

**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

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

**FOR THE PERIOD ENDED SEPTEMBER 30, 2005**

**THIRD QUARTER 2005**

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS AND FINANCIAL CONDITION FOR THE PERIOD ENDED SEPTEMBER 30, 2005

The following Management's Discussion and Analysis of Operations and Financial Condition ("MD&A") dated November 9, 2005, should be read in conjunction with the unaudited consolidated financial statements and notes of Royal Host Real Estate Investment Trust ("Royal Host" or the "Trust") for the nine months ended September 30, 2005, the audited consolidated financial statements and accompanying notes for the years ended December 31, 2004 and 2003 and management's discussion and analysis thereon. The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

### SELECTED FINANCIAL AND OPERATING HIGHLIGHTS

(\$000's, except as otherwise noted)	Three Months Ended			Nine Months Ended		
	Sept. 30/05	Sept. 30/04 (Restated)	Change %	Sept. 30/05	Sept. 30/04 (Restated)	Change %
Hospitality Revenue (continuing operations)						
Room	30,317	29,199	3.8	77,478	75,702	2.3
Food and Beverage	6,110	5,950	2.7	18,937	17,778	6.5
Other	4,811	4,938	(2.6)	12,896	11,975	7.7
	<u>41,238</u>	<u>40,087</u>	2.9	<u>109,311</u>	<u>105,455</u>	3.7
Gross Margin	<u>14,845</u>	<u>14,072</u>	5.5	<u>32,873</u>	<u>30,786</u>	6.8
Gross Margin %	<u>36.0</u>	<u>35.1</u>	2.6	<u>30.1</u>	<u>29.2</u>	3.1
Net Earnings (Loss)						
From Continuing Operations	3,528	2,774	27.2	2,918	965	202.4
From Discontinued Operations	81	532	(84.8)	(242)	(121)	100.0
	<u>3,609</u>	<u>3,306</u>	9.2	<u>2,676</u>	<u>884</u>	202.7
Basic Per Unit Net Earnings (Loss) (\$)						
From Continuing Operations	0.13	0.11	18.2	0.10	0.02	400.0
From Discontinued Operations	-	0.02	-	(0.01)	(0.01)	-
	<u>0.13</u>	<u>0.13</u>	-	<u>0.09</u>	<u>0.01</u>	800.0
Diluted Per Unit Net Earnings (Loss) (\$)						
From Continuing Operations	0.13	0.10	30.0	0.10	0.02	400.0
From Discontinued Operations	-	0.02	-	(0.01)	(0.01)	-
	<u>0.13</u>	<u>0.12</u>	8.3	<u>0.09</u>	<u>0.01</u>	800.0
Cash Available for Distribution	<u>9,562</u>	<u>8,558</u>	11.7	<u>15,782</u>	<u>13,722</u>	15.0
Basic Per Unit Cash Available For Distribution (\$)	<u>0.35</u>	<u>0.35</u>	-	<u>0.61</u>	<u>0.56</u>	8.9
Diluted Per Unit Cash Available for Distribution (\$)	<u>0.29</u>	<u>0.26</u>	11.5	<u>0.54</u>	<u>0.50</u>	8.0
Distributions Declared	<u>2,748</u>	<u>1,468</u>	87.2	<u>7,377</u>	<u>4,404</u>	67.5
Basic Per Unit Distributions Declared (\$)	<u>0.10</u>	<u>0.06</u>	66.7	<u>0.28</u>	<u>0.18</u>	55.6
Number of Units Outstanding (000's), end of period (375,000 were repurchased in late September under the Normal Course Issuer Bid and cancelled subsequent to quarter end)	<u>27,479</u>	<u>24,809</u>	10.8			

The third quarter is traditionally the Trust's strongest and this quarter was no exception, with results in line with Management expectations. The Trust believes that a key measure of performance is cash available for distribution to unitholders. Cash available for distribution for the three months ended September 30, 2005 was \$9.6 million, an increase of \$1.0 million, or 11.7%, over the same period in 2004. For the nine months ended September 30, 2005, cash available for distribution was \$15.8 million, an increase of \$2.1 million or 15.0% over the \$13.7 million in the same period in 2004. On a per unit basis cash available for distribution for the three months was \$0.35, equal to the \$0.35 realized in 2004. This reflects a 10.8% increase in the underlying number of units as a result of the conversion of redeemable partnership units in the second quarter. For the nine months, cash available for distribution improved to \$0.61 per unit, an 8.9% increase over the \$0.56 per unit realized in 2004.

On October 20, 2005, the Trust completed a \$60 million offering of Convertible Unsecured Subordinated Debentures. The debentures have a coupon rate of 6% and mature in ten years (2015). The holders have a conversion option at a price of \$6.85 per unit. The net proceeds from the offering totaled \$57.5 million after all estimated costs. This is a very important step in positioning the Trust for future success and providing overall financial flexibility. These funds ensure the Trust has a stable and long-term, cost-effective base of capital, which is a very important component to our strategy going forward.

Subsequent to September 30, 2005, the Trust applied \$27.8 million of these funds towards the retirement of outstanding mortgage debt. Of this amount \$25.6 million was used to repay principal, \$0.2 million to pay interest, with the balance of \$2.0 million being penalties incurred for the early retirement. The early retirement payments will be expensed in the fourth quarter.

As a result, the Trust has no mortgage debt obligations, other than ongoing principal repayments, that are due before November 2009. In addition, the repayment of this debt has resulted in the removal of security on seven properties, which provides the Trust with additional financial flexibility. Of the properties that are now unsecured, Management has identified two that have development opportunities with substantial upside.

Royal Host is now positioned to fund all capital activities that have been identified in its existing asset base and that meet its return on investment thresholds. The Trust intends to continue to pursue and maximize its Normal Course Issuer Bids for both its Units and the 9.25% Convertible Debentures. Management anticipates funding the balance of the Royal Private Residence Club development project with internal cash on hand. The Trust is also now positioned to ensure it has funding to repay the 9.25% \$40 million Convertible Debentures when they become due in March 2007. Royal Host will continue to actively seek acquisition opportunities that meet its parameters and are in its core areas and expertise.

In summary, this financing will allow the Trust to take the next step from focusing on internal strengths to measured growth. The goal, as always, is to produce increasing distributions that are generated from a very stable base.

## **NON-GAAP FINANCIAL MEASURES**

This MD&A includes certain non-GAAP financial measures (measures that are not calculated or presented in accordance with GAAP). These measures are not recognized under GAAP and our method of calculation may not be comparable to measures presented by other entities. These measures should not be used as an alternative to net earnings (loss) determined in accordance with GAAP as an indicator of Royal Host's financial performance. However, we believe these measures are useful in supplementing the reader's understanding of the Trust's performance.

The following non-GAAP financial measures have been included in this MD&A: Average Daily Rate (ADR), Occupancy, Revenue per Available Room (RevPAR), Cash Available from Operations, and Cash Available for Distribution. These non-GAAP financial measures are key indicators commonly used within the hospitality industry and by Real Estate Investment Trusts.

The following table summarizes key performance operating indicators for the period ended September 30, 2005 and 2004:

	Three Months Ended			Nine Months Ended		
	Sept. 30/05	Sept. 30/04	Change	Sept. 30/05	Sept. 30/04	Change
	\$	\$	%	\$	\$	%
Average Daily Rate ("ADR")						
- Continuing Operations	99.50	95.81	3.9	94.32	91.30	3.3
- Total Operations	99.23	95.26	4.2	94.02	90.87	3.5
Occupancy						
- Continuing Operations	75.0	75.2	(0.3)	67.8	68.5	(1.0)
- Total Operations	74.2	74.8	(0.8)	66.7	67.8	(1.6)
Revenue Per Available Room ("RevPAR")						
- Continuing Operations	74.63	72.06	3.6	63.91	62.51	2.2
- Total Operations	73.64	71.21	3.4	62.74	61.59	1.9

The RevPAR in the third quarter from same store sales, increased primarily as a direct result of the overall improvement in ADR. The biggest gain was seen in the Western region where RevPAR increased by 6.8% as a result of a 4.1% increase in ADR and 2.6% increase in Occupancy. In Ontario, the largest region, the Trust saw an increase in ADR of 3.9% offset by a decline in Occupancy of 1.6%, resulting in a net overall RevPAR increase of 2.2%. In the Atlantic region, the smallest area, there was an overall decline in RevPAR of 3.3% driven by a decline in Occupancy of 5.8%.

### Seasonality

The hospitality business is seasonal in nature. The Trust's revenue and profitability are typically stronger in the second and third quarters, as compared to the first and fourth quarters. The Board of Trustees sets cash distributions based on annual performance; as a result, actual distributions will not equal cash available for distribution in any one quarter.

### Cash Available from Operations and Cash Available for Distribution

(\$000's, except as otherwise noted)	Three Months Ended		Nine Months Ended	
	Sept. 30/05	Sept. 30/04	Sept. 30/05	Sept. 30/04
Earnings From Continuing Operations	3,528	2,774	2,918	965
Add:				
Depreciation and Amortization	3,790	4,265	11,306	12,817
Property Impairment Provision	590	-	980	-
Future Income Taxes	1,627	1,314	1,271	378
Cash Available from Continuing Operations	9,535	8,353	16,475	14,160
Cash Available from Discontinued Operations	27	394	(315)	129
<b>Cash Available from Operations</b>	<b>9,562</b>	<b>8,747</b>	<b>16,160</b>	<b>14,289</b>
Less: Distributions on Redeemable Partnership Units	-	(189)	(378)	(567)
<b>Cash Available for Distribution</b>	<b>9,562</b>	<b>8,558</b>	<b>15,782</b>	<b>13,722</b>
Distributions Declared	2,748	1,468	7,377	4,404
Basic Per Unit Cash Available For Distribution (\$)	0.35	0.35	0.61	0.56
Diluted Per Unit Cash Available For Distribution (\$)	0.29	0.26	0.54	0.50
Basic Per Unit Distributions Declared (\$)	0.10	0.06	0.28	0.18

Cash available for distribution is calculated as cash available from operations less distributions on redeemable partnership units. It represents cash available to distribute to unitholders from total operations.

Cash available for distribution for the three months ended September 30, 2005 increased by 11.7% to \$9.6 million (2004 - \$8.6 million). Cash available for distribution for the nine months ended September 30, 2005 increased by 15.0% to \$15.8 million (2004 - \$13.7 million). This is a direct result of the strong third quarter driven by an overall improvement in ADR and steady Occupancy, coupled with strong other revenue and an improved gross margin.

Royal Host's Trustees approve distributions based on, among other things, projected cash flows, capital requirements, and working capital needs. 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 month. In January 2005, as a direct result of improved results, distributions per unit were increased from \$0.02 to \$0.03 per month. The Trustees further increased distributions per unit to \$0.035 commencing with the September 2005 distribution.

During the quarter the Trust declared distributions of \$2.7 million (2004 - \$1.5 million) bringing distributions declared to the end of September to \$7.4 million (2004 - \$4.4 million).

In addition to the distributions, the Trust used cash from operations to fund recurring principal repayments of \$1.0 million for the quarter bringing total principal repayments to \$3.0 million for the nine month period. Ongoing maintenance capital is estimated at 4% of total revenues. Based on this estimate, approximately \$4.4 million of the total capital of the \$5.1 million spent during the period would be considered maintenance capital. Of this amount a certain portion is to be funded from restricted cash.

## **FORWARD-LOOKING STATEMENTS**

Certain statements in this MD&A, including those in the Outlook section, relate to future periods commencing after September 30, 2005 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 other risk factors. Royal Host does not undertake to update such forward-looking statements should our estimates or assumptions change, except as required by law. Additional information relating to Royal Host, including our Annual Information Form, is available at [www.sedar.com](http://www.sedar.com).

## **THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2005 (Continuing Operations)**

### **Hospitality Revenue**

Hospitality revenue for the three months increased \$1.1 million or 2.9% to \$41.2 million (2004 - \$40.1 million). Substantially, all of the increase is attributable to the improvement in rooms revenue.

Hospitality revenue for the nine months increased \$3.8 million or 3.7% to \$109.3 million (2004 - \$105.5 million). Increases were realized in all areas with improving rooms revenue being supplemented by very strong food and beverage and other hospitality revenue.

### **Rooms Revenue**

Rooms revenue for the three months from same store sales increased \$1.1 million or 3.8% to \$30.3 million (2004 - \$29.2 million), a result of the 3.9% increase in ADR to \$99.50 (2004 - \$95.81), which more than offset a decrease in Occupancy of 0.3% to 75.0% (2004 - 75.2%). The increase in ADR is a result of Management's focused program on room rate yield management and improving overall industry rates.

Rooms revenue for the nine months increased \$1.8 million or 2.3% to \$77.5 million (2004 - \$75.7 million). This is due to a 3.3% increase in ADR to \$94.32 (2004 - \$91.30), which more than offset a 1.0% decrease in Occupancy to 67.8%.

## **Food and Beverage Revenue**

Food and beverage revenue for the three months increased \$0.1 million, or 2.7% to \$6.1 million (2004 - \$6.0 million), based on same store sales. Improvements were realized in all areas with only the Grand Okanagan Resort experiencing a year over year decrease, as a direct result of a decrease in banquets. The Grand had an exceptionally large number of banquets in the third quarter of 2004, which were not repeated in 2005.

Food and beverage revenue for the nine months increased by \$1.1 million or 6.5% to \$18.9 million (2004 - \$17.8 million), due to improving operations in a number of properties and the addition of food and beverage operations in two of our hotel properties.

## **Other Hospitality Revenue**

Other hospitality revenue for the three months decreased \$0.1 million or 2.6% to \$4.8 million (2004 - \$4.9 million). Travelodge franchise fees and ongoing management fees continue to be strong. Royal Host receives management fees based on the properties' gross revenue.

Other hospitality revenue for the nine months was very solid, increasing \$0.9 million or 7.7% to \$12.9 million (2004 - \$12.0 million). Travelodge franchise fees continue to be strong and the large increase is primarily the result of the success of Royal Host's management of Supertel Hospitality's 69 hotel properties, which commenced on August 1, 2004, and the management contract for the Wingate Inn Edmonton West, which commenced on January 1, 2005. The revenue from the new contracts more than offset the reduction resulting from the termination of the Peninsula contract and continuing planned decrease in timeshare activities.

## **Hospitality Expenses**

Royal Host has committed particular attention to managing its costs, as reflected in the quarter as hospitality expenses decreased as a percentage of revenues to 64.0% (2004 - 64.9%).

Hospitality expenses for the nine months decreased as a percentage of revenue to 69.9% a decrease from 70.8% in the same period in 2004. Total hospitality expenses increased by \$1.7 million or 2.3% to \$76.4 million (2004 - \$74.7 million). Despite increased food and beverage revenues, which have higher proportionate costs than room revenue, 54% of the \$3.8 million increase in revenue that Royal Host realized in the period translated into gross margin. This reflects management's continuing focus on operations and the success of the operations managers.

## **Gross Margin**

As a result of strong revenue growth in rooms revenue, a direct consequence of higher ADR and success in managing hospitality expenses, gross margin percentage for the quarter increased to 36.0%. This is a 2.6% increase compared to the 2004 gross margin percentage of 35.1%.

Gross margin for the nine months increased \$2.1 million or 6.8% to \$32.9 million (2004 - \$30.8 million) as a result of the higher revenues. Gross margin as a percentage of revenue improved by 3.1% to 30.1% (2004 - 29.2%). This overall improvement was realized despite an increase in food and beverage operations, which have higher proportionate costs than rooms revenue.

## **Other Expenses**

Other expenses were steady during the quarter at \$11.3 million (2004 - \$11.3 million). The Trust realized a \$0.5 million decrease in depreciation and amortization due to a number of assets being fully depreciated in 2005. This was offset by an impairment provision of \$0.6 million taken on the timeshare property in Mexico. Interest expense decreased primarily as a result of lower overall capital costs and offsetting interest income.

Year-to-date other expenses increased by less than 1% to \$30.0 million as compared to \$29.8 million. The Trust was able to reduce net interest expense by \$0.8 million from lower overall rates and interest income received on notes receivable. This was offset by a higher future income tax estimate, which is a non-cash item. Also included is \$1.0 million in property impairment provisions, which is also a non-cash item.

## **Net Earnings**

As a result of the strong revenue growth, improved gross margins, and an overall decrease in other expenses, net earnings from continuing operations for the quarter improved to \$3.5 million and net earnings from total operations increased to \$3.6 million. This compares to net earnings from continuing operations of \$2.7 million and earnings of \$3.3 million from total operations in the third quarter 2004.

Year-to-date net earnings are \$2.7 million as a result of the strong third quarter. This is an increase of \$1.8 million, or 202.7% over the \$0.9 million net earnings realized in 2004.

## **DISCONTINUED OPERATIONS**

For the three months ended September 30, 2005, revenue and gross margin from discontinued operations were \$0.2 million (2004 - \$1.6 million) and \$Nil (2004 - \$0.3 million). For the nine months ended September 30, 2005, revenue and gross margin from discontinued operations were \$1.1 million (2004 - \$4.3 million) and negative \$0.3 million (2004 - \$0.1 million), respectively.

On February 23, 2005, the Travelodge North York hotel was sold to a condominium developer. Under the agreement of purchase and sale, the Trust received \$10.8 million for its 50% interest in the property. Payment was made by way of \$7.0 million in cash and a \$3.8 million vendor take-back mortgage, which was collected in the third quarter. In addition, Royal Host received a subordinated vendor take-back mortgage for a maximum of \$2.0 million to recover certain costs associated with closing the hotel. As at September 30, 2005, \$2.0 million of the subordinated vendor take-back mortgage was recognized and included in Long-term Notes Receivable. Cash proceeds received from the transaction were used to repay a \$5.5 million mortgage on the property and for general corporate purposes.

Royal Host has received an offer of \$3.1 million to purchase its 95-room hotel in Orillia, Ontario. Currently the Trust is working to complete the purchase and sale agreement.

## SUMMARY OF QUARTERLY FINANCIAL RESULTS

(\$000's, except as otherwise noted)	2005				2004			2003
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Revenue	41,238	37,998	30,075	33,330	40,087	35,621	29,747	30,379
Net Earnings (Loss)								
From Continuing Operations	3,528	2,528	(3,138)	(6,102)	2,774	339	(2,148)	(2,740)
From Discontinued Operations	81	(214)	(109)	388	532	(587)	(66)	(95)
	3,609	2,314	(3,247)	(5,714)	3,306	(248)	(2,214)	(2,835)
Cash Available for Distribution								
From Continuing Operations	9,535	6,140	422	(1,995)	8,164	4,508	921	2,630
From Discontinued Operations	27	(202)	(140)	1,043	394	(16)	(249)	156
	9,562	5,938	282	(952)	8,558	4,492	672	2,786
Per Unit Results								
Earnings from Continuing Operations								
Basic	0.13	0.09	(0.14)	(0.26)	0.11	0.01	(0.10)	(0.12)
Diluted	0.13	0.09	(0.14)	(0.26)	0.10	0.01	(0.10)	(0.12)
Earnings from Total Operations								
Basic	0.13	0.08	(0.14)	(0.24)	0.13	(0.01)	(0.10)	(0.12)
Diluted	0.13	0.08	(0.14)	(0.24)	0.12	(0.01)	(0.10)	(0.13)
Cash Available from Continuing Operations								
Basic	0.35	0.24	0.02	(0.08)	0.33	0.18	0.04	0.11
Diluted	0.29	0.20	0.01	(0.08)	0.25	0.18	0.03	0.07
Cash Available from Total Operations								
Basic	0.35	0.23	0.01	(0.04)	0.35	0.18	0.03	0.11
Diluted	0.29	0.20	0.01	(0.04)	0.26	0.18	0.02	0.08

## LIQUIDITY AND CAPITAL RESOURCES

As at September 30, 2005, cash and short-term investments were \$10.5 million and undrawn credit facilities were \$12.0 million. The \$3.8 million vendor take-back mortgage was collected in the third quarter. Restricted cash as at September 30, 2005 was \$8.5 million (December 31, 2004 - \$6.4 million). Restricted cash consists primarily of funds held by lenders pursuant to financing arrangements for future planned capital expenditures within the next twelve months and to cover municipal tax obligations. During the nine months ended September 30, 2005, the Trust added \$1.2 million to restricted cash in connection with the Grand Okanagan Resort. It is anticipated that approximately \$3 million of the restricted cash will be drawn down in the fourth quarter for approved expenditures made during 2005.

These liquid resources, together with Royal Host's future cash flows, and the Convertible Debenture issue completed in October, are more than sufficient to fund anticipated cash requirements over the next year.

### Financing Activities

On January 13, 2005, the Trust replaced the \$25 million mortgage on the Grand Okanagan Resort. The mortgage was originally scheduled to mature in August 2005 and was included in the current portion of mortgages as at December 31, 2004. The 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, were used for working capital and general corporate purposes.

In April 2005, Royal Host, along with the joint venture partner in the Royal Private Residence Club (PRC), 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 are available to be used to complete the project. During the nine months ended September 30, 2005, \$7.4 million was drawn on the construction loan with \$4.0 million being drawn in the third quarter. The full amount of \$8.0 million was drawn on the mezzanine loan in April 2005.

Mortgages increased to \$171.6 million (December 31, 2004 - \$157.0 million) due in part to the replacement financing and PRC funding described above, offset by overall repayments of \$12.3 million. The current portion of mortgages and other debt has decreased to \$21.7 million and includes \$15.4 million related to the Royal Private Residence Club from \$39.1 million at December 31, 2004.

The Trust expects that the sale of residence units will be sufficient to repay all amounts related to the PRC as they become due in 2006. It anticipates funding all future development to completion from cash on hand. The Trust currently has \$12.6 million available from undrawn project credit facilities available to fund the PRC if required. In addition the Trust has also arranged a takeout commitment of up to \$13 million from a US lender who specializes in resort funding should it be required.

The following table identifies Royal Host's mortgage and lease obligations:

**Mortgages and Leases**

As at September 30, 2005

(\$000's)	Total	2006	2007	2008	2009	2010	Thereafter
Mortgages	171,621	21,733	21,054	4,224	3,834	59,936	60,840
Obligations Under Capital Leases	1,387	520	490	373	4	-	-
Obligations Under Operating Leases	520	251	134	79	34	22	-
	<u>173,528</u>	<u>22,504</u>	<u>21,678</u>	<u>4,676</u>	<u>3,872</u>	<u>59,958</u>	<u>60,840</u>

The \$40 million 9.25% Convertible Debentures mature in March 2007; the \$35 million 7.9% Convertible Debentures mature in April 2009.

As at September 30, 2005, the average maturity of the mortgages is 4.8 years. If the Convertible Debentures are included, the average maturity is 4.0 years. The weighted average interest rate on mortgages outstanding at September 30, 2005 is 8.29%, which compares to the December 2004 rate of 8.45% (September 2004 – 8.70%). Including the Convertible Debentures, the weighted average interest rate is 8.40%, which compares to the December 2004 rate of 8.50% (September 2004 – 8.66%).

Subsequent to September 30, 2005, the Trust completed a \$60 million offering of 6.0% Convertible Debentures. The offering closed on October 20, 2005; net proceeds to the Trust were \$57.5 million. The Trust used \$27.8 million of the proceeds to repay debt. Of this amount \$25.6 million was applied to principal repayments, \$0.2 million to interest, with the balance of \$2.0 million being prepayment costs. As a result the Trust has no material debt maturities until November 2009. Including these repayments, Royal Host now has an overall average maturity of debt of 5.4 years and an average interest rate calculated to be 7.83%.

**Investing Activities**

During the three months ended September 30, 2005, Royal Host incurred \$2.3 million in capital expenditures (three months ended September 30, 2004 - \$2.0 million). During the nine months ended September 30, 2005, the Trust spent \$5.1 million on capital expenditures (nine months ended September 30, 2004 - \$4.4 million). A key focus has been on its customer retention program by improving existing facilities. The Trust has an ongoing capital program whereby it has replaced over 2,200 beds in 18 of its hotels and over 1,200 televisions in 20 of its hotels thus far in 2005. High-speed Internet access has been added in almost all properties and it is expected that this program will be completed by the end of 2005.

Restricted cash, described above, is available for funding certain hotel capital expenditures. A portion of the capital expenditures planned for the balance of 2005 will be funded out of restricted cash. It is forecast that total expenditures for 2005 will be approximately \$6.5 million. This is lower than the \$8 million originally forecast, and the Trust will be including the additional planned 2005 capital expenditures as part of the 2006 budget.

Property under development was \$31.5 million as at September 30, 2005, an increase of \$14.1 million from the \$17.4 million as at December 31, 2004. Property under development relates to the Royal Private Residence Club, a 70-unit luxury condominium development in which the Trust is the lead joint venture partner, which is being developed adjacent to the Grand Okanagan Lakefront Resort. As at September 30, 2005, 72% of the development's residence units have been sold. Construction of the development's first phase, the parkade, was completed in 2005. Construction on the residence units commenced in May 2004 and is expected to be completed early in 2006.

### **Equity**

As described under "Changes in Accounting Policies" below, Convertible Debentures have been reclassified from equity to liabilities. Equity as at December 31, 2004, originally reported at \$183.4 million has been restated to \$110.6 million (to reflect the reclassification of Convertible Debentures and related debt issuance costs). Equity has decreased to \$100.7 million as at September 30, 2005, attributable to the net earnings for the nine months ended September 30, 2005 of \$2.7 million and distributions of \$7.7 million. In addition, the Trust paid \$2.4 million in cash pursuant to the redemption of the redeemable partnership units (described below), resulting in a reduction of equity.

### **Normal Course Issuer Bids**

Royal Host initiated a Normal Course Issuer Bid, commencing December 21, 2004, to repurchase a maximum of 1.2 million of the Trust's issued and outstanding trust units. The Trust believes that the repurchase of units at current levels is accretive to unitholders. During the three months ended September 30, 2005, 375,000 trust units were repurchased at an average cost of \$5.95 per unit. These were cancelled subsequent to the quarter end. This brings the total trust units repurchased during the nine months ended September 30, 2005 to 475,000, at an average cost of \$5.84 per unit.

Subsequently, to November 8, 2005, the Trust has repurchased an additional 249,600 units at an average price of \$5.95.

Royal Host initiated a Normal Course Issuer Bid, commencing July 15, 2005, to repurchase a maximum of \$2.0 million of its 9.25% subordinated unsecured Convertible Debentures. To date no debentures have been repurchased.

### **Redeemable Partnership Units**

During the nine months ended September 30, 2005, 3,151,433 redeemable partnership units were redeemed by way of a combination of issuance of 2,706,682 Royal Host trust units and a payment of \$2.4 million. The partnership units were held by entities controlled by certain officers and trustees of Royal Host. As such, the redemption was a related party transaction and was recorded at the historical amount of \$27.5 million that the partnership units had been recorded in the financial statements.

As at September 30, 2005 a total of 10 (2004 - 3,151,443) redeemable partnership units remained outstanding.

## **CHANGES IN ACCOUNTING POLICIES**

The financial statements for the nine months ended September 30, 2005 have been prepared in accordance with accounting policies described in our financial statements for the year ended December 31, 2004, except as follows:

## **Consolidation of Variable Interest Entities**

In November 2003, the CICA issued Accounting Guideline 15 "Consolidation of Variable Interest Entities" ("AcG-15"), effective for fiscal years beginning after November 1, 2004. The objective of AcG-15 is to improve financial reporting by companies involved with variable interest entities. AcG-15 provides guidance related to identifying variable interest entities and determining whether the assets, liabilities, and results of activities of the entity should be consolidated. AcG-15 requires an enterprise to consolidate a variable interest entity when the enterprise is the primary beneficiary of the entity, the enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

Prior to the issuance of AcG-15, an enterprise generally consolidated an entity when the enterprise had a controlling financial interest in the entity through ownership of a majority voting interest.

Prior to the adoption of AcG-15, the Trust proportionately consolidated the Royal Private Residence Club Joint Venture. However, the Joint Venture is a variable interest entity as Royal Host absorbs a majority of the Joint Venture's expected losses and receives the majority of the Joint Venture's expected residual returns. Accordingly, effective January 1, 2005, Royal Host is now consolidating the joint venture.

## **Equity Settled Obligations**

In November 2003, the CICA amended Section 3860 "Financial Instruments – Disclosure and Presentation" requiring that certain obligations that may be settled at the issuer's option in cash or the equivalent value by a variable number of the issuer's own equity instruments to be presented as liabilities. The amendments to Section 3860 are effective for fiscal years beginning on or after November 1, 2004. We have applied the provisions of Section 3860 retroactively, and have restated prior years' comparatives. The amendments result in our Convertible Debentures being classified as a liability on the Consolidated Balance Sheets and the associated interest expense correspondingly being classified as Interest on Convertible Debentures on the Consolidated Statements of Net Earnings.

As a result of the reclassification, other expenses for the three months ended September 30, 2005 increased by \$1.7 million, other expenses for the nine months ended September 30, 2004 increased by \$4.9 million, and deferred debt issuance costs as at December 31, 2004 increased by \$2.3 million.

## **OFF BALANCE SHEET ARRANGEMENTS**

As at September 30, 2005, Royal Host had no undisclosed off balance sheet arrangements.

## **RISKS AND UNCERTAINTIES**

The Trust's business is subject to various risks and uncertainties that occur in the normal course of business that could adversely affect our cash flow and our ability to make distributions to unitholders. These risks include general economic risks, operating risks, competitive risks, environmental risks, and development risks amongst others.

These risks and uncertainties facing Royal Host's operations are described in detail in the MD&A and Annual Information Form for the year ended December 31, 2004.

## **OUTLOOK**

Royal Host has made significant progress in 2005 toward its goal of simplification by focusing on its core competencies of hotel ownership, management and franchising. The Trust intends to continue to focus on expansion within its areas of expertise, which may include acquiring limited, full and focused service hotels in Canada. The funding of the Royal Private Residence Club has been finalized, construction is on track and on budget, and the Trust anticipates profitably exiting this non-core business in 2006. The management contract with Supertel Hospitality is performing very well as the Trust is delivering on its management promises and is contributing to overall profitability in 2005. The Trust will continue to focus on its customer retention programs with more beds and televisions being replaced and other improvements being completed.

National demand in the hospitality industry is growing and is returning to 2000 levels. Pannell Kerr Forster Consulting Inc., a recognized industry consultant, is forecasting solid growth in ADR and steady Occupancy. The Trust anticipates that the growth in ADR will continue and is optimistic about the remainder of 2005. The Trust exits the third quarter with a strong focused team, a diversified portfolio, and a strong capital base. The Trust is well positioned to take advantage of this positive environment to continue its growth and realize on opportunities to add value and deliver on its goal of providing increasing distributions from a stable base of well-managed assets.



**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

**Consolidated Financial Statements**

*(unaudited)*

**For the period ended September 30, 2005**

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Consolidated Balance Sheets

in \$000's

*(unaudited)*

	As at	
	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
		(restated - Notes 2 and 3)
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and short-term investments	10,525	8,707
Accounts and notes receivable	11,567	9,435
Prepaid expenses	4,561	3,686
Inventories	3,072	2,993
Assets of discontinued operations (Note 3)	325	306
Property held for sale (Note 3)	2,704	2,704
Property under development (Note 4)	31,510	17,437
Future income taxes	716	1,004
	<u>64,980</u>	<u>46,272</u>
<b>Restricted cash</b>	<b>8,545</b>	<b>6,380</b>
<b>Long-term notes receivable</b> (Note 3)	<b>2,243</b>	<b>466</b>
<b>Assets of discontinued operations</b> (Note 3)	<b>-</b>	<b>10,456</b>
<b>Capital assets</b> (Note 5)	<b>314,538</b>	<b>320,246</b>
<b>Deferred debt issuance costs</b>	<b>4,387</b>	<b>5,061</b>
	<u>394,693</u>	<u>388,881</u>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities	23,222	20,795
Equity distributions payable	995	561
Interest accrued on convertible debentures	1,456	1,686
Current portion of mortgages (Notes 4, 6 and 13)	21,733	39,083
Current portion of obligations under capital leases (Note 7)	442	563
Other liabilities	1,480	2,249
Liabilities of discontinued operations (Note 3)	192	546
	<u>49,520</u>	<u>65,483</u>
<b>Mortgages</b> (Notes 4, 6 and 13)	<b>149,888</b>	<b>117,896</b>
<b>Convertible debentures</b>	<b>75,000</b>	<b>75,000</b>
<b>Obligations under capital leases</b> (Note 7)	<b>799</b>	<b>961</b>
<b>Deferred revenue</b>	<b>713</b>	<b>688</b>
<b>Future income taxes</b>	<b>8,739</b>	<b>8,329</b>
	<u>284,659</u>	<u>268,357</u>
<b>Minority interest</b> (Note 4)	<b>9,351</b>	<b>9,917</b>
<b>Unitholders' equity</b> (Note 8)	<b>100,683</b>	<b>110,607</b>
	<u>394,693</u>	<u>388,881</u>

*See accompanying Notes to the Consolidated Financial Statements*

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Consolidated Statements of Net Earnings

in \$000's (except per unit amounts)

*(unaudited)*

	Three Months Ended		Nine Months Ended	
	September 30, 2005	September 30, 2004 (restated - Notes 2 and 3)	September 30, 2005	September 30, 2004 (restated - Notes 2 and 3)
<b>Hospitality revenue</b>				
Rooms	30,317	29,199	77,478	75,702
Food and beverage	6,110	5,950	18,937	17,778
Other	4,811	4,938	12,896	11,975
	<u>41,238</u>	<u>40,087</u>	<u>109,311</u>	<u>105,455</u>
<b>Hospitality expenses</b>	<u>26,393</u>	<u>26,015</u>	<u>76,438</u>	<u>74,669</u>
<b>Gross margin</b>	<u>14,845</u>	<u>14,072</u>	<u>32,873</u>	<u>30,786</u>
<b>Other expenses</b>				
Interest on mortgages and capital leases	3,092	3,500	9,661	10,499
Interest on convertible debentures	1,605	1,560	4,853	4,479
Depreciation and amortization	3,790	4,265	11,306	12,817
Trust administration	433	465	1,615	1,420
Future income taxes	1,627	1,314	1,271	378
Capital and other taxes	49	50	155	138
Loss on foreign currency translation	131	144	114	90
Property impairment provision (Note 9)	590	-	980	-
	<u>11,317</u>	<u>11,298</u>	<u>29,955</u>	<u>29,821</u>
<b>Earnings from continuing operations</b>	<u>3,528</u>	<u>2,774</u>	<u>2,918</u>	<u>965</u>
<b>Earnings (loss) from discontinued operations (Note 3)</b>	<u>81</u>	<u>532</u>	<u>(242)</u>	<u>(121)</u>
<b>Net earnings</b>	<u>3,609</u>	<u>3,306</u>	<u>2,676</u>	<u>844</u>
<b>Basic per unit net earnings (Note 10)</b>				
- from continuing operations	0.13	0.11	0.10	0.02
- from discontinued operations	0.00	0.02	(0.01)	(0.01)
	<u>0.13</u>	<u>0.13</u>	<u>0.09</u>	<u>0.01</u>
<b>Diluted per unit net earnings (Note 10)</b>				
- from continuing operations	0.13	0.10	0.10	0.02
- from discontinued operations	0.00	0.02	(0.01)	(0.01)
	<u>0.13</u>	<u>0.12</u>	<u>0.09</u>	<u>0.01</u>

*See accompanying Notes to the Consolidated Financial Statements*

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Consolidated Statements of Cash Flows

in \$000's

(unaudited)

CASH PROVIDED BY (USED IN):	Three Months Ended		Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
<b>Operating activities</b>				
Net earnings	3,609	3,306	2,676	844
Net (earnings) loss from discontinued operations (Note 3)	(81)	(532)	242	121
Items not affecting cash:				
Depreciation and amortization	3,790	4,265	11,306	12,817
Future income taxes	1,627	1,314	1,271	378
Property impairment provision (Note 9)	590	-	980	-
<b>Funds from continuing operations</b>	<b>9,535</b>	<b>8,353</b>	<b>16,475</b>	<b>14,160</b>
<b>Funds from discontinued operations</b>	<b>27</b>	<b>588</b>	<b>(315)</b>	<b>(369)</b>
Changes in non-cash working capital (Note 12)	2,211	(122)	1,604	(1,138)
	<b>11,773</b>	<b>8,819</b>	<b>17,764</b>	<b>12,653</b>
<b>Financing activities</b>				
Net additions to mortgages	4,023	-	26,426	5,750
Principal repayments on mortgages and capital leases	(1,444)	(3,971)	(12,342)	(12,571)
Issuance of convertible debentures, net of retirements	-	-	-	13,000
Financing issuance costs	-	16	(428)	(1,648)
Repurchase of trust units pursuant to normal course issuer bid	(2,242)	-	(2,783)	-
Redemption of redeemable partnership units	-	-	(2,415)	-
Equity distributions	(2,480)	(1,629)	(6,968)	(4,777)
	<b>(2,143)</b>	<b>(5,584)</b>	<b>1,490</b>	<b>(246)</b>
<b>Investing activities</b>				
Capital expenditures	(2,286)	(2,042)	(5,103)	(4,391)
Net cash from sale of properties	-	-	6,248	654
Property under development	(4,800)	(2,052)	(14,073)	(3,294)
Restricted cash	(461)	(688)	(2,165)	(1,379)
Long-term notes receivable	96	(19)	(1,777)	132
Minority interest in joint venture	346	-	(566)	-
	<b>(7,105)</b>	<b>(4,801)</b>	<b>(17,436)</b>	<b>(8,278)</b>
<b>Net change in cash and short-term investments</b>	<b>2,525</b>	<b>(1,566)</b>	<b>1,818</b>	<b>4,129</b>
<b>Cash and short-term investments, beginning of period</b>	<b>8,000</b>	<b>10,878</b>	<b>8,707</b>	<b>5,183</b>
<b>Cash and short-term investments, end of period</b>	<b>10,525</b>	<b>9,312</b>	<b>10,525</b>	<b>9,312</b>
<b>Cash interest paid</b>				
Mortgages and capital leases	3,301	3,798	9,818	10,318
Convertible debentures	1,850	1,850	5,083	3,700
	<b>5,151</b>	<b>5,648</b>	<b>14,901</b>	<b>14,018</b>

See accompanying Notes to the Consolidated Financial Statements

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

(unaudited)

#### 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.

These consolidated financial statements follow the same accounting policies and methods as Royal Host's consolidated financial statements for the year ended December 31, 2004, except as stated in Note 2, and include all adjustments necessary to present fairly the results of the interim period. Certain information and disclosure included in the year-end consolidated financial statements has been condensed or omitted. In the opinion of Management, all adjustments considered necessary for fair presentation have been included in these consolidated financial statements. Operating results for the nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005 due to the seasonal nature of operations. These consolidated financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2004.

#### 2. CHANGES IN ACCOUNTING POLICIES

##### (a) Variable Interest Entities

In November 2003, the CICA issued Accounting Guideline 15, "*Consolidation of Variable Interest Entities*" ("AcG-15"), effective for fiscal years beginning after November 1, 2004. The objective of AcG-15 is to improve financial reporting by companies involved with variable interest entities. AcG-15 provides guidance related to identifying variable interest entities and determining whether such assets, liabilities and results of activities of the entity should be consolidated. AcG-15 requires an enterprise to consolidate a variable interest entity when the enterprise is the primary beneficiary of the entity, meaning that the enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, whether that is contractually or by other financial interests in the entity.

Prior to issuance of AcG-15, an enterprise generally consolidated an entity when the enterprise had a controlling financial interest in the entity through ownership of a majority voting interest.

Prior to the adoption of AcG-15, Royal Host proportionately consolidated the Royal Private Residence Club Joint Venture (the "Joint Venture"). However, the Joint Venture is a variable interest entity as Royal Host absorbs a majority of the Joint Venture's expected losses and receives a majority of the Joint Venture's expected residual returns. Therefore, effective January 1, 2005, Royal Host consolidates the Joint Venture. The consolidated balance sheet as at December 31, 2004 has been restated to include all of the Joint Venture's assets and liabilities. In particular, property under development has been restated from \$6.9 million to \$17.4 million, current assets have been restated from \$36.9 million to \$46.3 million, current liabilities have been restated from \$65.2 million to \$65.5 million and minority interest in joint venture has been restated from \$Nil to \$9.9 million. Previously reported earnings and unitholders' equity did not change as a result of this restatement.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

Notes to the Consolidated Financial Statements

(unaudited)

### 2. CHANGES IN ACCOUNTING POLICIES (CONTINUED)

#### (b) Liabilities and Equity

In November, 2003, the CICA amended Section 3860 (replaced in April, 2005 by Section 3861), "*Financial Instruments - Disclosure and Presentation*" to require that certain obligations that may be settled at the issuer's option in cash or the equivalent value by a variable number of the issuer's own equity instruments be presented as a liability. The amendments to Section 3860 are effective for fiscal years beginning on or after November 1, 2004. The Trust has applied the provisions of Section 3860 retroactively, with restatement of prior years presented. The amendments result in the Trust's convertible debentures being classified as a liability on the consolidated balance sheets and the associated interest expense correspondingly being classified as "interest on convertible debentures" on the consolidated statements of net earnings.

As a result of the reclassification, other expenses for the three months ended September 30, 2004 increased by \$1.7 million, other expenses for the nine months ended September 30, 2004 increased by \$4.9 million and deferred debt issuance costs as at December 31, 2004 increased by \$2.3 million.

As the associated interest expense was already included in the September 30, 2004 per unit net earnings (loss) calculations, this reclassification does not impact per unit earnings for the three months and nine months ended September 30, 2004.

### 3. PROPERTY HELD FOR SALE, DISPOSAL OF LONG-LIVED ASSETS, AND DISCONTINUED OPERATIONS

On February 23, 2005, Royal Host completed the sale of its 50% interest in a hotel property located in Toronto, Ontario to a condominium developer. The property was sold for proceeds of \$10.8 million, consisting of \$7.0 million cash and a \$3.8 million vendor take-back ("VTB") mortgage which was received in August, 2005. Royal Host operated the property as a hotel for the period subsequent to the closing date in order to wind-up the hotel operations. Royal Host was entitled to all operating revenues and funded all operating and closing costs during the wind-up period. The net cost of winding up the business, to a maximum of \$2.0 million, is to be reimbursed to Royal Host in the form of a non-interest bearing, 18-month VTB mortgage (included in "long-term notes receivable"). The December 31, 2004 consolidated balance sheet and September 30, 2004 consolidated statement of net earnings have been restated to reflect these discontinued operations.

The Trust has received an offer to purchase of \$3.1 million for a 95-room hotel property in Ontario. Accordingly, this property has been reflected as "property held for sale" and "assets and liabilities of discontinued operations" on the consolidated balance sheets.

On November 26, 2004, the Trust completed the sale of a hotel property located in North Battleford, Saskatchewan for \$1.2 million.

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

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***3. PROPERTY HELD FOR SALE, DISPOSAL OF LONG-LIVED ASSETS, AND DISCONTINUED OPERATIONS (CONTINUED)**

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

	Three Months Ended		Nine Months Ended	
	<i>(in \$000's)</i>		<i>(in \$000's)</i>	
	<u>September 30,</u> <u>2005</u>	<u>September 30,</u> <u>2004</u>	<u>September 30,</u> <u>2005</u>	<u>September 30,</u> <u>2004</u>
<b>Hospitality revenue</b>				
Rooms	233	1,286	840	3,042
Food and beverage	-	262	169	989
Other	7	37	44	240
	<u>240</u>	<u>1,585</u>	<u>1,053</u>	<u>4,271</u>
<b>Hospitality expenses</b>	<u>213</u>	<u>1,260</u>	<u>1,365</u>	<u>4,164</u>
<b>Gross margin</b>	<u>27</u>	<u>325</u>	<u>(312)</u>	<u>107</u>
<b>Other expenses</b>				
Interest on capital leases	-	7	2	12
Depreciation and amortization	3	55	83	361
Future income taxes (recovery)	(83)	(193)	(382)	(413)
Capital and other taxes	-	3	5	10
Gain on foreign currency translation	-	(79)	(4)	(44)
Property impairment provision	-	-	(21)	498
(Gain) loss on disposition	26	-	247	(196)
	<u>(54)</u>	<u>(207)</u>	<u>(70)</u>	<u>228</u>
<b>Earnings (loss) from discontinued operations</b>	<u>81</u>	<u>532</u>	<u>(242)</u>	<u>(121)</u>

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

Notes to the Consolidated Financial Statements

*(unaudited)*

### **4. PROPERTY UNDER DEVELOPMENT**

A subsidiary of Royal Host is participating in a joint venture to develop the Royal Private Residence Club on a portion of the property at the Grand Okanagan Lakefront Resort and Conference Centre in Kelowna, British Columbia for resale. Construction of the first phase of the project, a parkade, commenced in January, 2004 and was completed in October, 2004. Construction of the residence units commenced in May, 2004. As the project is still in the development phase, no revenue has been recognized. All costs incurred have been capitalized to "property under development".

As stated in Note 2(a), Royal Host consolidates the joint venture. The \$9.4 million (December 31, 2004 - \$9.9 million) minority interest in joint venture on the consolidated balance sheet as at September 30, 2005 represents the portion of net assets of the joint venture not owned by Royal Host.

In April, 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 are to be used to complete the project. As at September 30, 2005, \$7.4 million was drawn on the construction loan and \$8.0 million was drawn on the mezzanine loan.

Royal Host has provided a completion, cost overrun and debt service deficiency guarantee on the \$20.0 million construction loan, a specific guarantee of the payment of notes receivable from certain limited partners and a guarantee on an \$8.0 million mezzanine loan.

Included in property under development is \$0.4 million in capitalized interest as at September 30, 2005 (December 31, 2004 - \$Nil).

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***5. CAPITAL ASSETS**

	<i>(in \$000's)</i>		
	<u>Gross Book Value</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
<b>September 30, 2005</b>			
Buildings	311,169	60,271	250,898
Land	38,815	-	38,815
Furniture, fixtures, and equipment	46,077	36,826	9,251
Other	1,632	738	894
	<u>397,693</u>	<u>97,835</u>	<u>299,858</u>
Intangible assets:			
Franchise rights and management contracts	27,414	16,658	10,756
Customer lists and intellectual capital	7,270	7,083	187
Capital assets under development	3,737	-	3,737
	<u>436,114</u>	<u>121,576</u>	<u>314,538</u>

	<i>(in \$000's)</i>		
	<u>Gross Book Value</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
<b>December 31, 2004</b>			
Buildings	309,113	53,966	255,147
Land	38,644	-	38,644
Furniture, fixtures, and equipment	44,660	34,248	10,412
Other	1,320	460	860
	<u>393,737</u>	<u>88,674</u>	<u>305,063</u>
Intangible assets:			
Franchise rights and management contracts	27,414	15,278	12,136
Customer lists and intellectual capital	7,270	6,970	300
Capital assets under development	2,747	-	2,747
	<u>431,168</u>	<u>110,922</u>	<u>320,246</u>

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***6. MORTGAGES**

	<i>(in \$000's)</i>	
	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
Mortgages secured by hotel properties	<b>171,621</b>	156,979
Less: current portion	<b>21,733</b>	39,083
	<b><u>149,888</u></b>	<u>117,896</u>

Principal repayments required for the years ending September 30:

	<u><i>(in \$000's)</i></u>
2006	21,733
2007	21,054
2008	4,224
2009	3,834
2010	59,936
Subsequent	<u>60,840</u>
	<u>171,621</u>

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

Debt issuance costs are deferred and amortized over the term of the related debt. For the nine months ended September 30, 2005, \$1.1 million was included in amortization (2004 - \$0.9 million).

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***7. OBLIGATIONS UNDER CAPITAL LEASES**

Royal Host has entered into various capital lease obligations to acquire computers and furniture, fixtures, and equipment. The present values of future minimum lease payments under capital leases as at September 30, 2005 are as follows:

	<i>(in \$000's)</i>	
	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
Present value of future minimum lease payments	<b>1,241</b>	1,524
Less: current portion of principal payments	<b>442</b>	563
	<u><b>799</b></u>	<u>961</u>

Total repayments required for the years ending September 30:

	<i>(in \$000's)</i>	
		<u></u>
2006	520	
2007	490	
2008	373	
2009	4	
Future minimum lease payments		<u>1,387</u>
Less: amounts representing interest		<u>146</u>
Present value of future minimum lease payments		<u><u>1,241</u></u>

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

(unaudited)

**8. UNITHOLDERS' EQUITY**

	<i>(in \$000's)</i>	
	<u>September 30,</u> <b>2005</b>	<u>December 31,</u> 2004
<b>Balance, beginning of period, as previously reported</b>		93,366
Prior period adjustment (Note 2(b))		1,183
<b>Balance, beginning of period, restated</b>	<b>83,107</b>	<u>94,549</u>
Net earnings (loss) (2004 restated - Note 2(b))	<b>2,676</b>	(5,197)
Issuance of trust units and contributed surplus pursuant to redemption of redeemable partnership units	<b>25,085</b>	-
Issuance of trust units pursuant to distribution reinvestment plan	<b>255</b>	309
Employee loans pursuant to employee unit purchase program	<b>13</b>	17
Equity financing issue costs	-	(1,607)
Restatement of debenture financing issue costs (Note 2(b))	-	1,664
Trust units cancelled pursuant to normal course issuer bid (Note 11(a))	<b>(541)</b>	-
Trust units repurchased pursuant to normal course issuer bid (Note 11(a))	<b>(2,242)</b>	-
Equity distributions		
Trust units	<b>(7,292)</b>	(5,872)
Redeemable partnership units	<b>(378)</b>	(756)
	<b>100,683</b>	<u>83,107</u>
Convertible equity		
Redeemable partnership units	-	27,500
<b>Balance, end of period</b>	<b>100,683</b>	<u>110,607</u>
<b>(a) Trust units</b>	<u>Number of</u> <u>Units</u>	<u>(in \$000's)</u>
<b>Balance, December 31, 2003</b>	24,762,344	223,537
Issuance of trust units pursuant to distribution reinvestment plan	62,598	309
<b>Balance, December 31, 2004</b>	24,824,942	223,846
Issuance of trust units pursuant to distribution reinvestment plan	47,208	255
Trust units cancelled pursuant to normal course issuer bid (Note 11(a))	(100,000)	(901)
Issuance of trust units pursuant to redemption of redeemable partnership units (Note 8(c))	2,706,682	24,387
<b>Balance, September 30, 2005</b>	<b>27,478,832</b>	<u>247,587</u>

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

Notes to the Consolidated Financial Statements

*(unaudited)*

### **8. UNITHOLDERS' EQUITY (CONTINUED)**

#### **(b) Accumulated Deficit**

As is common with Real Estate Investment Trusts and other income trusts, Royal Host distributes cash in excess of the net earnings, resulting in an accumulated deficit, which amounts to \$142.0 million at September 30, 2005 (December 31, 2004 - \$137.0 million).

#### **(c) Redeemable Partnership Units**

In May, 2005, 3,151,433 redeemable partnership units were redeemed by way of a combination of issuance of 2,706,682 Royal Host trust units and \$2.4 million in cash. The redeemable partnership units were held by entities controlled by certain officers and trustees of Royal Host. As such, the redemption of the redeemable partnership units was a related party transaction and was recorded at the historical amount of the redeemable partnership units in the financial statements. The trust units issued on the redemption have been recorded to unit capital and contributed surplus. The net carrying value of the redeemable partnership units of \$25.1 million, being \$27.5 million net of cash of \$2.4 million, has been recorded to unit capital in the amount of \$24.4 million with the balance of \$0.7 million being recorded to contributed surplus.

As at September 30, 2005, a total of 10 (2004 - 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 holders of Royal Host trust units. In addition, each partnership unit is redeemable by the holders, for one Royal Host unit or for cash based on the market value of Royal Host's trust units. Royal Host, in its sole discretion, may redeem the redeemable partnership units by way of issuance of trust units of Royal Host or payment of cash.

#### **(d) Unit Options**

Royal Host has reserved 1,883,000 units under its unit option plan. As at September 30, 2005, Royal Host has unit options outstanding to certain board members, employees, and consultants to purchase an aggregate of 137,500 units (December 31, 2004 - 137,500 units) at an exercise price of \$10.00 per unit (December 31, 2004 - \$10.00). All unit options were issued prior to 1999 and were fully vested and exercisable at September 30, 2005 and December 31, 2004. The options currently outstanding expire on October 31, 2007.

During the nine months ended September 30, 2005 and 2004, no options were issued or exercised and no options expired (December 31, 2004 - Nil).

### **9. PROPERTY IMPAIRMENT PROVISION**

During the third quarter of 2005, the Trust recorded a property impairment provision of \$0.6 million relating to its timeshare resort property in Cabo San Lucas, Mexico.

During the first quarter of 2005, the Trust recorded a property impairment provision of \$0.4 million relating to a hotel property in Lethbridge, Alberta.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

*(unaudited)***10. PER UNIT CALCULATIONS**

There were 27,478,832 trust units outstanding as at September 30, 2005 (September 30, 2004 - 24,809,250). Per unit computations are based on the weighted average number of trust units outstanding for the period, after adjusting the net loss for distributions on the redeemable partnership units of \$378,000 (September 30, 2004 - \$567,000).

<b>For the three months ended September 30, 2005:</b>		Weighted Average Units	Per Unit
	<i>(in \$000's)</i>	<i>(in 000's)</i>	<i>(\$)</i>
Net earnings - continuing operations	3,528		
Less: distributions on redeemable partnership units	-		
Basic earnings - continuing operations	3,528		0.13
Basic earnings - discontinued operations	81		0.00
<b>Basic earnings - total operations</b>	<b>3,609</b>	<b>27,239,950</b>	<b>0.13</b>
Net earnings - continuing operations	3,528		
Less: distributions on redeemable partnership units	-		
	3,528		
Add: interest on 7.90% convertible debentures	697		
Diluted earnings - continuing operations	4,225		0.13
Diluted earnings - discontinued operations	81		0.00
<b>Diluted earnings - total operations</b>	<b>4,306</b>	<b>33,073,283</b>	<b>0.13</b>
<b>For the three months ended September 30, 2004:</b> (restated - Notes 2 and 3)		Weighted Average Units	Per Unit
	<i>(in \$000's)</i>	<i>(in 000's)</i>	<i>(\$)</i>
Net earnings - continuing operations	2,774		
Less: distributions on redeemable partnership units	(189)		
Basic earnings - continuing operations	2,585		0.11
Basic earnings - discontinued operations	532		0.02
<b>Basic earnings - total operations</b>	<b>3,117</b>	<b>24,581,267</b>	<b>0.13</b>
Net earnings - continuing operations	2,774		
Less: distributions on redeemable partnership units	(189)		
	2,585		
Add: redeemable partnership units	189		
Diluted earnings - continuing operations	2,774		0.10
Diluted earnings - discontinued operations	532		0.02
<b>Diluted earnings - total operations</b>	<b>3,306</b>	<b>27,732,710</b>	<b>0.12</b>

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***10. PER UNIT CALCULATIONS (CONTINUED)**

<b>For the nine months ended September 30, 2005:</b>	<u>Weighted</u> <u>Average Units</u> <i>(in 000's)</i>	<u>Per Unit</u> <u>(\$)</u>
Net earnings - continuing operations	<u>2,918</u>	
Less: distributions on redeemable partnership units	<u>(378)</u>	
Basic and diluted earnings - continuing operations	<u>2,540</u>	<u>0.10</u>
Basic and diluted loss - discontinued operations	<u>(242)</u>	<u>(0.01)</u>
<b>Basic and diluted earnings - total operations</b>	<b><u>2,298</u></b>	<b><u>0.09</u></b>
<b>For the nine months ended September 30, 2004:</b> (restated - Notes 2 and 3)	<u>Weighted</u> <u>Average Units</u> <i>(in 000's)</i>	<u>Per Unit</u> <u>(\$)</u>
Net earnings - continuing operations	965	
Less: distributions on redeemable partnership units	<u>(567)</u>	
Basic and diluted earnings - continuing operations	398	0.02
Basic and diluted loss - discontinued operations	<u>(121)</u>	<u>(0.01)</u>
<b>Basic and diluted earnings - total operations</b>	<b><u>277</u></b>	<b><u>0.01</u></b>

**11. NORMAL COURSE ISSUER BIDS****(a) Trust units**

Commencing on December 21, 2004, Royal Host initiated a normal course issuer bid to repurchase a maximum of 1,200,000 of its issued and outstanding trust units.

In April, 2005, 100,000 Royal Host trust units were repurchased and cancelled at an aggregate cost of \$0.5 million, net of contributed surplus of \$0.4 million.

In September, 2005, 375,000 Royal Host trust units were repurchased at an aggregate cost of \$2.2 million. These units were cancelled subsequent to quarter-end, and as such, remain in unit capital as at September 30, 2005.

**(b) Convertible debentures**

Commencing on July 15, 2005, Royal Host initiated a normal course issuer bid to repurchase up to \$2.0 million in principal of its issued and outstanding 9.25% convertible debentures. To date, Royal Host has not repurchased any of the debentures.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

*(unaudited)***12. CHANGES IN NON-CASH WORKING CAPITAL**

	Three Months Ended		Nine Months Ended	
	<i>(in \$000's)</i>		<i>(in \$000's)</i>	
	<u>September 30,</u> <u>2005</u>	<u>September 30,</u> <u>2004</u>	<u>September 30,</u> <u>2005</u>	<u>September 30,</u> <u>2004</u>
<b>(Increase) decrease in:</b>				
Accounts and notes receivable	(277)	(1,838)	(2,132)	(1,515)
Mortgage receivable	3,800	-	3,800	-
Prepaid expenses	205	(75)	(875)	(2,040)
Inventories	(13)	(116)	(79)	39
Assets of discontinued operations	121	-	(19)	-
	<u>3,836</u>	<u>(2,029)</u>	<u>695</u>	<u>(3,516)</u>
<b>Increase (decrease) in:</b>				
Accounts payable and accrued liabilities	(856)	2,309	2,427	2,346
Interest accrued on convertible debentures	(246)	(211)	(230)	328
Other liabilities	(331)	(293)	(769)	(130)
Deferred revenue	7	102	25	(166)
Future income taxes	(190)	-	(190)	-
Liabilities of discontinued operations	(9)	-	(354)	-
	<u>(1,625)</u>	<u>1,907</u>	<u>909</u>	<u>2,378</u>
	<u>2,211</u>	<u>(122)</u>	<u>1,604</u>	<u>(1,138)</u>

**13. SUBSEQUENT EVENTS**

On October 20, 2005, Royal Host issued \$60.0 million of 6.00% convertible unsecured subordinated debentures, due October 31, 2015, for net proceeds of \$57.5 million.

Subsequently, \$27.8 million of the net proceeds was applied to mortgage repayments, comprised of principal repayments of \$25.6 million, interest of \$0.2 million and prepayment fees of \$2.0 million. Prepayment fees will be expensed in the fourth quarter of 2005.

**14. COMPARATIVE FIGURES**

Certain comparative figures have been reclassified to conform to the presentation adopted for 2005.

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