gross Book Value</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>
<b>December 31, 2004</b>			
Land	39,712	-	39,712
Buildings	320,723	56,344	264,379
Furniture, fixtures and equipment	38,066	30,765	7,301
Furniture, fixtures and equipment under capital leases	7,348	4,081	3,267
Paving and other	1,320	460	860
	<u>407,169</u>	<u>91,650</u>	<u>315,519</u>
Capital assets under development	2,647	-	2,647
Intangible assets			
Franchise rights and management contracts	27,414	15,278	12,136
Customer lists and intellectual and human capital	7,270	6,970	300
	<u>444,500</u>	<u>113,898</u>	<u>330,602</u>

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

	<i>(in \$000's)</i>		
	<u>Gross Book Value</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u> <u>(Restated - Note 11)</u>
<b>December 31, 2003</b>			
Land	41,433	-	41,433
Buildings	322,045	50,201	271,844
Furniture, fixtures and equipment	39,221	30,179	9,042
Furniture, fixtures and equipment under capital leases	7,292	3,126	4,166
Paving and other	1,319	400	919
	<u>411,310</u>	<u>83,906</u>	<u>327,404</u>
Capital assets under development	1,164	-	1,164
Intangible assets			
Franchise rights and management contracts	27,612	12,679	14,933
Customer lists and intellectual and human capital	7,270	6,070	1,200
	<u>447,356</u>	<u>102,655</u>	<u>344,701</u>

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 industry average historic capitalization rate and the units of Royal Host are to be priced based on a 20 day weighted average trading price per unit. This specified capitalization rate is not determined with reference to a base-lending rate such as prime rate. This calculation has been taken into consideration in the diluted per unit calculations in Note 13 and determined to be anti-dilutive.

On April 1, 2003, Royal Host acquired the Calgary Best Western Village Park Inn adding 160 guestrooms, for an aggregate purchase price of \$12,786,000.

Royal Host has spent \$6,426,000 (2003 - \$13,999,000) to renovate and reposition the hotel properties, excluding capital lease additions totaling \$200,000 (2003 - \$1,522,000) and the net purchases of hotel property for an aggregate purchase price of \$Nil (2003 - \$12,116,000).

As at December 31, 2004, Royal Host has committed \$530,000 to complete capital assets under development (2003 - \$Nil).

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**8. LONG-TERM NOTES RECEIVABLE AND OTHER ASSETS**

	<i>(in \$000's)</i>	
	<u>December 31, 2004</u>	<u>December 31, 2003</u>
Notes receivable	466	685
Deferred financing costs (net of accumulated amortization)	2,810	2,612
	<u><b>3,276</b></u>	<u><b>3,297</b></u>

The notes receivable mature between January 1, 2005 and March 18, 2009, require monthly payments of principal and interest based on individual customer amortization schedules, and bear interest at rates of between 9.8% and 16.9%. The carrying value of the notes receivable approximates fair value.

**9. MORTGAGES AND OTHER DEBT**

	<i>(in \$000's)</i>	
	<u>December 31, 2004</u>	<u>December 31, 2003</u>
Mortgages and other debt secured by hotel properties	156,979	161,165
Less current portion	39,083	39,515
<b>Long-term obligations</b>	<u><b>117,896</b></u>	<u><b>121,650</b></u>
Principal repayments required for the years ending December 31:		
2005	39,083	
2006	4,047	
2007	21,518	
2008	3,658	
2009	25,305	
Subsequent	63,368	
	<u><b>156,979</b></u>	
<b>Supplementary Information:</b>	<u><b>December 31, 2004</b></u>	<u><b>December 31, 2003</b></u>
Cash interest paid in the years ended	<u>13,220</u>	<u>13,697</u>

On November 8, 2004, Royal Host completed a financing arrangement for a \$25.0 million, 5-year term mortgage, secured by The Hilton, London, Ontario and The Chimo Hotel, Ottawa properties. The proceeds were used to retire \$24.5 million of the principal balance outstanding on an existing \$30.0 million portfolio mortgage which matured March 31, 2004. The interest for the refinanced loan will be paid quarterly at a rate equal to 7.35% per annum.

On September 29, 2003, Royal Host completed financing in the amount of \$8.7 million, of which the proceeds were used to pay down short-term debt and for working capital and general corporate purposes. This is a 10 year term mortgage, secured by a certain hotel property. The interest is 7.37% compounded semi-annually.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

On March 27, 2003, Royal Host completed two financings with one lender in the amounts of \$2.4 and \$3.7 million, the proceeds to be used for working capital and corporate purposes. These are 20 year term mortgage loans, secured by certain hotel properties. The interest is adjusted semi-annually and is the greater of:

- a) 3.2% over the yield on the Government of Canada mortgage benchmark bond; and
- b) A floor of 7.9% per annum.

On February 6, 2003, Royal Host completed financing in the form of a revolving operating loan, repayable on demand, available to the Trust at prime rate plus 2.0% per annum payable monthly in arrears or as a First Bank Acceptance with a Stamping Fee of 3.0% per annum. The proceeds of this loan are to be used for general working capital purposes. The loan is secured by a certain hotel property. As at December 31, 2004, Royal Host had received net advances of funds in the amount of \$1,000,000 (2003 - \$Nil) related to the arranged financing. Currently, the maximum amount available for borrowing is \$4.0 million.

On February 5, 2003, Royal Host completed financing in the amount of \$6.2 million, the proceeds to be used for working capital and corporate purposes. This is an operating loan, repayable on demand, bearing interest at prime plus 1.0% per annum, with interest payable monthly. The loan is secured by a certain hotel property. As at December 31, 2004, Royal Host had received net advances of funds in the amount of \$1,050,000 (2003 - \$3,740,000) related to the arranged financing.

Mortgages and other debt bear interest at rates ranging from 5.13% to 9.47% per annum (2003 – 5.25% to 9.47%) with a weighted average year-end rate of 8.46% per annum (2003 – 8.62%) and mature between 2005 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 total \$1,365,000 at December 31, 2004 (2003 - \$1,405,000).

Financing charges are deferred and amortized over the term of the related debt. In 2004, \$594,000 was included in amortization (2003 - \$660,000).

**10. OBLIGATIONS UNDER CAPITAL LEASES**

Royal Host 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, 2004 are as follows:

	<i>(in \$000's)</i>	
	<b>December 31, 2004</b>	<b>December 31, 2003</b>
Present value of future minimum lease payments	1,524	2,354
Less current portion	563	864
<b>Long-term obligations</b>	<b>961</b>	<b>1,490</b>
Years ending December 31		
2005	671	
2006	475	
2007	347	
2008	238	
2009	-	
Future minimum lease payments	1,731	
Amounts representing interest	207	
Present value of future minimum lease payments	<b>1,524</b>	

The leases outstanding at December 31, 2004 bear interest at a weighted average annual rate of 8.25% per annum (2003 – 8.42%).

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**11. FUTURE INCOME TAXES**

The Trust has tax losses of approximately \$2,710,000 (2003 - \$1,541,000) available to reduce future taxable income. The losses will begin to expire in 2008, but the majority of the losses will expire in 2010 and 2011. The adjustment for the change in effective tax rates reflects the benefit from the reduction of the currently substantially enacted federal rate resulting in combined federal and provincial rates of between 34.1% and 39.1%, depending on the province.

The net future income tax liability is calculated as follows:

	<i>(in \$000's)</i>	
	<u>December 31, 2004</u>	<u>December 31, 2003</u>
		<b>(Restated)</b>
Tax assets relating to operating losses	1,004	583
Tax assets (liabilities) relating to differences in tax and book basis and other items	<u>(8,329)</u>	<u>(7,715)</u>
Net future tax liability	<u><b>(7,325)</b></u>	<u><b>(7,132)</b></u>

The prior year's future tax liability balance and capital asset balance have been increased by \$6,365,000 to reflect additional differences between the carrying value of assets and their corresponding tax basis for capital assets held in the Trust subsidiaries. This adjustment has no material impact on the consolidated statements of net earnings or equity of the prior year.

**12. EQUITY**

	<i>(in \$000's)</i>	
	<u>December 31, 2004</u>	<u>December 31, 2003</u>
<b>Balance, beginning of year</b>	<b>93,366</b>	<b>111,261</b>
Net earnings	1,557	19
Issuance of trust units		
Distribution reinvestment plan	309	629
Employee loans pursuant to employee unit purchase program <i>(Note 13(g))</i>	17	8
Equity financing issue costs	(1,607)	-
Contributed surplus	-	89
Equity distributions		
Trust units	(5,872)	(11,667)
Redeemable partnership units	(756)	(1,513)
Interest paid on convertible debentures	<u>(6,158)</u>	<u>(5,460)</u>
	<u><b>80,856</b></u>	<u><b>93,366</b></u>
<b>Convertible Equity</b>		
Redeemable partnership units	27,500	27,500
Convertible debentures	75,000	62,000
	<u><b>102,500</b></u>	<u><b>89,500</b></u>
<b>Balance, end of year</b>	<u><b>183,356</b></u>	<u><b>182,866</b></u>

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**a) Unit Capital**

	<u>Number of units</u>	<u>(in \$000's)</u>
<b>Balance, December 31, 2002</b>	<b>24,634,976</b>	<b>222,908</b>
Issuance of trust units		
Distribution reinvestment plan	127,368	629
<b>Balance, December 31, 2003</b>	<b>24,762,344</b>	<b>223,537</b>
Issuance of trust units		
Distribution reinvestment plan	62,598	309
<b>Balance, December 31, 2004</b>	<b>24,824,942</b>	<b>223,846</b>

As is common with REITs and other income trusts, Royal Host distributes cash in excess of the net earnings, and accordingly an accumulated deficit results, which at December 31, 2004 amounts to \$142,990,000 (2003 - \$130,171,000).

**b) Distributions to Unitholders**

For the year ended December 31, 2004, distributions declared to Unitholders, excluding distributions on redeemable partnership units, aggregated \$5,872,000 (2003 - \$11,667,000). The distributions to holders of redeemable partnership units for fiscal 2004 were \$756,000 (2003 - \$1,513,000) and interest on convertible debentures was \$6,158,000 (2003 - \$5,460,000).

**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, Royal Host 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, 2004, Royal Host has unit options outstanding to certain board members, employees and consultants to purchase an aggregate total of 137,500 units (December 31, 2003 - 852,500 units), at an exercise price of \$10.00 per unit (December 31, 2003 - weighted average exercise price of \$10.03). All unit options were issued prior to 1999 and were fully vested and exercisable at the end of December 31, 2004 and 2003. The options currently outstanding expire on October 31, 2007. Of the options outstanding at December 31, 2003, 797,500 options were to expire as of October 31, 2007 and 55,000 options as of March 23, 2008. During 2004 and 2003, no options were issued or exercised and no options expired in the year ended December 31, 2004 (December 31, 2003 - 55,000). As per agreements signed April 21, 2004, 715,000 options held by board members and executives of Royal Host were cancelled and terminated by agreement of the Board of Trustees. Of these cancelled unit options, 660,000 options were to expire October 31, 2007 and 55,000 options were to expire on March 23, 2008.

**e) Redeemable Partnership Units**

Holders of redeemable partnership units ("Holders") are 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 Holders 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. Subsequent to December 31, 2004, the holders of the redeemable partnership units gave notice of redemption.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

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

**f) Convertible Debentures**

**i) 9.25% Convertible Unsecured Subordinated Debentures**

The convertible debentures of \$40,000,000 bear interest at 9.25% per annum and are payable semi-annually in arrears on March 1 and September 1 in each year commencing September 1, 2002.

On redemption or at maturity on March 1, 2007, Royal Host has the option to repay the debentures in either cash or in equivalent units of Royal Host. The number of units to be issued will be determined by dividing the principal amount of the debentures by 95% of the current market price of the units. The term "current market price" is defined in the Indenture to mean the weighted average trading price of the units on the TSE for the twenty (20) consecutive trading days ending on the fifth (5) trading day preceding the date of maturity.

The debentures will not be redeemable on or before March 1, 2005. Thereafter, the debentures will be redeemable, in whole at any time or in part from time to time, at the option of Royal Host on at least 30 days prior notice at a price equal to the principal amount thereof, plus accrued and unpaid interest, provided that the current market price preceding the date upon which notice of redemption is given is at least 125% of the conversion price of \$7.00 per unit.

Based on certain conditions, the debentures are convertible, at the holders' discretion, at \$7.00 per trust unit from date of issue to maturity at March 1, 2007.

**ii) 7.90% Convertible Unsecured Subordinated Debentures, Series A**

During the quarter ended June 30, 2004, \$35,000,000 convertible unsecured subordinated debentures were issued. These debentures bear interest at 7.90% per annum and are payable semi-annually in arrears on April 30 and October 31 in each year commencing October 31, 2004.

The Series A debentures may not be redeemed by Royal Host prior to the maturity date. At maturity on April 30, 2009, Royal Host has the option to repay the debentures in either cash or in equivalent units of Royal Host. The number of units to be issued will be determined by dividing the principal amount of the debentures by 95% of the current market price of the units. The term "current market price" is defined in the Indenture to mean the weighted average trading price of the units on the TSX for the twenty (20) consecutive trading days ending on the fifth (5) trading day preceding the date of maturity.

Based on certain conditions, the debentures are convertible, at the holders' discretion, at \$6.00 per trust unit at any time from the date of issue to close of business on the day prior to the maturity date, April 30, 2009.

Royal Host used approximately \$22.0 million of the net proceeds of the Debentures to retire its 8.00% Convertible Secured Debentures and the balance will be used for working capital and general trust purposes, including acquisitions.

For accounting purposes, the convertible debentures have equity characteristics and accordingly they are classified as equity instruments in 2004. Effective January 1, 2005, the Trust will be implementing the changes to CICA Handbook Section 3860, Financial Instruments – Disclosure and Presentation. The recommendations of this section require certain instruments that may be settled in cash or by a variable number of an issuer's own equity instruments, at the issuer's discretion, to be presented as liabilities. As a result, the convertible debentures will be classified as liabilities in 2005.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**g) Employee Unit Purchase Program**

During 2000, the Trustees approved the issuance of up to 400,000 units from treasury for an employee unit purchase program. Under this program, certain approved Royal Host employees (excluding certain senior executives) were eligible to finance the purchase of units from treasury at a prescribed per unit rate based on current market values.

As at December 31, 2004, 182,500 units (2003 – 182,500 units) were allocated under this plan. The employee unit purchase program represents a financing program for selected employees to purchase units of Royal Host. Royal Host has outstanding employee loans receivable, net of additions and terminations, of \$896,000 (2003 - \$913,000) with respect to the program. These loans bear interest at a fixed rate of 3.0% per annum (2003 – 3.0%), a rate established based on consideration of existing institutional rates and Canada Revenue Agency (“CRA”) guidelines for employee loan rates. This plan structure does not meet the definition of stock based compensation plans, and therefore does not fall under the Handbook Section 3870 – Stock Based Compensation Plans.

In accordance with EIC (“Emerging Issues Committee”) 44, for accounting purposes, these employee loans receivable have been offset against the corresponding trust units equity.

**13. PER UNIT COMPUTATIONS**

There were 24,824,942 trust units outstanding as at December 31, 2004 (2003 – 24,762,344). Per unit computations are based on the weighted average number of trust units outstanding for the year, after adjusting the net earnings for payments on the convertible debentures of \$6,158,000 (2003 - \$5,460,000) and payments on the redeemable partnership units of \$756,000 (2003 - \$1,513,000).

For the years ended:	December 31, 2004			December 31, 2003		
	(\$000's)	Weighted Average Units (000's)	Per Unit	(\$000's)	Weighted Average Units (000's)	Per Unit
<b>Earnings</b>						
Earnings-continuing operations	1,237			138		
Less:						
Distributions on redeemable partnership units	(756)			(1,513)		
Interest on 8.00% convertible debentures	(524)			(1,760)		
Interest on 9.25% convertible debentures	(3,700)			(3,700)		
Interest on 7.90% convertible debentures	(1,934)			-		
Basic loss - continuing operations	<b>(5,677)</b>	<b>24,574</b>	<b>(0.23)</b>	<b>(6,835)</b>	<b>24,550</b>	<b>(0.28)</b>
Basic earnings (loss)						
-discontinued operations	<b>320</b>		0.01	(119)		-
<b>Basic loss - total operations</b>	<b>(5,357)</b>	<b>24,574</b>	<b>(0.22)</b>	<b>(6,954)</b>	<b>24,550</b>	<b>(0.28)</b>
Unit options		138			852	
Unit option repurchase		(271)			(1,774)	
<b>Diluted loss - total operations</b>	<b>(5,357)</b>	<b>24,441</b>	<b>(0.22)</b>	<b>(6,954)</b>	<b>23,628</b>	<b>(0.29)</b>
Diluted earnings (loss)						
-discontinued operations	320	24,441	0.01	(119)	23,628	-
Diluted loss - continuing operations	(5,677)	24,441	(0.23)	(6,835)	23,628	(0.29)

In computing the diluted earnings per unit from total operations in fiscal 2004 and 2003, the convertible debentures and redeemable partnership units had an anti-dilutive impact on earnings and therefore did not impact the calculation.

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**14. COMMITMENTS**

**a) Energy Contracts**

Royal Host has entered into long-term supply arrangements with two electrical utility companies and a natural gas provider to supply electricity and natural gas requirements for certain properties.

i. Electricity

The electricity contracts are for a term of five years at a blended rate of approximately 7.17 cents per kilowatt-hour, excluding delivery, for annual usage of approximately 13.5 million kilowatt-hours in 2005 (2004 – approximately 7.12 cents per kilowatt-hour for approximately 14.9 million kilowatt-hours).

ii. Natural Gas

The natural gas contract is for a term of five years, at a rate of approximately 26.90 cents per cubic meter, excluding delivery, on annual usage of approximately 524,000 cubic meters for 2005 (2004 – 26.90 cents per cubic meter for approximately 569,000 cubic meters). Royal Host is not required to guarantee usage levels for any contracts.

**b) Contractual Guarantee**

Royal Host has guaranteed the lease obligations of an unincorporated, independent vacation club society (the "Society") for a period of five years, effective from the lease commencement date of January 1, 2002, should the Society default on any obligations. Royal Host has avenues to pursue recourse with the Society for the full extent of any default on the lease payments. The maximum potential amount of future payments for the period from January 1, 2005 to December 31, 2006 is approximately \$443,000. The estimated fair value of this obligation is \$408,000. As at December 31, 2004, the Society has not defaulted on any lease payments.

**c) Private Residence Club Guarantee**

Pursuant to the loan agreement described in Note 5, Royal Host has provided a completion, cost overrun and debt service deficiency guarantee on the construction loan along with a specific guarantee of the payment of notes receivable from existing limited partnership unitholders. In addition, Royal Host has guaranteed the full \$8.0 million mezzanine loan.

**d) Other Guarantees and Indemnifications**

In the normal course of business, the Trust may provide indemnification to counterparties in transactions such as credit facilities, leasing transactions, service arrangements, director and officer indemnification agreements and sales of assets. These indemnification agreements may require the Trust to compensate the counterparties for costs incurred as a result of changes in laws and regulations (including tax legislation) or as a result of litigation claims or statutory sanctions that may be suffered by counterparties as a consequence of the transaction. The terms of these indemnification agreements may vary based on the contract and do not provide any limit on the maximum potential liability. To date, the Trust has not made any significant payments under such indemnifications and no amount has been accrued in the financial statements with respect to these indemnification agreements.

In the normal course of business, the Trust may enter into various agreements that may meet the AcG-14 definition of a guarantee. AcG-14 defines a guarantee to be a contract (including an indemnity) that contingently requires the Trust to make payments to the guaranteed party based on (i) changes in an underlying interest rate, foreign exchange rate, equity or commodity instrument, index or other variable, that is related to an asset, a liability or an equity security of the counterparty, (ii) failure of another party to perform under an obligating agreement or, (iii) failure of a third party to pay its indebtedness when due.

**15. FRANCHISE AND MEMBERSHIP 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 34 of the 38 hotels owned by Royal Host (2003 - 35 of the 39 hotels).

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

In 2003, Royal Host acquired a hotel property (see Note 7) that required it to enter into a membership agreement for which the member fees are paid to an external party. The membership agreement is for one-year terms, renewable annually at the end of the membership organization's fiscal year (November 30).

The franchise royalties and membership fees paid to external parties are calculated based upon percentages of defined revenues and amounted to \$2,209,000 for the year (2003 - \$2,233,000).

**16. OPERATING LEASES**

Certain property and equipment is 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, 2004:

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

2005	853
2006	473
2007	252
2008	89
2009	24
Total future minimum rental payments	<u>1,691</u>

**17. RISK MANAGEMENT**

Royal Host's key financial risk exposures include credit risks arising from receivables from corporate accounts and amounts owed by purchasers of timeshares, 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 timeshare owners are secured by the timeshares purchased.

Commodity price risk is managed through the use of fixed price contracts, where available, 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 \$7,031,000 or 3.0% of the Royal Host total debt portfolio as at December 31, 2004 (2003 - \$9,157,000 or 4.1%). Variable rates for 2004 ranged from prime plus 3/4% to prime plus 2.0% (2003 - prime plus 3/4% to prime plus 2.0%).

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**Notes to Consolidated Financial Statements**  
**As at December 31, 2004 and December 31, 2003**

**18. FAIR VALUES**

Current assets and liabilities approximate their carrying values at December 31, 2004, 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>(in \$000's)</i>	<u>Carrying Values</u>	<u>Fair Values</u>
Mortgages and other debt	117,896	125,414
Capital leases	961	1,035
Redeemable partnership units and convertible debentures	102,500	107,341

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.

**19. SUBSEQUENT EVENTS**

**a) Refinancing**

On January 13, 2005, Royal Host completed the early replacement of mortgage debt on the Grand Okanagan Lakefront Resort and Conference Center ("the Grand"). The existing \$25.0 million mortgage, which was originally scheduled to mature in August 2005, has been increased to \$35.0 million for a five-year term with a 7.50% fixed interest rate. The additional proceeds will be utilized for working capital and general corporate purposes.

**b) Sale of Interest in Hotel Property**

Effective February 23, 2005, Royal Host completed the sale of its 50% interest in a hotel property located in Toronto, Ontario. The property was sold for proceeds of \$10.8 million consisting of \$7.0 million cash and a \$3.8 million 8% vendor take-back ("VTB") mortgage with a 60-day term. Royal Host will continue to operate the property as a hotel following the closing date in order to wind up the hotel operations. Royal Host will be entitled to all operating revenues and shall fund all operating and closing costs during the wind up period. The net cost of the winding up of the business will be reimbursed to Royal Host in the form of a 0%, 18-month VTB mortgage.

**20. COMPARATIVE FIGURES**

Certain prior year's figures have been reclassified to conform to the presentation adopted for 2004.

**Royal Host Real Estate Investment Trust**  
**2004 Management's Discussion and Analysis**  
**of Operations and Financial Condition**

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS AND FINANCIAL CONDITION

The following Management's Discussion and Analysis of Operations and Financial Condition (MD&A) dated March 15, 2005, is the responsibility of management. The Board of Trustees carries out its responsibility for review of this discussion and analysis principally through its Audit Committee.

This MD&A should be read in conjunction with the audited consolidated financial statements and notes of Royal Host Real Estate Investment Trust ("Royal Host" and/or the "Trust") for the year ended December 31, 2004. The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP). The results are reported in Canadian dollars with foreign operations measured in US dollars and translated into Canadian dollars using the temporal method.

### OUR VISION

Our Vision is to be considered by all of our stakeholders as one of the best mid-market hotel companies in North America.

We will achieve our vision by:

- Conducting our business with simplicity, integrity and trust;
- Communicating with our stakeholders, conveying a message of confidence and professionalism to our external customers, and promoting an atmosphere of clear and open communication with our internal team members;
- Building a team of talented, highly skilled employees, who are empowered to achieve, and who are recognized and rewarded for their performance; and
- Striving for excellence, driven and motivated by results.

### OUR CORE BUSINESS

At December 31, 2004, we owned 38 hotels, managed 141 properties and franchised 120 locations comprising over 20,000 guestrooms in mid-market to upscale hospitality segments. We also own the master franchise rights for Travelodge in Canada and provide hotel management services for our own portfolio and to third-party owned properties.

Our main revenue streams are hotel room rentals, food and beverage services and other hotel services. Revenues from third-party hotel management and hotel franchising represent secondary sources of income.

Travellers are attracted to our hotels for a variety of reasons including:

- Location and price;
- Quality and mix of amenities and service;
- Position within the local market;
- Affiliations with a hotel franchise;
- Ease of making reservations; and
- Our unique rewards program for frequent visitors.

We have two primary types of operations:

- Full and focused service operations, concentrating on the broad range of needs of business travellers, client groups, conferences and meetings; and
- Limited service operations with limited amenities aimed at recreational travellers, vacations, group tours, sports teams and weekend get-aways.

Demand from these two groups of travellers and the supply of available accommodation are the primary drivers of our financial performance. Macroeconomic factors affecting demand for, and supply of hotel accommodation, include:

- General economic conditions and consumer confidence that affect discretionary spending;
- The financial condition of the airlines and other transportation industries;
- Demographic shifts impacting the nature of travel;
- Geopolitical events affecting consumer and business confidence; and
- The rate of exchange between the U.S. and Canadian dollar.

## **OUR STRATEGY FOR VALUE CREATION**

Our strategy for achieving our Vision and the underlying objective of increasing Unitholder value is based on four strategic elements:

- Focus on our core strengths of hotel management, ownership and franchising;
- Growth through acquisition of new hotel properties which have potential to meet our standards and are accretive to earnings, and replacement of older, non-core properties with newer ones;
- Maintaining a fresh appearance in our hotels through a systematic program of upgrading and renovation; and
- Striving to grow our Travelodge franchising and management business to provide us with a steady source of revenue from third party franchise and management fees.

## **RESOURCES**

The key resources we require for the implementation of our strategy and ongoing management of our business include financial, human, capital infrastructure, system and process and internalized management.

### **Financial Resources**

Our financial and liquid resources are discussed under Liquidity and Capital Resources on page 14 of this MD&A. In general, our total debt resources are limited to 45 percent of total assets plus accumulated amortization under the terms of our Trust Indenture. Financing in excess of these limits requires the issuance of new equity. At present, management believes that our balance sheet is conservative and that we have sufficient capacity to finance our future operations or expansion plans either through issuance of debt or equity.

### **Human Resources**

We employ approximately 3,950 people throughout our organization, and we recognize that they are all critical to the success of our business. In order to retain a highly skilled team of managers and staff, we maintain competitive compensation programs, an extensive commitment to training and development and empowerment within specific areas of responsibility. We also recognize and reward the successes of our employees.

### **Capital Infrastructure Resources**

It is important to maintain the quality and appearance of our hotels in order to continue appealing to our guests. Consequently, we set aside a budget for regular maintenance and upgrading programs to ensure all our hotels remain competitive.

### **System and Process Resources**

We use our established systems and processes to maintain a competitive operating advantage. These systems include comprehensive "Standard Operating Procedure" manuals, modern, innovative information and data communication systems, sound internal controls and an innovative guest reward program that is unique to major hotel chains in our industry.

## **Internalized Management**

Royal Host is only one of two Canadian hotel real estate investment trusts ("REIT") that owns and controls the management of its own hotels.

The hotel business is highly management intensive and unlike other forms of real estate ownership, success or failure of a hotel property is highly dependent on management. We believe that ownership of the management company is an excellent way to align Royal Host's interest with that of its unitholders.

## **INTERPRETING OUR FINANCIAL RESULTS**

### **Key Accounting Policies and Estimates**

Note 2 to the financial statements includes a complete summary of all of our significant accounting policies.

Application of certain of these policies requires us to make estimates of future events that may have a material effect on current or future financial results. These estimates require experience and judgement and are subject to the inherent risk of inaccuracy, particularly where they relate to events that are expected to take place well into the future. There are two key areas where material estimates are required to complete our financial results:

#### **(1) Revenue Recognition**

We recognize revenues from our hospitality operations when the service has been provided and collection is reasonably assured. In certain cases, such as period end accruals, application of this policy may require estimates to be made of final charges, discounts and allowances, cost of the product or service delivered and creditworthiness of the customer. We make these estimates based on the most recent information available and consider consistency with historical trends. Generally, such estimates are spread over a short period of time to a diverse customer base and any inaccuracies in the estimates tend to be compensating.

#### **(2) Capital Assets**

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

Hotel properties are amortized using the straight-line method over their estimated useful lives. Each individual property is evaluated quarterly and its useful life is estimated based on certain factors including construction materials used, location, condition of the property and the particular capital maintenance program and requirements of the property.

Estimates of future cash flows and the useful lives of hotel properties require substantial judgement, and are subject to ongoing review and adjustment as conditions change.

## **NEW ACCOUNTING STANDARDS**

### **(1) Property held for Sale, Disposal of Long-Lived Assets and Discontinued Operations**

Effective January 1, 2004, the Trust adopted the new CICA Handbook Section 3475, Disposal of Long-Lived Assets and Discontinued Operations. The recommendations of this section require that disposals of long-lived assets be classified as held for sale, and the results of operations and cash flows associated with the assets disposed and held for sale be reported separately as discontinued operations, net of applicable income taxes. A long-lived asset is classified by the Trust as an asset held for sale at the point in time when:

- it is available for immediate sale;
- management has committed to a plan to sell the asset;

- the Trust is actively locating a buyer for the asset at a sales price that is reasonable in relation to the current fair value of the asset; and
- the sale is probable and expected to be completed within a one-year period.

For unsolicited interest in a long-lived asset, the asset is classified as held for sale if:

- all the conditions of the purchase and sale agreement have been met;
- a sufficient purchaser deposit has been received; and
- the sale is probable and expected to be completed shortly after the end of the current period.

## (2) Impairment of Long-Lived Assets

Effective January 1, 2004, the Trust prospectively adopted the recommendations of CICA Handbook Section 3063, Impairment of Long-Lived Assets. The recommendations of this section require that an impairment loss on long-lived assets to be held and used be recognized when their carrying value exceeds the total undiscounted cash flows expected from their use and eventual disposition. The amount of the impairment loss is determined as the excess of the carrying value of the asset over its fair value. The impact of adopting the new recommendations has been reflected in the consolidated statements of net earnings as a property impairment provision.

## (3) Liabilities and Equity

Effective January 1, 2005, the Trust will be adopting the amended CICA Handbook Section 3860, Financial Instruments, Disclosure and Presentation. The recommendations of this section require certain instruments that may be settled in cash or by a variable number of an issuer's own equity instruments, at the issuer's discretion, to be presented as liabilities. As a result, the \$75 million convertible debentures, which are currently classified as equity, will be reclassified to debt.

Pursuant to the transitional provisions of Section 3860, the 2004 comparative financial statements will be restated to reflect the change in accounting policy as outlined below.

	Year Ended	Three Months Ended			
	31-Dec-04 (000's)	31-Mar-04	30-Jun-04	30-Sep-04	31-Dec-04 (000's)
Increase in liabilities	75,000	62,000	75,000	75,000	75,000
Decrease in equity	(52,683)	(44,483)	(57,281)	(57,226)	(57,216)
Decrease in retained earnings (beginning of period)	(16,159)	(16,159)	(16,159)	(16,159)	(16,159)
Decrease in net income	(6,158)	(1,358)	(1,560)	(1,615)	(1,625)
Decrease in retained earnings (end of period)	(22,317)	(17,517)	(17,719)	(17,774)	(17,784)

## Key Performance Drivers and Measures

The hotel industry has developed three key indicators for comparing the financial performance of hotel operators:

- Occupancy Rate measures the level of hotel room utilization and is calculated by dividing the number of rooms available for a given period into the number of rooms actually rented for the period;
- Average Daily Rate (ADR) measures the average room price for all guest rooms by dividing total room revenues by the number of rooms rented; and

- Revenue per Available Room (RevPAR) is a key hotel industry indicator as it combines information about both pricing levels and occupancy. This measure of efficiency is based on all available rooms regardless of whether they are occupied or not. RevPAR is calculated by dividing the number of rooms available during a given time period into the room revenue for the same period.

These measures are not recognized under GAAP and our method of calculation may not be comparable to other companies. They should not, therefore, be used as an alternative to net earnings (loss) determined in accordance with GAAP as an indicator of our performance. However, we believe these measures are useful in supplementing the reader's understanding of our historical performance.

## **OUR RESULTS**

### **Overview**

In the fourth quarter of 2003, we named a new Chief Executive Officer. In the fourth quarter of 2004, we announced the departure of both the President and the Chief Financial Officer. As part of this process, we have also implemented a strategy of simplifying our business and improving the focus on our core strengths. As a result of this renewed focus, a number of hotel assets and ancillary businesses were deemed to be non-core and targeted for divestiture.

During the second quarter of 2004, we had pending sales for four hotels designated as being non-core. The sale of the 38 room North Battleford hotel was completed in October 2004. The sale of the Lethbridge and Regina Super 8 hotels was subject to mortgage lender approval. However, these hotels were part of a pool of assets securing a debenture and a satisfactory release agreement could not be reached with the lender. As a result, these properties were reclassified from "property held for sale" to "capital assets" at reduced values, after taking a property impairment provision (Note 4 to the financial statements). The sale of the 95 room Orillia hotel is still pending and the transaction is expected to close by June of 2005. The Orillia hotel has been classified as a property held for sale in the financial statements.

In April 2004, we completed the placement of a \$35 million unsecured subordinated convertible debenture. Proceeds of the offering were used to retire an existing \$22 million convertible secured debenture, with the remaining funds being used for working capital and general corporate purposes (Note 12 to the financial statements).

On August 1, 2004, we successfully took over the management of 69 U.S. based hotels owned by Humphrey Hospitality, a NASDAQ listed REIT. Under the terms of the management contract, Royal Host receives a management fee based on a percentage of gross sales of the hotel properties. For the first five months ended December 31, 2004, the contract made a positive contribution to Royal Host's bottom line. However, the impact of this contract is not material and therefore results of this operation have not been segmented.

On November 8, 2004, we completed a \$25 million, five year mortgage financing secured by the London Hilton and the Ottawa Chimo hotels. Net proceeds were used to partially pay down a \$30 million portfolio mortgage, which had matured. The balance of this portfolio mortgage was repaid in February 2005, when the North York hotel was sold (see "Subsequent Events" page 17).

## Key Performance Indicators

The following table summarizes the key performance indicators for total hotel operations for the three years ended December 31:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Average Daily Rate	\$89.45	\$87.95	\$89.91
Occupancy	65.2%	64.2%	63.9%
RevPAR	\$58.29	\$56.45	\$57.43

## Results

For total operations in 2004, occupancy improved by 1.6%, ADR improved 1.7% and RevPAR improved 3.3% over comparable numbers in 2003. These increases clearly show recovery from disastrous events, including severe acute respiratory syndrome (SARS), which plagued much of the Canadian hotel industry in 2003.

While healthy, our annual 3.3% growth in RevPAR in 2004 over 2003, is lower than the growth experienced by the hospitality industry as a whole. The primary reasons for the different results between, ourselves and the industry are:

### Transitional Properties

- As the North York, North Battleford and Orillia properties were in transition throughout much of 2004, they were a significant drag on our operating results. North Battleford and Orillia were put up for sale in early 2004 and, throughout the year, North York was being converted into a condominium joint venture. North Battleford and the North York hotel were sold in November 2004 and February 2005, respectively. We expect to sell the Orillia hotel by June of 2005.

### Disproportionate Representation

- The industry experienced significant growth in the province of Quebec where we do not own hotels.

It is important to note that while ADR improved from 2003 to 2004, it is still lower than the comparable period in 2002. This is significant since ADR is a key driver of operating margins. Consequently, an improvement in RevPAR, due primarily to occupancy increases, results in lower margins, on a year-over-year comparative basis.

**SELECTED FINANCIAL AND OPERATING HIGHLIGHTS**

<b>For the years ended December 31, (\$000's)</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
Room revenues	99,692	96,004	90,011
Food and beverage revenues	25,876	25,353	22,823
Other revenues	16,987	16,664	19,412
<b>Total Hospitality Revenues</b>	<b>\$142,555</b>	<b>\$138,021</b>	<b>\$132,246</b>
<b>Net (Loss) Earnings</b>			
from continuing operations	1,237	138	7,140
from discontinued operations	320	(119)	220
<b>Net Earnings</b>	<b>\$1,557</b>	<b>\$19</b>	<b>\$7,360</b>
<b>Basic Per Unit Net (Loss) Earnings</b>			
from continuing operations	(0.23)	(0.28)	0.00
from discontinued operations	0.01	0.00	0.01
<b>Basic Per Unit Net (Loss) Earnings</b>	<b>(\$0.22)</b>	<b>(\$0.28)</b>	<b>\$0.01</b>
<b>Diluted Per Unit Net (Loss) Earnings</b>			
from continuing operations	(0.23)	(0.29)	0.00
from discontinued operations	0.01	0.00	0.01
<b>Diluted Per Unit Net (Loss) Earnings</b>	<b>(\$0.22)</b>	<b>(\$0.29)</b>	<b>\$0.01</b>
<b>TOTAL OPERATIONS</b>			
Adjusted cash available for distribution (Page11)	12,448	11,709	18,202
<b>Cash distributions declared</b>	<b>5,872</b>	<b>11,667</b>	<b>17,611</b>
Adjusted cash available for distribution per unit (basic)	0.51	0.48	0.74
<b>Cash distributions declared per unit</b>	<b>\$0.24</b>	<b>\$0.48</b>	<b>\$0.72</b>
<b>Total Assets</b>	<b>\$376,411</b>	<b>\$375,880</b>	<b>\$369,020</b>
Mortgages and other debt	156,979	161,165	141,240
Capital leases	1,524	2,354	2,333
<b>Total long term liabilities</b>	<b>\$158,503</b>	<b>\$163,519</b>	<b>\$143,573</b>

The following analysis relates to continuing operations only, except where identified.

**CONSOLIDATED STATEMENT OF NET EARNINGS (000's)**

**Hospitality Revenues**

<b>Year Ended December 31</b>	<b>2004</b>	<b>2003</b>
Total Hospitality Revenues	144,242	141,544
Less Discontinued Operations	(1,687)	(3,523)
Continuing Operations	<u>\$142,555</u>	<u>\$138,021</u>

Hospitality revenues from continuing operations in 2004 increased by \$4.5 million or 3.3% compared to 2003. The increase is largely due to improved year-over-year hotel operating conditions and improvements in occupancies and average daily rates. Higher revenues were also recorded due to the inclusion of twelve months of operations in 2004 for the Calgary Village Park Inn, versus only nine months beginning April 1, 2003. The new hotel management contract in the United States, which began on August 1, 2004, also contributed to higher revenues.

**Room Revenues**

In 2004, room revenues from continuing operations increased by \$3.7 million to \$99.7 million or 3.8% due to a 3.6% improvement in RevPAR, from 2003. Occupancy increased by 2.0% and the average daily rate increased by 1.6% to \$89.82 compared to 2003.

**Food and Beverage Revenues**

Food and beverage revenues in 2004 increased by \$523,000 or 2.1% to \$25.9 million, or year-over-year, compared to 2003. The increase is primarily due to the additional food and beverage operations at the Calgary Village Park Inn as well as improved revenues at the Travelodge Ottawa West, The Grand Okanagan Resort and London Hilton hotels.

**Other Hospitality Revenues**

Other hospitality revenues increased by \$323,000, or 1.9%, to \$17.0 million compared to 2003. Timeshare revenues continue to decline due to the ongoing restructuring of the timeshare operations. The reduction in timeshare revenues was offset by an increase in management fees from the new management contract.

**Expenses**

In 2004 we incurred one-time expenses of \$4.4 million, of which approximately \$2.0 million were included in "Hospitality Expenses" and approximately \$2.4 million were included in "Other Expenses and (Income)". These expenses resulted from: asset write-downs, accounts receivable allowances, severance expenses, and a property impairment provision. Without these one-time costs, adjusted cash available for distribution would have been substantially greater. Given that almost all of these items are non-recurring, future adjusted cash available for distribution should show substantial improvement.

## Hospitality Expenses

<b>Year Ended December 31</b>	<b>2004</b>	<b>2003</b>
Total Hospitality Expense	107,558	106,655
Less Discontinued Operations	(1,701)	(3,241)
Continuing Operations	<u>\$105,857</u>	<u>\$103,414</u>

Hospitality expenses from continuing operations increased by \$2.4 million, or 2.4%, in 2004 compared to 2003. Approximately \$2.0 million of this increase is directly due to one-time expenses comprised of asset write downs and accounts receivable allowances. The majority of these items were booked in the fourth quarter of 2004 and do not impact our current cash position. In addition, as they are one time costs, they are not expected to recur in future years.

Hospitality expenses also increased due to the addition of the Humphrey Hospitality management contract in August of 2004, which required additional staff and administrative expenses. In addition to increasing the volume of expenses, these costs were also higher than normal due to initial set up requirements. Although, after only five months, the contract has been a net contributor to earnings.

## Gross Margin

<b>Year Ended December 31</b>	<b>2004</b>	<b>%</b>	<b>2003</b>	<b>%</b>
Total Operations	\$36,684	25.4%	\$34,889	24.7%
Continuing Operations	<u>\$36,698</u>	<u>25.7%</u>	<u>\$34,607</u>	<u>25.1%</u>

In 2004, gross margin from continuing operations increased by \$2.1 million despite incurring one-time expenses totalling approximately \$2.0 million. These results confirm that 2004 has been a period of recovery from the negative events that plagued 2003. The recovery is not complete as the 2004 total gross margin of \$36.7 million still lags the 2002 gross margin of \$39.7 million. Industry performance is compared against the 2002 operating results since it is seen as being a normal year of operations.

## Other Expenses and (Income)

Other expenses increased by approximately \$1.0 million in 2004 from 2003. Increases were primarily due to: higher debt interest expenses; increased trust administration expenses mainly relating to severance costs; and a property impairment provision. The largest reductions were recorded in amortization and future income tax (both non-cash items). Both the severance expense of approximately \$1.6 million and the property impairment provision of \$734,000 are expected to be non-recurring. This will result in reduced future expenses.

**CASH AVAILABLE FOR DISTRIBUTION (1)**

<u>YEAR ENDED DECEMBER 31 (\$000's)</u>	<u>2004</u> <u>Continuing</u> <u>Operations</u>	<u>2004</u> <u>Total</u> <u>Operations</u>	<u>2003</u> <u>Continuing</u> <u>Operations</u>	<u>2003</u> <u>Total</u> <u>Operations</u>
Basic earnings (loss) (Note 13 - Financial Statements)	(\$5,677)	(\$5,357)	(\$6,835)	(\$6,954)
Add non-cash items deducted from earnings (2)	17,874	18,084	18,270	18,663
Deduct drawdown of tax allowance	(279)	(279)	-	-
Adjusted cash available for distribution (3)	\$11,918	\$12,448	\$11,435	\$11,709
Distribution payout ratio		47%		100%
Basic per unit adjusted cash available for distribution:	\$0.49	\$0.51	\$0.47	\$0.48
Diluted per unit adjusted cash available for distribution:	\$0.46	\$0.48	\$0.47	\$0.48
<b>Cash distribution declared per unit</b>		<b>\$0.24</b>		<b>\$0.48</b>

Note (1) Cash available for distribution is not a standardized measure under GAAP and therefore may not be comparable to similarly titled measures used by other trusts.

Note (2) Includes amortization of capital assets, amortization for deferred finance charges, unrealized gain/loss on translation of foreign subsidiaries, future income taxes and property impairment provision.

Note (3) Adjusted cash available for distribution is calculated after interest payments on convertible debentures and distributions on redeemable partnership units.

**Adjusted Cash Available for Distribution**

Adjusted cash available for distribution is calculated after payment of interest on convertible debentures and distributions on redeemable units. It represents cash available to fund cash distributions on ordinary units, as well as reserves for capital expenditures.

In 2004, adjusted cash available for distribution for total operations increased by \$739,000 an increase of 6.3% to \$12.4 million in 2004 from \$11.7 million in 2003. Excluding the one time cash expenses, of approximately \$3.7 million, adjusted cash available for distribution from total operations would have been \$16.1 million or \$0.66 per unit basic and \$0.59 per unit diluted.

For the year ended December 31, 2004, cash distributions declared were \$5.9 million compared to \$11.7 million in 2003. This represents a payout ratio of 47% for total operations compared to 100% in 2003 (Note 12 of the financial statements).

The Board of Trustees approves distributions periodically based on projected cash flows, capital requirements and working capital needs. In December 2004, the 2005 annual distribution rate was increased from \$0.24 per unit to \$0.36 per unit.

Royal Host pays cash distributions on a monthly basis to unitholders of record on or about the fifteenth day of each month. Distributions are payable on or about the last business day of the following month.

### SELECTED QUARTERLY FINANCIAL DATA

(\$000's)	2004				2003			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total Hospitality revenues	30,986	37,067	41,673	34,516	29,797	36,085	40,595	35,067
earnings from continuing operations	(726)	1,120	4,792	(3,949)	(828)	645	1,527	(1,206)
earnings from discontinued operations	(37)	341	252	(236)	(57)	(9)	107	(160)
<b>Net earnings</b>	<b>(763)</b>	<b>1,461</b>	<b>5,044</b>	<b>(4,185)</b>	<b>(885)</b>	<b>636</b>	<b>1,634</b>	<b>(1,366)</b>
<b>Basic per unit net earnings</b>								
from continuing operations	(0.09)	(0.02)	0.12	(0.23)	(0.11)	(0.05)	0.00	(0.12)
from discontinued operations	0.00	0.01	0.01	(0.01)	0.00	0.00	0.00	0.00
<b>Basic per net unit earnings</b>	<b>(0.09)</b>	<b>(0.01)</b>	<b>0.13</b>	<b>(0.24)</b>	<b>(0.11)</b>	<b>(0.05)</b>	<b>0.00</b>	<b>(0.12)</b>
<b>Diluted per unit net earnings</b>								
from continuing operations	(0.10)	(0.02)	0.11	(0.24)	(0.12)	(0.05)	0.00	(0.12)
from discontinued operations	0.00	0.01	0.02	(0.01)	0.00	0.00	0.00	0.00
<b>Diluted per unit net earnings</b>	<b>(0.10)</b>	<b>(0.01)</b>	<b>0.13</b>	<b>(0.25)</b>	<b>(0.12)</b>	<b>(0.05)</b>	<b>0.00</b>	<b>(0.12)</b>

### **Fourth Quarter Results**

For total operations in 2004, fourth quarter ADR increased by \$0.34 to \$86.17; Occupancy decreased 1.9 percentage points to 59.3%; and RevPAR was \$1.45 lower at \$51.06 (a decrease of 2.8%) compared to the fourth quarter of 2003.

**SELECTED FOURTH QUARTER DATA**

<b>Three months ended December 31 (\$000's)</b>	<b>2004 Continuing Operations</b>	<b>2004 Total Operations</b>	<b>2003 Continuing Operations</b>	<b>2003 Total Operations</b>
Hospitality revenue	\$34,252	\$34,516	\$34,290	\$35,067
Hospitality expense	28,425	28,725	25,568	26,262
Earnings (loss)	(3,949)	(4,185)	(1,206)	(1,366)
Less:				
Distribution of redeemable partnership units	(189)	(189)	(189)	(189)
Interest on convertible debentures	(1,615)	(1,615)	(1,376)	(1,376)
Basic earnings (loss)	(5,753)	(5,989)	(2,771)	(2,931)
Add: non-cash items deducted from earnings	4,256	4,816	5,540	5,683
Deduct: drawdown of tax allowance	(58)	(58)	-	-
Adjusted cash available for distribution	(1,555)	(1,231)	2,769	2,752
Basic per unit adjusted cash available for distribution	(0.06)	(0.05)	0.11	0.11
Diluted per unit adjusted cash available for distribution	(\$0.06)	(\$0.05)	\$0.11	\$0.11

Hospitality revenues from continuing operations were almost unchanged in the fourth quarter of 2004, compared to the same quarter of 2003. While other hospitality revenues, due primarily to the new Humphrey Hospitality Management contract, were \$559,000 higher, this was offset by a \$508,000 or 2.2% decrease in room revenues.

Gross margin of \$5.8 million was \$2.9 million lower in 2004 compared to the same quarter of 2003. As previously noted, the one-time expenses of approximately \$1.8 million incurred in the fourth quarter of 2004 were a major contributor to the reduced gross margin.

Fourth quarter adjusted cash available for distribution from total operations was \$4.0 million lower in 2004 compared to the same quarter of 2003. As previously noted, one-time expenses recorded in the fourth quarter of 2004 were the major cause of this decrease. These expenses resulted from asset write-downs due to impairment or obsolescence, accounts receivable allowances and severance expense. These results do not alter our outlook for improved operations in 2005 as the transitional Orillia and North York hotels pulled down our quarterly results.

**BALANCE SHEET (000'S)**

For the years ended December 31	2004	2003 Restated
Units outstanding	24,825	24,762
Potential issuance of units:		
Conversion of convertible unsecured subordinated debentures (conversion price \$7.00)	5,714	5,714
Conversion of convertible unsecured debentures, series A (conversion price \$6.00)	5,833	-
Conversion of convertible secured debentures (conversion price \$11.00)	-	2,000
Options outstanding (exercise price \$10.00)	138	853
Redeemable partnership units	3,151	3,151

**Liquidity and Capital Resources**

As of December 31, 2004, we had \$9.4 million in cash and short term investments and \$11.0 million in undrawn working capital credit facilities. We also has additional borrowing capacity of \$113.5 as the debt to gross book value stood at 32% at the end of 2004 compared to a maximum allowable of 45%.

At December 31, 2004 long-term debt obligations were \$117.9 million, a reduction of \$3.8 million from \$121.7 million as at December 31, 2003. Monthly principal and interest payments on long-term debt obligations totalled \$1.37 million in 2004 compared to \$1.41 million in 2003.

The following chart identifies our debt and contractual obligations by maturity.

Contractual Obligations	Total	Payments Due by Period		
		Less than 1 year	1 - 3 years	4 - 5 years
Long Term Debt	\$156,979	\$39,083	\$29,223	\$88,673
Capital Lease Obligations	1,731	671	1,060	-
Operating Leases	1,690	853	813	24
<b>Total Obligations</b>	<b>\$160,400</b>	<b>\$40,607</b>	<b>\$31,096</b>	<b>\$88,697</b>

With the completion of the Grand Okanagan mortgage financing in January 2005, we have no material debt maturities until the first quarter of 2007.

**Capital Expenditures**

During 2004, Royal Host invested \$6.4 million in capital expenditures and had \$6.9 million in property under development. This compares to \$14.0 million in property capital expenditures and \$2.1 million in property under development for the year ended December 31, 2003.

In 2005, we expect to spend approximately \$8.0 million on capital expenditures and will use a \$28.0 million construction loan to fund the completion of the Royal Private Residence Club in Kelowna (see "Subsequent Events" Page 17). It is possible that we will not be able to complete all of the projected \$8.0 million in capital expenditures in calendar 2005, and some of the actual work may move into the 2006 fiscal year.

At December 31, 2004, Royal Host had a restricted cash balance of \$5.7 million. All of these funds are available to be used to fund capital expenditures on certain hotels. A portion of the previously mentioned \$8.0 million capital expenditure program in 2005 will be funded out of reserved cash. Approximately \$1.4 million of the 2004 capital expenditures were funded out of this reserve.

### **Discontinued Operations**

During the second quarter of 2004, we decided to sell certain non-core hotel properties and had pending sales to two separate, unrelated buyers. The first pending sale involved an offer of \$5.8 million in net consideration, to purchase three properties with a total of 190 rooms in Western Canada. Two of these sales were conditional on mortgage lender approval. On November 26, 2004 we completed the sale of one of the hotel properties located in North Battleford, Saskatchewan for \$1.2 million. As at December 31, 2004, we were unable to negotiate a satisfactory release of mortgage security in net consideration with the mortgage lender for the two remaining properties, resulting in the cancellation of the pending sale. The two remaining properties were transferred from property held for sale to capital assets at reduced values, after taking a property impairment provision.

The second pending sale involves an offer to purchase the Orillia Travelodge hotel for \$2.7 million in net consideration. The sale is conditional on a rezoning application. The expected completion date of this transaction is prior to June 30, 2005.

On May 28, 2004, we completed the sale of a marina and recreational vehicle facility in Oklahoma, USA for \$1.2 million.

The following table summarizes the results of operations from the Orillia Travelodge currently held for sale and the North Battleford Super 8, which was sold in November 2004. Partial results for the Oklahoma marina which was sold in May 2004 are also included. The results are being separately reported as discontinued operations for the current and prior years.

## **DISCONTINUED OPERATIONS**

<b>Year ended December 31 (\$000's)</b>	<b>2004</b>	<b>2003</b>
<b>Hospitality Revenues</b>		
Rooms	\$1,365	\$1,786
Food and beverage	154	1,170
Other hospitality revenues	168	567
	<u>1,687</u>	<u>3,523</u>
<b>Hospitality Expenses</b>	<b>1,701</b>	<b>3,241</b>
<b>Gross Margin</b>	<b>(14)</b>	<b>282</b>
<b>Other Expense</b>		
Interest on mortgages and other debt	6	4
Capital and other taxes	8	4
Amortization	94	411
Property impairment provision	406	-
(Gain) loss on foreign currency translation	(39)	56
	<u>475</u>	<u>475</u>
<b>Operating loss from discontinued operations before income taxes</b>	<b>(489)</b>	<b>(193)</b>
Future income tax recovery	(250)	(74)
<b>Operating earnings (loss) from discontinued operations</b>	<b>(239)</b>	<b>(119)</b>
Gain on disposition	559	-
<b>Net earnings (loss) from discontinued operations</b>	<b>\$320</b>	<b>(\$119)</b>

### **Property under Development**

Royal Host has launched the Royal Private Residence Club (PRC) to develop a portion of the property at the Grand Okanagan Lakefront Resort and Conference Centre in Kelowna, British Columbia. This program involves the development and sale of 67 luxury condominium units on available land at the Grand Okanagan hotel. As at December 31, 2004, 64% of the units have been sold.

Construction of the first phase of the project, a parkade, commenced in January 2004 and construction on the residence units commenced in May 2004. Revenue from the sale of land or property will be recorded on closing or, where sold by way of an agreement of purchase and sale, when the agreement is duly executed and delivered. Profit from the sale of land or property is recorded on closing or, where sold by way of an agreement of purchase and sale, when the collection of the sale proceeds is reasonably assured and all other material conditions are met (Note 5 to the financial statements).

We account for this subsidiary's interest in the above joint venture on a proportionate consolidation basis. Accordingly, these financial statements reflect our undivided interest in the assets, liabilities, revenues and expenses in the joint venture (Note 5 to the financial statements). As a joint venture participant, we are subject to the normal development risks associated with property development activity.

## **Redeemable Partnership Units**

As at December 31, 2004 a total of 3,151,443 redeemable partnership units were outstanding. Holders of these redeemable units are entitled to receive distributions from Royal Host equivalent to the distributions paid to Royal Host unitholders. In addition, each partnership unit is redeemable by the holders, for one Royal Host unit or for cash based on the market value of a Royal Host unit. It is Royal Host's option to exchange the redeemable partnership units into Royal Host units or cash.

On January 25th, 2005, the holders of the redeemable units have requested Royal Host to convert 3,151,433 units into either cash or units of Royal Host. The Board of Trustees is currently evaluating whether to redeem these units for cash or trust units of Royal Host. It is expected that this redemption will take place in the first quarter of 2005.

## **Subsequent Events**

Subsequent to December 31, 2004, Royal Host completed the replacement of the mortgage debt on the Grand Okanagan Resort and Conference Centre. The existing \$25 million mortgage was originally scheduled to mature in August 2005 and was included in "Current portion of mortgages and other debt" in the December 31, 2004 audited financial statements. On January 13, 2005, the original \$25 million mortgage was increased to \$35 million for a five year term at a 7.5% fixed interest rate. The additional proceeds from the financing, net of expenses, will be utilized for working capital and general corporate purposes.

With the completion of this mortgage financing, we have no significant debt maturities until the first quarter of 2007.

On February 23, 2005, the Travelodge North York Hotel was sold to an unrelated third party developer. The development group is planning to convert the property from hotel usage to residential condominiums. Under the agreement of purchase and sale, Royal Host received \$10.8 million for its 50% interest in the North York property. Payment was made by way of \$7.0 million in cash and a \$3.8 million, 60-day vendor take-back loan, which is secured by the property. In addition we will receive a subordinated vendor take back mortgage for up to \$2.0 million to recover some of the costs associated with closing the hotel. Cash proceeds from the transaction were used to paydown an existing \$5.5 million mortgage on the property, with the remaining balance available for general corporate purposes. It is expected that the sale of this property will have no material impact on Royal Host's 2005 earnings or cashflows. In February 2005 due to the sale of assets, changes in exchange rate and cost increases, the contract to manage 24 Super 8 hotels in the Pacific Northwest was determined to be underperforming and was cancelled.

In February 2005, Royal Host, together with a joint venture partner, entered into a non-revolving \$28.0 million financing arrangement consisting of a \$20.0 million construction loan and an \$8.0 million mezzanine loan. Proceeds from this financing will be used to complete the Royal Private Residence Club development project at the Grand Okanagan hotel.

## **Outlook**

Commencing January 2005, Royal Host increased its annual per unit distributions from \$0.24 to \$0.36. Based on the total number of units outstanding at December 31, 2004, a \$0.36 per unit annual distribution represents a 72% payout ratio on the 2004 total adjusted cash available for distribution of \$12.4 million.

Assuming no significant deterioration in operating results from the 2004 level, Royal Host can easily support the current level of cash distributions to unitholders, as well as meet its capital expenditure and working capital requirements.

## **Risks and Uncertainties**

Our business is subject to various risks and uncertainties that occur in the normal course of business that could adversely affect our earnings and cash flow, as well as our ability to make distributions to Unitholders. The following is a discussion of the key risks and uncertainties facing our business on a day-to-day basis, and the strategies we adopt to mitigate these risks. However, it should not be assumed that this discussion is exhaustive or that the strategies adopted to mitigate these risks will be effective.

### **General Economic Risks**

Hotel performance is affected by the following factors:

- General economic conditions and consumer confidence which determine discretionary spending;
- The state of the airline and other transportation industries;
- Demographic shifts impacting nature of travel;
- Geopolitical events affecting consumer and business confidence;
- Fiscal and taxation policies;
- Changes in legislation; and
- Fluctuations in interest rates.

While these factors are mainly external and uncontrollable, we adopt several strategies in an effort to minimize their impact:

- Diversification of our existing hotel portfolio both geographically and across market segments in order to lower our exposure to regional economic fluctuations;
- Acquisition of properties in desirable locations with a history of stable cash flows that are at or above our minimum expected rate of return;
- Maintaining a corporate legal structure to limit taxation and other risks;
- Maintaining a strong balance sheet and conservative fiscal strategies; and
- Using debt instruments with fixed interest rates where such financing can be obtained on favourable terms.

### **Operating Risk**

We also face normal operating risks associated with the hotel business. These risks include:

- Operating cost increases due to inflation and other factors;
- Dependence on business travellers and tourism;
- Increases in energy costs and other expenses; and
- Reliance on key personnel.

In order to mitigate these risks, we have developed strategies focusing on:

- Ensuring consumer satisfaction through proactive measures such as staff training;
- Maintaining a high quality product by ensuring that our hotel portfolio is constantly renovated and managed at or above industry standards;
- Developing specific sales and marketing programs targeting a wide variety of customer segments, using innovative electronic marketing techniques;
- Employing sophisticated operating systems to manage and control cost;
- Managing our capital structures; and
- Providing incentive based compensation programs to attract and maintain a high quality management team.

### **Competitive Risks**

Substantially all of our hotels are located in developed areas that include other hotel properties. The number of competitive hotel properties in a particular area could have a material effect on occupancy and ADR of our hotels or at hotel properties acquired in the future. New, competing hotels may be opened in our markets, which could adversely affect the profitability of hotel operations.

## **Environmental Risk**

We are subject to numerous federal, provincial and local laws and regulations governing the environment. Under these laws and regulations, we may be liable for the costs of removal or remediation of certain hazardous or toxic substances on our properties.

In recent years environmental legislation in Canada has undergone significant change in response to greater public awareness. As a result, environmental management and remediation standards have increased. The nature of our business does not subject us to a high level of environmental risk, but we take this risk seriously. Under our current investment guidelines, all potential acquisition properties must have minimum phase one environmental assessments conducted by an independent consultant. We also maintain environmental impairment insurance on all properties.

## **Development Risk**

The development of the Royal Private Residence Club is a complex and non-standard project for Royal Host. Additionally, development projects are subject to different risks than the regular hotel business. These risks include:

- Cost increases and/or cost over runs;
- Sales/marketing risks;
- Reliance on external experts/advisors;
- Financing risks;
- Timing risks related to holding assets in inventory pending sale; and
- Closing risk, as some purchasers may not complete the purchase.

We have attempted to mitigate these risks by:

- Completing drawings and entering into fixed price contracts for the construction of the project;
- Forming a joint venture with an arms length party to reduce our cash equity requirements;
- Establishing relationships and entering into service contracts with reputable experts and advisors that have experience with this type of project;
- Requiring non-refundable deposits from potential purchasers;
- Engaging experienced sales professionals to reduce the sales/timing risk.

## **Forward Looking Statement**

Certain statements in this MD&A, including those in the Outlook section, relate to future periods commencing after December 31, 2004 and contain estimates or assumptions about the outcome of future events. These forward-looking statements are subject to risks, uncertainties and other factors that could result in the outcome of these events being materially different from those anticipated in this MD&A. These factors include, but are not limited to: general economic conditions, levels of travel in our key market areas, political conditions and events, competitive pressures, changes in government policy or regulations and the other risk factors discussed in "Risks and Uncertainties" and elsewhere in the MD&A. We do not undertake to update such forward-looking statements should our estimates or assumptions change. Additional information relating to Royal Host, including our annual information form (AIF), is available at [www.sedar.com](http://www.sedar.com).