



**ROYAL HOST REAL ESTATE INVESTMENT TRUST**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF OPERATIONS AND FINANCIAL CONDITION**  
**FOR THE YEAR ENDED DECEMBER 31, 2006**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS AND FINANCIAL CONDITION FOR THE YEAR ENDED DECEMBER 31, 2006**

The following Management's Discussion and Analysis of Operations and Financial Condition ("MD&A") dated March 8, 2007 is the responsibility of Management. The Board of Trustees carries out its responsibility for review of this MD&A 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" or the "Trust") for the year ended December 31, 2006. The Consolidated Financial Statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP").

### **FORWARD-LOOKING STATEMENTS**

Certain statements in this MD&A, including those in the Outlook section, relate to periods commencing after December 31, 2006 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 Royal Host's key market areas, political conditions and events, competitive pressures, changes in government policy or regulations and other risk factors including risks and uncertainties described below. Royal Host does not undertake to update such forward-looking statements should its estimates or assumptions change, except as required by law. Additional information relating to Royal Host and the risks to which its business is subject is contained in its Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

### **2006 HIGHLIGHTS**

Royal Host delivered record results in 2006 and realized its highest per unit Cash Available for Distribution. Net earnings from continuing hospitality activities totalled \$4.7 million, a 155.0% increase over 2005. In addition, during 2006, the Trust completed the Royal Private Residence Club ("PRC"), a 71-unit luxury condominium development adjacent to the Grand Okanagan Lakefront Resort and Conference Centre, realizing an \$8.8 million profit, bringing the Trust's total Earnings from Continuing Operations for 2006 to \$13.5 million.

- Basic per unit Cash Available for Distribution increased by 106% to \$1.05 (2005 - \$0.51).
- Monthly distributions were increased twice in 2006 with total distributions increasing by 30% to \$0.50 per unit (2005 - \$0.39 per unit), and further increased in February 2007 to \$0.055 per unit (\$0.66 per annum).
- Issued \$60 million of 6.25% Convertible Debentures further reducing overall cost of debt.
- Cash and short-term investments totalled \$94.1 million as at December 31, 2006.
- Repurchased 1.8 million Trust Units in 2006 pursuant to its Normal Course Issuer Bid, bringing cumulative repurchases to 3.0 million Trust Units over the last two years.

## SELECTED FINANCIAL INFORMATION

(\$000's, except as otherwise noted)	Years ended December 31		Change (%)
	2006	2005	
Hospitality Revenue (continuing operations)			
Rooms	103,783	99,984	3.8
Food and Beverage	26,852	26,460	1.5
Franchising and Management	2,505	2,640	(5.1)
Other	11,141	10,867	2.5
Total	<u>144,281</u>	<u>139,951</u>	3.1
Hospitality Expenses	<u>101,162</u>	<u>100,196</u>	1.0
Hospitality Gross Margin	<u>43,119</u>	<u>39,755</u>	8.5
Hospitality Gross Margin %	<u>29.9</u>	<u>28.4</u>	5.3
Royal Private Residence Club	<u>8,790</u>	<u>-</u>	
Gross Margin	<u>51,909</u>	<u>39,755</u>	30.6
Net Earnings			
From Continuing Operations	13,476	1,838	633.2
From Discontinued Operations	782	508	53.9
	<u>14,258</u>	<u>2,346</u>	507.8
Basic Per Unit Net Earnings (\$)			
From Continuing Operations	0.53	0.05	940.0
From Discontinued Operations	0.03	0.02	50.0
	<u>0.56</u>	<u>0.07</u>	685.7
Cash Available For Distribution	<u>26,753</u>	<u>13,259</u>	101.8
Distributions Declared on Trust Units	<u>12,715</u>	<u>10,044</u>	26.6
Basic Per Unit Cash Available For Distribution (\$)	<u>1.05</u>	<u>0.51</u>	105.9
Per Unit Distributions Declared (\$)	<u>0.50</u>	<u>0.385</u>	29.8
Weighted Average Number of Trust Units Outstanding (000's)	<u>25,654</u>	<u>26,115</u>	(1.8)
Number of Trust Units Outstanding (as at December 31) (000's)	<u>24,501</u>	<u>26,596</u>	(7.7)
Closing Trust Unit Trading Price as at December 31 (\$)	<u>6.55</u>	<u>5.90</u>	11.0

## OVERVIEW

Royal Host's core businesses are hotel ownership, management and franchising. As at December 31, 2006, Royal Host owned 37 hotels (comprising 4,508 rooms), managed additional properties for third parties, and franchised 109 locations (including 15 owned by the Trust) under the Travelodge and Thriftlodge banners.

Royal Host currently employs 2,000 people throughout its organization, and is one of only two Canadian hotel real estate investment trusts that manages its own hotels.

## **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 Royal Host's 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 determined in accordance with GAAP when assessing Royal Host's financial performance. However, the Trust believes these measures are useful in supplementing the reader's understanding of the Trust's performance.

This MD&A includes the following non-GAAP financial measures: Average Daily Rate ("ADR"), Occupancy, Revenue per Available Room ("RevPAR"), Cash Available for Distribution (and Basic and Diluted Per Unit Cash Available for Distribution), Funds From Operations and Adjusted Funds From Operations.

### **Key Performance Drivers and Measures**

The hospitality industry and hotel real estate investment trusts commonly use three non-GAAP financial measures as key indicators of financial performance:

- Occupancy, which measures the level of hotel room utilization and is calculated by dividing the number of rooms rented in a given time period by the number of rooms available in the same period;
- ADR, which measures the average room price for all guest rooms and is calculated by dividing total room revenue by the number of rooms rented; and
- RevPAR, which 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 in a given period into the room revenue in the same period.

### **Cash Available for Distribution, Funds from Operations and Adjusted Funds from Operations**

Cash Available for Distribution, Funds from Operations and Adjusted Funds from Operations are non-GAAP financial measures commonly used by hotel real estate investment trusts. As a "non-GAAP" measure, no standards exist for the calculation of Cash Available for Distribution and reporting practices vary widely.

The policies of the Canadian Securities Administrators and the draft guidance issued by the Canadian Institute of Chartered Accountants consider distributable cash (Cash Available for Distribution) a cash flow measure and, as such, require that it be reconciled to Cash Flows from Operating Activities. The Trust has conformed to this guidance and presented this calculation in this manner.

The Trust calculates Funds from Operations and Adjusted Funds from Operations, as defined by the Real Property Association of Canada.

## Room Statistics – Total

	Three months ended December 31			Years ended December 31		
	2006	2005	Change (%)	2006	2005	Change (%)
<b>CONTINUING OPERATIONS</b> (4,433 rooms)						
Occupancy	60.5%	62.1%	(2.6)	65.8%	66.4%	(0.9)
ADR	\$95.03	\$89.94	5.7	\$97.71	\$93.29	4.7
<b>RevPAR</b>	<b>\$57.45</b>	<b>\$55.89</b>	<b>2.8</b>	<b>\$64.26</b>	<b>\$61.90</b>	<b>3.8</b>
<b>TOTAL OPERATIONS</b> (4,508 rooms)						
Occupancy	59.7%	61.2%	(2.5)	64.9%	65.0%	(0.2)
ADR	\$94.80	\$89.94	5.4	\$97.52	\$92.95	4.9
<b>RevPAR</b>	<b>\$56.55</b>	<b>\$54.97</b>	<b>2.9</b>	<b>\$63.30</b>	<b>\$60.44</b>	<b>4.7</b>

The fourth quarter of 2006 saw RevPAR from continuing operations increase by 2.8%. The increase resulted from a \$5.09, or 5.7%, increase in ADR offset by a 2.1% decrease in Occupancy, which was attributable to four of the Trust's properties. RevPAR from continuing operations for the year grew by 3.8% in 2006, attributable to a \$4.42, or 4.7%, increase in ADR.

## Room Statistics – By Region (Continuing Operations)

	Three months ended December 31			Years ended December 31		
	2006	2005	Change (%)	2006	2005	Change (%)
<b>ONTARIO</b> (56.8% of rooms revenue / 2,489 rooms)						
Occupancy	61.7%	61.4%	0.5	66.0%	65.1%	1.4
ADR	\$97.09	\$93.77	3.5	\$98.00	\$95.18	3.0
<b>RevPAR</b>	<b>\$59.90</b>	<b>\$57.60</b>	<b>4.0</b>	<b>\$64.67</b>	<b>\$61.93</b>	<b>4.4</b>

The Trust's Ontario region produced healthy rooms revenue as RevPAR for the three months and year increased 4.0% and 4.4%, respectively, over 2005. The London Hilton, the Holiday Inn Oakville, the Chimo Hotel in Ottawa and the Travelodge Ottawa West all produced particularly strong results.

	Three months ended December 31			Years ended December 31		
	2006	2005	Change (%)	2006	2005	Change (%)
<b>WESTERN</b> (37.0% of rooms revenue / 1,587 rooms)						
Occupancy	57.1%	61.0%	(6.4)	63.8%	66.2%	(3.6)
ADR	\$94.66	\$87.40	8.3	\$100.04	\$93.00	7.6
<b>RevPAR</b>	<b>\$54.08</b>	<b>\$53.31</b>	<b>1.4</b>	<b>\$63.81</b>	<b>\$61.61</b>	<b>3.6</b>

The Grand Okanagan Lakefront Resort and Conference Centre in Kelowna, the Best Western Village Park Inn in Calgary, the Holiday Inn (The Palace) in Edmonton and the Thriftlodge Fort Nelson all produced very strong results in the Trust's Western region, while three of the Trust's Southern Alberta limited service hotels and the Yellowknife Inn produced relatively weak rooms revenue as a result of lower Occupancy.

	Three months ended December 31			Years ended December 31		
	2006	2005	Change (%)	2006	2005	Change (%)
<b>ATLANTIC</b> (6.2% of rooms revenue / 357 rooms)						
Occupancy	65.7%	70.2%	(6.4)	70.7%	72.8%	(2.9)
ADR	\$85.51	\$80.13	6.7	\$89.76	\$87.11	3.0
<b>RevPAR</b>	<b>\$56.21</b>	<b>\$56.23</b>	<b>-</b>	<b>\$63.46</b>	<b>\$63.41</b>	<b>-</b>

The County Inns & Suites properties in Moncton and Dartmouth were impacted by new supply and a modest decrease in demand impacting occupancy. The Trust's Atlantic properties were successful in offsetting this with a 3% increase in ADR.

## Cash Available for Distribution

(\$000's, except as otherwise noted)	Years ended December 31		
	2006	2005	Change (%)
<b>Cash Flows from Operating Activities</b>	<b>55,201</b>	<b>(5,826)</b>	
Changes in Non-Cash Working Capital	3,352	2,124	
Distributions on Redeemable Partnership Units	-	(378)	
Changes in investment in PRC	(35,166)	20,224	
Changes in minority interest	8,591	150	
<b>Cash Flows from Total Operations</b>	<b>31,978</b>	<b>16,294</b>	<b>96.3</b>
Provision for Capital Replacement	(5,225)	(5,058)	
Mortgage retirement costs	-	2,023	
<b>Cash Available for Distribution</b>	<b>26,753</b>	<b>13,259</b>	<b>101.8</b>
<b>Distributions Declared</b>	<b>12,715</b>	<b>10,044</b>	<b>26.6</b>
<b>Basic Per Unit Cash Available For Distribution (\$)</b>	<b>1.05</b>	<b>0.51</b>	<b>105.9</b>
<b>Diluted Per Unit Cash Available For Distribution (\$)</b>	<b>0.78</b>	<b>0.50</b>	<b>56.0</b>
<b>Per Unit Distributions Declared (\$)</b>	<b>0.50</b>	<b>0.385</b>	<b>29.8</b>

Cash Available for Distribution is calculated by deducting a provision for capital replacement from cash flows from total operations. The Trust designates a portion of its capital expenditure budget for capital replacement to be funded from cash flows from operating activities. This provision is calculated as 4.0% of rooms and food and beverage revenue, or \$5.2 million (2005 - \$5.1 million). In addition, the amortization of deferred debt issuance costs and accretion of Convertible Debentures are added back, as these are non-cash items. In 2005, the Trust incurred \$2.0 million of mortgage retirement costs. This amount was funded from the proceeds of the 2005 Convertible Debenture offering and, accordingly, has been added back to determine Cash Available for Distribution. Cash Available for Distribution for the year ended December 31, 2006 increased to \$26.8 million, or \$1.05 per unit (2005 - \$13.3 million, or \$0.51 per unit), of which \$18.0 million (\$0.71 per unit) was generated from hospitality operations and \$8.8 million (\$0.34 per unit) was generated from PRC.

The Trust's revenue and profitability are typically higher in the second and third quarters, as compared to the first and fourth quarters. Therefore, cash flows from operating activities are not generated evenly throughout the year. Royal Host's Board of Trustees determines monthly distributions to Unitholders based on, among other considerations, annual performance, projected cash flows, capital commitments and working capital requirements. The objective is to set the distributions at a level that will be sustainable over a longer period. Accordingly, cash distributions will not equal cash available for distribution in any one quarter. The PRC profit of \$8.8 million will be used to fund long-term initiatives and to support future distributions in meeting the Trust's stated objective of generating sustainable distributions.

During the year ended December 31, 2006, the Trust declared distributions on Trust Units of \$12.7 million, an increase of 26.6% (2005 - \$10.0 million). Royal Host pays monthly cash distributions to Unitholders of record on or about the 15th day of each month. Distributions are payable on or about the last business day of the month.

As a result of improving results, the Trust increased monthly distributions twice in 2006, from \$0.035 in January 2006 to \$0.04 in April 2006, and \$0.05 per unit beginning in November 2006. Effective the February 2007 distribution, the Trust increased monthly distributions to \$0.055 per unit, or \$0.66 annually.

The Trust made various cash outlays in addition to distributions. The Trust made total debt principal repayments of \$18.8 million, including \$15.4 million related to PRC, as described further under "Liquidity and Capital Resources". In addition, the Trust spent \$8.4 million on capital investment, which it funded from cash from operations and restricted cash. It also repurchased \$10.1 million of Trust Units and \$1.7 million of Convertible Debentures pursuant to its Normal Course Issuer Bids ("NCIBs"), which it funded from cash on hand.

## Funds From Operations and Adjusted Funds From Operations

(\$000's, except as otherwise noted)	Years ended December 31		
	2006	2005	Change (%)
<b>Cash Flows from Total Operations</b>	<b>31,978</b>	<b>16,294</b>	<b>96.3</b>
Amortization of deferred debt issuance costs	(1,567)	(1,693)	
Accretion of convertible debentures	(154)	(20)	
<b>Funds From Operations</b>	<b>30,257</b>	<b>14,581</b>	<b>107.5</b>
Provision for Capital Replacement	(5,225)	(5,058)	
<b>Adjusted Funds From Operations</b>	<b>25,032</b>	<b>9,523</b>	<b>162.9</b>

During the year ended December 31, 2006, the Trust generated Funds from Operations of \$30.3 million, or \$1.19 per unit (2005 - \$14.6 million, or \$0.56 per unit). Funds from Operations reflects the adjustment for the deduction of accretion of convertible debentures and amortization of deferred debt issuance costs, which was \$1.6 million in 2006 (2005 - \$1.7 million). Deferred debt issuance costs are expensed over the life of the related debt. Adjusted Funds from Operations is calculated by deducting the Trust's provision for capital replacement from Funds from Operations. In 2006, Adjusted Funds from Operations was \$25.0 million, or \$0.98 per unit (2005 - \$9.5 million, or \$0.37 per unit).

## SEASONALITY

The hospitality industry business is seasonal in nature. The Trust's revenue and profitability are typically higher in the second and third quarters, as compared to the first and fourth quarters.

## YEAR ENDED DECEMBER 31, 2006 (Continuing Operations)

### Hospitality Revenue

Hospitality revenue from continuing operations for the year ended December 31, 2006 increased by \$4.3 million to \$144.3 million (2005 - \$140.0 million).

Years ended December 31 (\$000's, except as otherwise noted)	2006	2005	Change	Change (%)
<b>Revenue</b> (continuing operations)				
Rooms	103,783	99,984	3,799	3.8
Food and Beverage	26,852	26,460	392	1.5
Franchising and Management	2,505	2,640	(135)	(5.1)
Other	11,141	10,867	274	2.5
	<u>144,281</u>	<u>139,951</u>	<u>4,330</u>	<u>3.1</u>

The largest revenue increase was in rooms revenue, up by \$3.8 million, or 3.8%, to \$103.8 million (2005 - \$100.0 million), a direct result of the 4.7% increase in ADR to \$97.71 (2005 - \$93.29). The increase in ADR reflects management's continued focus on managing room rate yield and the improvement in overall industry rates. The Grand Okanagan Resort and Conference Centre, the London Hilton, the Best Western Village Park Inn and the Holiday Inn (The Palace) produced particularly strong results, more than offsetting lower rooms revenue at the Yellowknife Inn and certain of the Trust's Southern Alberta smaller limited service hotels.

Food and beverage revenue increased modestly to \$26.9 million (2005 - \$26.5 million).

Franchising and management revenue was flat at \$2.5 million (2005 - \$2.6 million), reflecting the steady nature of this business. Travelodge franchise fees were consistent with 2005. Subsequent to December 31, 2006, Royal Host sold its US hotel management business and, accordingly, management fees earned in 2006 and 2005 from its US hotel management business are included in discontinued operations.

Other revenue increased \$0.3 million to \$11.1 million (2005 - \$10.9 million), and includes revenue from telephone, retail sales and other (2006 - \$5.6 million; 2005 - \$6.0 million), tenant lease and parking (2006 - \$3.7 million; 2005 - \$3.2 million), spa and health club (2006 - \$1.1 million; 2005 - \$1.0 million) and prepaid vacations (2006 - \$0.7 million; 2005 - \$0.7 million).

### Hospitality Expenses

Years ended December 31 (\$000's, except as otherwise noted)	2006	2005	Change	Change (%)
<b>Hospitality Expenses</b>	101,162	100,196	966	1.0

Total hospitality expenses increased \$1.0 million, or 1.0%, to \$101.2 million (2005 - \$100.2 million). Operating expenses decreased as a percentage of revenue to 70.1% (2005 - 71.6%). The largest component of hospitality expenses is wages, which decreased to 28.8% of hospitality revenue (2005 - 29.2%). Utility costs, which represent approximately 5% of hotel revenue, decreased by \$0.3 million from 2005.

### Hospitality Gross Margin

Years ended December 31 (\$000's, except as otherwise noted)	2006	2005	Change	Change (%)
<b>Hospitality Gross Margin</b>	43,119	39,755	3,364	8.5

Hospitality gross margin increased \$3.4 million, or 8.5%, to \$43.1 million in 2006 (2005 - \$39.8 million), as a result of the higher overall revenue and lower incremental operating expenses. Gross margin as a percentage of revenue improved to 29.9% (2005 - 28.4%).

### Royal Private Residence Club

During the year ended December 31, 2006, the Trust completed construction of the Royal Private Residence Club, a 71-unit luxury condominium development adjacent to the Grand Okanagan Lakefront Resort and Conference Centre, and commenced closing of sales of the condominiums. As at December 31, 2006, sales of 96.8% of the condominiums were closed. To March 8, 2007, 99.7% of the condominiums have been sold and closed.

In 2006, the Trust recognized revenue from the sale of condominiums of \$55.7 million and cost of sales of \$46.9 million, producing a gross margin of \$8.8 million. The Trust does not anticipate recording any further significant profits in 2007. The Trust also repaid, in 2006, the \$15.4 million of debt associated with the project.

### Other Expenses

Other expenses increased overall by \$0.5 million. Overall net interest expense increased modestly by \$0.5 million to \$20.0 million (2005 - \$19.5 million). Interest on mortgages and capital leases decreased by \$2.4 million as a result of the debt repayment made in late 2005, and convertible debenture interest increased by \$4.0 million as a result of the additional Convertible Debentures in 2005 and 2006. Interest and investment income increased to \$1.7 million (2005 - \$0.6 million), a result of higher levels of cash on hand and an increase in overall BA rates.

Trust administration decreased by \$0.3 million to \$1.9 million (2005 - \$2.2 million), reflecting management's continued focus on costs. The Trust recorded a future income tax expense of \$0.7 million in 2006 (2005 - \$2.0 million recovery), resulting from the utilization of certain tax losses previously available to the Trust's corporate subsidiaries. 2005 also included a \$0.4 million property impairment provision.

### Net Earnings

The Trust's earnings from continuing operations for the year ended December 31, 2006 of \$13.5 million were a significant improvement over the \$1.8 million for 2005, and consisted of \$4.7 million from hospitality operations and \$8.8 million from PRC. Earnings from discontinued operations were \$0.8 million (2005 - \$0.5 million) and included the Trust's timeshare and US hotel management businesses, in addition to the Sundial Inn. Overall, net earnings from total operations in 2006 increased to \$14.3 million (2005 - \$2.3 million). Net earnings, excluding the PRC gross margin, were \$5.5 million, a significant 133.1% increase over 2005.

## DISCONTINUED OPERATIONS AND PROPERTY HELD FOR SALE

The operations of properties and businesses that were disposed of during the year ended December 31, 2006 or subsequent thereto, or that are held for sale as at December 31, 2006, have been included in discontinued operations on the consolidated statements of net earnings and reflected as assets and liabilities of discontinued operations and property held for sale on the consolidated balance sheets beginning in the year they are determined to be discontinued.

(\$000's, except as otherwise noted)	Years ended December 31		
	2006	2005	Change (%)
Revenue	5,492	5,511	(0.3)
Operating expenses	3,319	4,272	(22.3)
Gross margin	2,173	1,239	75.4
Other expenses	1,391	731	90.3
<b>Earnings from discontinued operations</b>	<b>782</b>	<b>508</b>	<b>53.9</b>

Revenue from discontinued operations for the year ended December 31, 2006 was \$5.5 million (2005 - \$5.5 million). Earnings from discontinued operations for the year totalled \$0.8 million (2005 - \$0.5 million).

Effective December 31, 2006, Royal Host sold its timeshare business unit for \$1.3 million, resulting in a loss on disposition of \$0.3 million. During 2005, the Trust recorded a property impairment provision in discontinued operations of \$0.6 million relating to its timeshare property located in Cabo San Lucas, Mexico.

Royal Host is actively seeking a buyer for the 75-room Sundial Inn in Orillia, Ontario. During the fourth quarter of 2006, Royal Host recorded a property impairment provision in discontinued operations of \$0.7 million relating to the Sundial Inn.

Subsequent to December 31, 2006, Royal Host sold its US hotel management business, resulting in a gain on disposition of approximately \$3.4 million US and, accordingly, the 2005 and 2006 operations have been included in discontinued operations.

On February 23, 2005, Royal Host sold its interest in the Travelodge North York hotel.

## LIQUIDITY AND CAPITAL RESOURCES

As at December 31, 2006, the Trust had cash and short-term investments of \$94.1 million and undrawn credit facilities of \$12.0 million.

In addition, the Trust had restricted cash as at December 31, 2006 of \$5.3 million (December 31, 2005 - \$6.0 million). Restricted cash consists primarily of funds held by lenders pursuant to financing arrangements for future planned capital expenditures.

The 9.25% Convertible Debentures (RYL.DB) matured in March 2007 and, accordingly, were classified as a current liability as at December 31, 2006. The Trust repaid the remaining balance of this obligation with funds on hand when it matured on March 1, 2007.

Royal Host's cash and short-term investments, together with its future cash flows, are expected to be sufficient to fund all anticipated cash requirements over the next year, including all debt repayments, forecast capital investment and operating expenses.

As the Trust evaluates long-term accretive opportunities, it invests excess cash not required for daily operations in liquid instruments. As a result of the higher levels of cash available in 2006 and improved investment rates, the Trust realized Interest and Investment Income of \$1.7 million (2005 - \$0.6 million).

## Financing Activities

As at December 31, 2006, the Trust's mortgages totalled \$126.9 million (December 31, 2005 - \$145.2 million). During the year, \$15.4 million of debt associated with PRC was repaid in full, and \$2.8 million of mortgage principal repayments were made pursuant to regular repayment schedules.

In September 2006, the Trust issued \$60.0 million of Convertible Debentures (RYL.DB.C). The Convertible Debentures bear interest at 6.25% per annum and mature in 2013.

## Contractual Obligations

The following tables identify Royal Host's mortgages, obligations under capital leases and Convertible Debentures and the amounts due during the periods indicated:

### Mortgages and Leases

As at December 31, 2006

(\$000's)	Total	2007	2008	2009	2010	2011	Thereafter
Mortgages	126,928	3,108	3,325	25,993	59,734	13,181	21,587
Capital Leases	617	375	242	-	-	-	-

### Convertible Debentures

(\$000's)	December 31, 2006	December 31, 2005	Maturity Date	Conversion Price
Current:				
9.25% Convertible Unsecured Subordinated	38,021	-	March 2007	\$7.00
Long-term:				
9.25% Convertible Unsecured Subordinated	-	39,712		
7.90% Convertible Unsecured Subordinated, Series A	35,000	35,000	April 2009	\$6.00
6.00% Convertible Unsecured Subordinated, Series B	58,464	58,340	October 2015	\$6.85
6.25% Convertible Unsecured Subordinated, Series C	58,225	-	September 2013	\$7.00
	151,689	133,052		

As at December 31, 2006, the average maturity of mortgages was 3.8 years, the average maturity of Convertible Debentures was 5.3 years, and the average maturity of mortgages and Convertible Debentures combined was 4.7 years. As at December 31, 2006, Royal Host's debt had an average overall interest rate of 7.52% (December 31, 2005 - 7.83%). With the repayment of the 9.25% Convertible Debentures, Royal Host's overall average debt interest rate decreased to 7.29%.

Subsequent to year end and prior to the maturity at March 1, 2007, \$5.6 million of the 9.25% Convertible Debentures were converted into 0.8 million Trust Units. On March 1, 2007, \$32.5 million of the 9.25% Convertible Debentures were repaid and cancelled.

Subsequent to year end to March 8, 2007, \$1.6 million of the 7.90% Convertible Debentures were converted into 0.3 million Trust Units, and \$0.5 million of the 6.00% Convertible Debentures were converted into 0.1 million Trust Units.

## Investing Activities

During the year ended December 31, 2006, the Trust's capital expenditures totalled \$10.6 million (2005 - \$7.0 million), including guest room upgrades at several hotels including the London Hilton, public area upgrades at several hotels including the Travelodge Toronto Airport, and including a \$1.2 million parkade addition at the Grand Okanagan Resort in connection with the completion of PRC. The actual cash expended related to capital was \$8.4 million (2005 - \$7.0 million). Over the last five years, Royal Host has invested in excess of \$44 million in its properties.

Restricted cash of \$3.1 million was applied to capital investment in 2006. Restricted cash, described above, is available for funding certain hotel capital expenditures.

## **Equity**

During the year ended December 31, 2006, equity decreased \$7.8 million to \$87.2 million. The overall decrease is attributable to net earnings of \$14.3 million and the recognition of a \$1.8 million equity element related to the conversion option of the \$60.0 million convertible debenture issued in the third quarter of 2006, less \$12.7 million of declared distributions and \$11.1 million related to the repurchase of 1.8 million Trust Units under the Trust's Normal Course Issuer Bid (described below).

As at December 31, 2006, 24,500,976 Trust Units were issued and outstanding, and as at March 8, 2007, 25,415,466 Trust Units were issued and outstanding. The increase is a result of conversions of Convertible Debentures into Trust Units.

### **Normal Course Issuer Bid – Trust Units**

Commencing on December 29, 2006, Royal Host initiated a Normal Course Issuer Bid ("NCIB") to repurchase a maximum of 2.0 million of its issued and outstanding Trust Units. Subsequent to December 31, 2006, 28,100 Trust Units with an aggregate cost of \$0.2 million (average cost of \$6.49 per unit) were repurchased pursuant to this NCIB.

Commencing on December 29, 2005, Royal Host initiated an NCIB to repurchase a maximum of 1.8 million of its issued and outstanding Trust Units. During the year ended December 31, 2006, 1.8 million Trust Units were repurchased at an aggregate cost of \$11.1 million (average cost of \$6.19 per unit).

Commencing on December 21, 2004, Royal Host initiated an NCIB to repurchase a maximum of 1.2 million of its issued and outstanding Trust Units. During the year ended December 31, 2005, Royal Host repurchased 1.2 million Trust Units at an aggregate cost of \$7.1 million (average cost of \$5.90 per unit) pursuant to this bid.

Cumulatively to March 8, 2007, Royal Host has repurchased 3.0 million Trust Units pursuant to its NCIBs at an average price of \$6.08 per Unit.

### **Normal Course Issuer Bid – 9.25% Convertible Debentures**

Commencing on July 17, 2006, Royal Host initiated an NCIB to repurchase up to \$3.9 million principal amount of its issued and outstanding 9.25% Convertible Debentures. During the year ended December 31, 2006, Royal Host repurchased \$0.9 million of Convertible Debentures at an average cost of \$101.88 per debenture. Subsequent to December 31, 2006, no debentures were repurchased pursuant to this bid.

Commencing on July 15, 2005, Royal Host initiated an NCIB to repurchase up to \$2.0 million principal amount of its issued and outstanding 9.25% Convertible Debentures. During the year ended December 31, 2006, Royal Host repurchased and cancelled \$0.8 million of Convertible Debentures at an average cost of \$104.00 per debenture pursuant to this NCIB. From commencement of the NCIB to expiration on July 15, 2006, Royal Host repurchased \$1.1 million of Convertible Debentures.

As at March 1, 2007, the date of the Convertible Debentures' maturity, a total of \$2.0 million of Convertible Debentures had been repurchased pursuant to the NCIBs.

### **Normal Course Issuer Bid – 7.90% Convertible Debenture**

Commencing on November 23, 2006, Royal Host initiated an NCIB to repurchase up to \$3.5 million principal amount of its issued and outstanding 7.90% Convertible Debentures. No debentures have been repurchased pursuant to this NCIB.

## Selected Annual Information For Three Years

(\$000's, except as otherwise noted)	2006	2005	2004 (restated)
Revenue	144,281	139,951	136,504
Net Earnings (Loss)			
From Continuing Operations	13,476	1,838	(5,103)
From Discontinued Operations	782	508	(94)
Net Earnings (Loss) Per Unit (\$)	0.56	0.07	(0.24)
Total Assets	440,033	421,004	387,705
Total Long-term Liabilities	283,647	270,314	202,874
Distributions Declared Per Unit (\$)	0.50	0.385	0.24

## THREE MONTHS ENDED DECEMBER 31, 2006

### Selected Fourth Quarter Data

For the three months ended December 31 (\$000's, except as otherwise noted)	2006	2005	Change	Change (%)
Hospitality Revenue (continuing operations)				
Rooms	23,129	22,506	623	2.8
Food and Beverage	7,586	7,523	63	0.8
Franchising and Management	667	683	(16)	(2.3)
Other	2,662	3,122	(460)	(14.7)
	<u>34,044</u>	<u>33,834</u>	210	
Hospitality Expenses	<u>24,796</u>	<u>25,792</u>	(996)	(3.9)
	9,248	8,042	1,206	15.0
Royal Private Residence Club	63	-	63	
Gross Margin	<u>9,311</u>	<u>8,042</u>	1,269	15.8
Other Expenses	<u>9,086</u>	<u>8,056</u>	1,030	12.8
Earnings (Loss) from Continuing Operations	225	(14)	239	
Loss from Discontinued Operations	<u>(470)</u>	<u>(316)</u>	(154)	
Net Loss	<u>(245)</u>	<u>(330)</u>	85	

Hospitality revenue from continuing operations in the fourth quarter of 2006 increased by \$0.2 million to \$34.0 million (2005 - \$33.8 million). Rooms revenue increased \$0.6 million to \$23.1 million (2005 - \$22.5 million). Food and beverage revenue increased modestly to \$7.6 million (2005 - \$7.5 million).

Hospitality expenses decreased \$1.0 million to \$24.8 million (2005 - \$25.8 million). Gross margin increased \$1.3 million in the fourth quarter of 2006 to \$9.3 million (2005 - \$8.0 million). Other expenses increased \$1.0 million to \$9.1 million (2005 - \$8.1 million).

Earnings from continuing operations increased to \$0.2 million (2005 - \$Nil), and the loss from discontinued operations increased to \$0.5 million (2005 - \$0.3 million), as a result of a \$0.7 million property impairment provision on the Sundial Inn and the recording of a future income tax expense in 2006 in contrast to a future income tax recovery in 2005.

## SUMMARY OF QUARTERLY FINANCIAL RESULTS

(\$000's, except as otherwise noted)	2006				2005			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenue	37,468	93,653	37,658	31,170	33,834	40,049	36,916	29,151
Net Earnings (Loss)								
From Continuing Operations	226	13,296	2,174	(2,220)	(14)	3,032	2,112	(3,290)
From Discontinued Operations	(470)	643	415	194	(316)	577	202	43
	(244)	13,939	2,589	(2,026)	(330)	3,609	2,314	(3,247)
Per Unit Results (\$)								
Earnings (Loss) from Continuing Operations								
Basic	0.01	0.52	0.08	(0.09)	-	0.11	0.08	(0.15)
Diluted	0.01	0.31	0.08	(0.09)	-	0.11	0.08	(0.15)
Earnings (Loss) from Total Operations								
Basic	(0.01)	0.54	0.10	(0.08)	(0.01)	0.13	0.08	(0.14)
Diluted	(0.01)	0.32	0.10	(0.08)	(0.01)	0.13	0.08	(0.14)

Quarterly financial results have been recalculated to reflect the changes to discontinued operations.

## DISCLOSURE CONTROLS AND PROCEDURES

The President and Chief Operating Officer (acting as Chief Executive Officer for this purpose) and Chief Financial Officer evaluated the effectiveness of the Trust's disclosure controls and procedures as at December 31, 2006. Based on that evaluation, the President and Chief Operating Officer and the Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective as at December 31, 2006 to provide reasonable assurance that material information relating to the Trust, including its consolidated subsidiaries, would be made known to them.

## INTERNAL CONTROL OVER FINANCIAL REPORTING

There have been no changes in the Trust's internal control over financial reporting that occurred during the most recent interim period ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Trust's internal control over financial reporting.

## KEY ACCOUNTING POLICIES AND ESTIMATES

Note 2 to the audited consolidated financial statements for the year ended December 31, 2006 includes a summary of the Trust's significant accounting policies.

The application of some of these policies requires the Trust 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.

## **CHANGES IN ACCOUNTING POLICIES**

### **Financial Instruments and Comprehensive Income**

The CICA issued new sections related to financial instruments that are effective for the Trust starting January 1, 2007.

CICA Handbook Section 3855, "Financial Instruments – Recognition and Measurement" provides guidance on when a financial instrument must be recognized on the balance sheet and how it is to be measured. It also provides guidance on the presentation of gains and losses on financial instruments. The initial adoption of this new section will result in the Trust: (i) measuring financial assets classified as loans and receivables, and held to maturity, at their amortized cost, (ii) measuring financial assets and financial liabilities classified as held for trading, if any, at fair value with the related gains or losses on measurement recognized in net earnings, (iii) measuring financial assets classified as available-for-sale at fair value, with the related gains and losses on measurement recognized in "other comprehensive income", a new account introduced with the application of Section 1530 discussed below.

CICA Handbook Section 1530, "Comprehensive Income" requires an entity to recognize certain unrealized gains and losses in "other comprehensive income", an account included in unitholders' equity, until such gains and losses are realized and then recognized in net earnings, and requires the introduction of a statement of comprehensive income.

The transitional impact of these new standards is being evaluated by the Trust.

## **RESTATEMENT**

Royal Host's financial statements for the periods ended December 31, 2002 through June 30, 2006 included changes in property under development and minority interest in cash from investing activities on its Consolidated Statements of Cash Flows. Changes in property under development and minority interest have been retroactively restated to be reclassified and included in cash from operating activities rather than in cash from investing activities. The effects of the reclassification are as follows: cash from operating activities for the year ended December 31, 2005 decreased by \$20,374,000 to (\$5,826,000) and cash from investing activities for the year ended December 31, 2005 increased by \$20,374,000 to \$3,646,000.

Royal Host's financial statements for the period ended June 30, 2004 through June 30, 2006 included property held for sale in current assets on its Consolidated Balance Sheets. Property held for sale of \$2.7 million as at December 31, 2005 has been retroactively restated to be included in long-term assets.

## **OFF BALANCE SHEET ARRANGEMENT**

Royal Host had no undisclosed off balance sheet arrangements as at December 31, 2006.

## **RISKS AND UNCERTAINTIES**

Royal Host's business is subject to various risks and uncertainties, which occur in the normal course of business that could adversely affect its earnings and cash flow, as well as its ability to make distributions to Unitholders. The following is a discussion of the key risks and uncertainties facing its business on a day-to-day basis and the strategies adopted 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.

These risks include general economic risks, operating risks, competitive risks, environmental risks, and development risks amongst others.

Additional information with respect to the risks and uncertainties to which Royal Host is subject is contained in its Annual Information Form for the year ended December 31, 2006, which may be viewed on SEDAR at [www.sedar.com](http://www.sedar.com).

## **General Economic Risks**

Hotel performance is affected by a number of factors, listed below, many of which the Trust cannot anticipate:

- 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, the Trust has adopted several strategies in an effort to minimize their impact:

- diversification of its existing hotel portfolio both geographically and across market segments in order to lower the exposure to regional economic fluctuations;
- ownership 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 risks;
- maintaining a strong balance sheet and undertaking conservative fiscal strategies; and
- using debt securities with fixed interest rates and repayment terms where such financing can be obtained on favourable terms.

## **Operating Risks**

The Trust also faces normal operating risks associated with the hotel business. These risks include:

- operating cost increases due to inflation and other factors;
- dependence on business travelers and tourism;
- increases in energy costs and other expenses; and
- reliance on key personnel.

In order to mitigate these risks, the Trust has developed strategies focusing on:

- ensuring customer satisfaction through proactive measures such as staff training;
- maintaining a high quality product by ensuring, through constant reinvestment, that the 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;
- employing sophisticated operating systems to manage and control costs;
- managing the capital structures with a focus on a constructive and prudent use of leverage; and
- providing incentive-based compensation programs to attract and maintain a high-quality management team.

## **Competitive Risks**

Substantially all of Royal Host's 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 its hotels or hotel properties acquired in the future. New, competing hotels may be opened in the Trust's markets, which could adversely affect the profitability of hotel operations.

## **Environmental Risks**

The Trust is subject to numerous federal, provincial and local laws and regulations concerning the environment. Under these laws and regulations, Royal Host may be liable for the costs of removal or remediation of certain hazardous or toxic substances on its 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 the business does not subject it to a high level of environmental risk, but Royal Host takes this risk

seriously. Under current investment guidelines, all potential acquisition properties must have minimum phase one environmental assessments conducted by an independent consultant prior to purchase. Royal Host also maintains environmental impairment insurance on all properties.

## **BUSINESS ENVIRONMENT AND OUTLOOK**

The Trust has achieved many significant accomplishments in 2006, delivering record results and continued Unitholder value, which were driven by very strong operating results and the successful completion of PRC. Royal Host sold its non-core timeshare business in December 2006 and its US management business in January 2007. In addition, Royal Host closed a \$60 million convertible debenture offering, ensuring the Trust is in a very strong financial position. The Trust intends to pursue accretive opportunities, continue to reduce its costs of funds and repay debt while reinvesting and repositioning certain of its properties to maximize value.

On December 21, 2006, the Minister of Finance released for comment draft legislation concerning the taxation of certain publicly-traded trusts and partnerships. The legislation reflects proposals originally announced by the Minister on October 31, 2006. Under the proposed legislation, certain distributions will not be deductible by publicly-traded income trusts and partnerships, with the exception of certain real estate investment trusts and, as a result, these entities will, in effect, be taxed as corporations on the amount of the non-deductible distributions. For entities in existence on October 31, 2006, such as Royal Host, the proposed rules, if passed into law, would apply in four years in 2011. Management is reviewing the potential impact of these proposed changes. The proposed changes may adversely affect the marketability of the Trust's units and the ability of the Trust to undertake financings and acquisitions, and at such time as the proposed rules apply to the Trust, the distributable cash of the Trust may be materially reduced.

The hospitality industry experienced steady growth in 2005 and 2006, and it is anticipated that growth will continue in 2007. Growth in demand is anticipated to exceed that of supply, resulting in anticipated improvements in Occupancy and ADR. Pannell Kerr Forster, a recognized industry consultant, has projected national RevPAR growth of 4.8% and growth in industry-wide profitability of 5.8% in 2007. Overall, Canada's general economic environment is strong and the hospitality industry's fundamentals remain sound.

Royal Host is in the fortunate position of having a strong balance sheet, a growing underlying business and a dedicated management group focused on owning, managing and franchising hotels in Canada and realizing value for its Unitholders.



**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

**Consolidated Financial Statements**

**For the year ended December 31, 2006**

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## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The preparation and presentation of the consolidated financial statements and the overall quality of financial reporting are the responsibility of Royal Host Real Estate Investment Trust (the "Trust"). The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and necessarily include certain amounts on management's best estimates and careful judgment. Financial information contained throughout the annual report is consistent with that contained in the consolidated financial statements.

Management is responsible for installing and maintaining a system of internal controls to provide reasonable assurance that assets are safeguarded and that transactions are properly authorized recorded and reported. The Trust augments the internal control system with a program of internal reviews covering significant aspects of the operations. Management believes that the system of internal controls operated efficiently in 2006.

The Board of Trustees (the "Board") is responsible for overseeing Management's performance of its responsibilities for financial reporting and internal control. The Board exercises this responsibility with the assistance of its Audit Committee (the "Committee"). The Committee reviews the financial statements with management and the independent auditors prior to submission to the Board for approval, considers the appropriateness of accounting policies and assesses the overall quality of the financial reporting. In addition, the Committee reviews and makes recommendations to the Board regarding financial matters and oversees the process Management has in place to identify business risks. Finally, the Committee reviews the recommendations of the independent auditors for improvements to internal controls as well as the actions of management to implement such recommendations.

The Committee reviews and approves the terms of engagement of the auditors, the scope and plan for the audit and reviews with the auditors the results of the audit and the Auditors' Report. The auditors report to the Audit Committee. The Committee also discusses with the auditors their independence from Management and the Trust and receives written confirmation of their independence.

Management and auditors attend various Committee meetings and each is provided with the opportunity to meet privately with the Committee.

As signed by

**Michael Jackson**  
President and Chief Operating Officer  
March 8, 2007

As signed by

**Wayne King**  
Chief Financial Officer  
March 8, 2007

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March 8, 2007

## **Auditors' Report**

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

We have audited the consolidated balance sheet of Royal Host Real Estate Investment Trust (the "Trust") as at December 31, 2006 and the consolidated statements of net earnings, cash flows, and unitholders' equity for the year then ended. These consolidated financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 company as at December 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at December 31, 2005 and for the year then ended, prior to the restatements described in Note 21, were audited by other auditors who expressed an opinion without reservation on those statements in their report dated March 3, 2006. We have audited the adjustments to the 2006 financial statements and in our opinion, such adjustments, in all material respects, are appropriate and have been properly applied.

*PricewaterhouseCoopers LLP*

**Chartered Accountants**

Calgary, Alberta

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Consolidated Balance Sheet

in \$000's

	As at	
	<u>December 31, 2006</u>	<u>December 31, 2005</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and short-term investments	94,144	31,483
Accounts and notes receivable	9,529	12,291
Prepaid expenses	3,237	3,484
Inventories	3,174	3,150
Property under development (Note 3)	1,551	37,908
Assets of discontinued operations (Note 4)	4,285	188
Future income taxes (Note 14)	931	3,100
	<u>116,851</u>	<u>91,604</u>
<b>Long-term notes receivable</b>	<b>47</b>	<b>190</b>
<b>Capital assets (Note 5)</b>	<b>308,396</b>	<b>314,102</b>
<b>Property held for sale (Notes 4 and 20)</b>	<b>2,056</b>	<b>2,704</b>
<b>Restricted cash (Note 6)</b>	<b>5,261</b>	<b>6,033</b>
<b>Deferred debt issuance costs</b>	<b>7,422</b>	<b>6,371</b>
	<u>440,033</u>	<u>421,004</u>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued liabilities	16,421	22,905
Equity distributions payable	1,232	924
Interest accrued on convertible debentures	3,390	2,429
Mortgages (Note 7)	3,108	18,304
Convertible debentures (Notes 8 and 19)	38,021	-
Obligations under capital leases (Note 9)	375	443
Other liabilities	2,288	2,086
Liabilities of discontinued operations (Note 4)	4,351	58
	<u>69,186</u>	<u>47,149</u>
<b>Mortgages (Note 7)</b>	<b>123,820</b>	<b>126,922</b>
<b>Convertible debentures (Notes 8 and 19)</b>	<b>151,689</b>	<b>133,052</b>
<b>Obligations under capital leases (Note 9)</b>	<b>242</b>	<b>660</b>
<b>Deferred revenue</b>	<b>417</b>	<b>639</b>
<b>Future income taxes (Note 14)</b>	<b>7,479</b>	<b>9,041</b>
	<u>352,833</u>	<u>317,463</u>
<b>Minority interest (Note 3)</b>	<b>-</b>	<b>8,591</b>
<b>Unitholders' equity (Note 10)</b>	<b>87,200</b>	<b>94,950</b>
	<u>440,033</u>	<u>421,004</u>

Commitments, Contingencies and Guarantees (Note 15)

*See accompanying Notes to the Consolidated Financial Statements*

Approved on behalf of the Board of Trustees:

As signed by

**Alvin G. Poettcker**  
Chairman of the Board

As signed by

**Stan Spavold**  
Chairman of the Audit Committee

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Consolidated Statements of Net Earnings

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

	Years Ended	
	December 31, 2006	December 31, 2005
<b>Hospitality revenue</b>		
Rooms	103,783	99,984
Food and beverage	26,852	26,460
Franchising and management	2,505	2,640
Other	11,141	10,867
	<u>144,281</u>	<u>139,951</u>
<b>Hospitality expenses</b>	<u>101,162</u>	<u>100,196</u>
	<u>43,119</u>	<u>39,755</u>
<b>Royal Private Residence Club (Note 3)</b>		
Revenue	55,668	-
Cost of sales	46,878	-
	<u>8,790</u>	<u>-</u>
<b>Gross margin</b>	<u>51,909</u>	<u>39,755</u>
<b>Other expenses</b>		
Trust administration	1,865	2,195
Interest on mortgages and capital leases	10,498	12,854
Interest on convertible debentures	11,206	7,236
Interest and investment income	(1,705)	(555)
Mortgage retirement costs (Note 7)	-	2,023
Depreciation and amortization	15,768	15,427
Property impairment provision (Note 11)	-	390
Future income taxes (recovery) (Note 14)	722	(2,001)
Capital and other taxes	172	330
(Gain) loss on foreign currency translation	(93)	18
	<u>38,433</u>	<u>37,917</u>
<b>Earnings from continuing operations</b>	<u>13,476</u>	<u>1,838</u>
<b>Earnings from discontinued operations (Note 4)</b>	<u>782</u>	<u>508</u>
<b>Net earnings</b>	<u>14,258</u>	<u>2,346</u>
<b>Basic per unit net earnings (Note 12)</b>		
- from continuing operations	0.53	0.05
- from discontinued operations	0.03	0.02
	<u>0.56</u>	<u>0.07</u>
<b>Diluted per unit net earnings (Note 12)</b>		
- from continuing operations	0.49	0.05
- from discontinued operations	0.02	0.02
	<u>0.51</u>	<u>0.07</u>

*See accompanying Notes to the Consolidated Financial Statements*

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Consolidated Statements of Unitholders' Equity

in \$000's

	Trust Units	Convertible Equity	Contributed Surplus	Accumulated Earnings	Distributions	Total
Balance, December 31, 2004	202,037	27,500	89	8,072	(127,091)	110,607
Net earnings	-	-	-	2,346	-	2,346
Equity distributions						
Trust units	-	-	-	-	(10,044)	(10,044)
Redeemable partnership units	-	-	-	-	(378)	(378)
Issuance of trust units pursuant to redemption of redeemable partnership units	25,085	(27,500)	-	-	-	(2,415)
Issuance of trust units pursuant to distribution reinvestment plan	257	-	-	-	-	257
Trust units repurchased pursuant to normal course issuer bid (Note 10)	(9,823)	-	2,713	-	-	(7,110)
Employee loans pursuant to employee unit purchase program (Note 10)	-	-	22	-	-	22
Restatement of convertible debenture issuance costs	(15)	-	-	-	-	(15)
Conversion option related to issued convertible debentures (Note 8)	-	1,680	-	-	-	1,680
Balance, December 31, 2005	217,541	1,680	2,824	10,418	(137,513)	94,950
<b>Net earnings</b>	-	-	-	<b>14,258</b>	-	<b>14,258</b>
<b>Equity distributions</b>						
<b>Trust units</b>	-	-	-	-	<b>(12,715)</b>	<b>(12,715)</b>
<b>Issuance of trust units pursuant to distribution reinvestment plan</b>	<b>12</b>	-	-	-	-	<b>12</b>
<b>Issuance of trust units pursuant to debenture conversion option</b>	<b>5</b>	-	-	-	-	<b>5</b>
<b>Trust units cancelled pursuant to normal course issuer bid (Note 10)</b>	<b>(15,816)</b>	-	<b>4,670</b>	-	-	<b>(11,146)</b>
<b>Employee loans pursuant to employee unit purchase program (Note 10)</b>	<b>33</b>	-	<b>3</b>	-	-	<b>36</b>
<b>Conversion option related to issued convertible debentures (Note 8)</b>	-	<b>1,800</b>	-	-	-	<b>1,800</b>
<b>Balance, December 31, 2006</b>	<b>201,775</b>	<b>3,480</b>	<b>7,497</b>	<b>24,676</b>	<b>(150,228)</b>	<b>87,200</b>

*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

	Years Ended	
	<u>December 31,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
		(Restated - Note 20)
<b>Operating activities</b>		
Net earnings from continuing operations	13,476	1,838
Items not affecting cash:		
Depreciation and amortization	15,768	15,427
Future income taxes	722	(2,001)
Property impairment provision (Note 11)	-	390
Accretion of convertible debentures (Note 8)	154	20
<b>Cash flows from continuing operations</b>	<u>30,120</u>	<u>15,674</u>
<b>Cash flows from discontinued operations</b> (Note 4)	<b>1,858</b>	998
Changes in non-cash working capital - continuing operations (Note 13)	(3,548)	(1,754)
Changes in non-cash working capital - discontinued operations (Note 4)	196	(370)
Decrease (increase) in property under development	35,166	(20,224)
Decrease in minority interest	(8,591)	(150)
	<u>55,201</u>	<u>(5,826)</u>
<b>Financing activities</b>		
Issuance of convertible debentures	60,000	60,000
Debt issuance costs	(2,618)	(3,003)
Equity distributions	(12,357)	(9,780)
Repurchase of trust units pursuant to normal course issuer bid	(10,102)	(7,110)
Repurchase of convertible debentures pursuant to normal course issuer bid	(1,691)	(288)
Principal repayments on mortgages and capital leases	(18,785)	(38,874)
Proceeds from the acquisition of mortgages	-	26,426
Redemption of redeemable partnership units	-	(2,415)
	<u>14,447</u>	<u>24,956</u>
<b>Investing activities</b>		
Acquisition of capital assets	(8,362)	(7,025)
Net cash from sale of capital assets	460	10,048
Decrease in restricted cash	772	347
Decrease in long-term notes receivable	143	276
	<u>(6,987)</u>	<u>3,646</u>
<b>Increase in cash and short-term investments</b>	<b>62,661</b>	<b>22,776</b>
<b>Cash and short-term investments, beginning of year</b>	<u>31,483</u>	<u>8,707</u>
<b>Cash and short-term investments, end of year</b>	<u>94,144</u>	<u>31,483</u>
<b>Cash interest paid</b>		
Mortgages and capital leases	11,516	12,232
Convertible debentures	10,091	6,464
	<u>21,607</u>	<u>18,696</u>

*See accompanying Notes to the Consolidated Financial Statements*

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 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.

#### 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, its wholly-owned subsidiaries and variable interest entities for which Royal Host is the primary beneficiary, and partnerships and joint ventures to the extent of Royal Host's interest in their respective assets, liabilities, revenues, expenses and cash flows. All intercompany transactions and balances have been eliminated.

##### (d) Revenue Recognition

Revenue, consisting of rooms, food and beverage, franchising and management, and other revenue, is recognized when services are provided and collection is reasonably assured. Other revenue includes telephone and retail sales, tenant leases and parking, spa and health clubs. 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.

Revenue from the Royal Private Residence Club is recorded at the time each condominium is closed, and title and possession have been transferred to the buyer.

##### (e) Capital Assets

Hotel properties are recorded at the lower of cost less accumulated amortization or net recoverable value. The net recoverable value 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.

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.

Franchise rights and management contracts are amortized using the straight-line method based on their estimated useful lives.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

##### (e) Capital Assets (continued)

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

##### (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 the carrying value of the asset exceeds the total undiscounted cash flows expected from its 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) Inventory

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

##### (h) Financing Costs

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

##### (i) Income Taxes

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

Royal Host utilizes the future 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.

##### (j) Cash and Short-Term Investments

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.

##### (k) 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.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 3. ROYAL PRIVATE RESIDENCE CLUB

A subsidiary of Royal Host developed, for resale, the Royal Private Residence Club, a residential condominium on a property adjacent to the Grand Okanagan Lakefront Resort and Conference Centre in Kelowna, British Columbia.

During the year ended December 31, 2006, Royal Host completed construction and closed the sales and transferred ownership of substantially all of the condominiums. Revenue and cost of sales (including commissions and other selling costs) are recorded at the time each condominium sale is closed, and title and possession have been transferred to the buyer. Revenue and cost of sales were recognized on 96.8% of the condominiums during the year ended December 31, 2006. Subsequent to December 31, 2006, additional sales of condominiums increased aggregate sales to 99.7%.

In April 2005, Royal Host 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. Royal Host provided a completion, cost overrun and debt service deficiency guarantee on the construction loan and a specific guarantee of payment of notes receivable. During the year ended December 31, 2006, the \$8.0 million mezzanine loan and the amount drawn on the construction loan of \$7.4 million were repaid in full.

Property under development includes \$0.1 million of capitalized interest as at December 31, 2006 (December 31, 2005 - \$1.3 million).

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

The operations of properties and businesses that were disposed of during the year ended December 31, 2006 or subsequent thereto, or that are held for sale as at December 31, 2006, have been included in discontinued operations on the consolidated statements of net earnings, and reflected as assets and liabilities of discontinued operations and property held for sale on the consolidated balance sheets.

Effective December 31, 2006, Royal Host sold its timeshare business unit for \$1.25 million, resulting in a loss on disposition of \$0.3 million. During the third quarter of 2005, the Trust recorded a property impairment provision in discontinued operations of \$0.6 million relating to its timeshare property located in Cabo San Lucas, Mexico.

Subsequent to December 31, 2006, Royal Host sold its US management business, resulting in a gain on disposition of approximately \$3.4 million US (see Note 19).

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 VTB mortgage (included in accounts receivable).

The Trust is actively seeking a buyer for a hotel property in Ontario. During the fourth quarter of 2006, the Trust recorded a property impairment provision in discontinued operations of \$0.7 million relating to this property.

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

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

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

	Years Ended (in \$000's)	
	December 31, 2006	December 31, 2005
<b>Revenue</b>		
Rooms	629	943
Food and beverage	-	169
Franchising and management	4,526	3,922
Other	337	477
	<u>5,492</u>	<u>5,511</u>
<b>Operating expenses</b>	<u>3,319</u>	<u>4,272</u>
<b>Gross margin</b>	<u>2,173</u>	<u>1,239</u>
<b>Other expenses</b>		
Depreciation and amortization	46	148
Property impairment provision	704	569
Future income taxes (recovery)	12	(475)
Capital and other taxes	273	185
Loss on foreign currency translation	42	56
Loss on disposition	314	248
	<u>1,391</u>	<u>731</u>
<b>Earnings from discontinued operations</b>	<u>782</u>	<u>508</u>

Cash flows from discontinued operations, reported on the statement of cash flows, are reconciled to the earnings from discontinued operations as follows:

	Years Ended (in \$000's)	
	December 31, 2006	December 31, 2005
<b>Earnings from discontinued operations</b>	782	508
Items not affecting cash:		
Future income taxes (recovery)	12	(475)
Depreciation and amortization	46	148
Property impairment provision	704	569
Loss on disposition	314	248
<b>Cash flows from discontinued operations</b>	<u>1,858</u>	<u>998</u>
<b>Changes in non-cash working capital</b>		
Assets of discontinued operations	(4,097)	118
Liabilities of discontinued operations	4,293	(488)
	<u>196</u>	<u>(370)</u>

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**5. CAPITAL ASSETS**

	<i>(in \$000's)</i>		
	<u>Gross Book Value</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
<b>December 31, 2006</b>			
Buildings	<b>321,413</b>	<b>71,018</b>	<b>250,395</b>
Land	<b>37,192</b>	-	<b>37,192</b>
Furniture, fixtures, and equipment	<b>48,532</b>	<b>39,029</b>	<b>9,503</b>
Other	<b>1,247</b>	<b>381</b>	<b>866</b>
	<b>408,384</b>	<b>110,428</b>	<b>297,956</b>
Capital assets under development	<b>2,157</b>	-	<b>2,157</b>
Intangible assets:			
Franchise rights and management contracts	<b>27,414</b>	<b>19,131</b>	<b>8,283</b>
	<b>437,955</b>	<b>129,559</b>	<b>308,396</b>
		<i>(in \$000's)</i>	
	<u>Gross Book Value</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
<b>December 31, 2005</b>			
Buildings	313,421	62,872	250,549
Land	38,815	-	38,815
Furniture, fixtures, and equipment	46,451	36,999	9,452
Other	1,152	343	809
	399,839	100,214	299,625
Capital assets under development	4,214	-	4,214
Intangible assets:			
Franchise rights and management contracts	27,414	17,151	10,263
	431,467	117,365	314,102

During the year ended December 31, 2006, capital additions to Royal Host's hotel properties totalled \$10.6 million (2005 - \$7.0 million).

**6. RESTRICTED CASH**

Restricted cash represents funds on deposit with lenders pursuant to financing arrangements for future planned capital expenditures.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**7. MORTGAGES**

	<i>(in \$000's)</i>	
	<u>December 31, 2006</u>	<u>December 31, 2005</u>
Mortgages secured by hotel properties	<b>126,928</b>	129,800
Mortgages secured by property under development	-	15,426
	<b>126,928</b>	145,226
Less: current portion	<b>3,108</b>	18,304
	<b>123,820</b>	126,922

Principal repayments required for the years ending December 31:

	<u><i>(in \$000's)</i></u>
2007	3,108
2008	3,325
2009	25,993
2010	59,734
2011	13,181
Thereafter	21,587
	<u>126,928</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.

In April 2005, Royal Host entered into financing arrangements for property under development totalling \$28.0 million as described in Note 3. In 2006, all funds drawn were repaid and the facility was terminated.

During the fourth quarter of 2005, Royal Host repaid \$25.6 million in mortgages. Retirement costs of \$2.0 million were incurred as a result of these repayments.

Mortgages bear interest at rates ranging from 7.35% to 9.38% per annum (2005 - 5.75% to 10.00%) with a weighted average year-end rate of 8.19% per annum (2005 - 8.18%) and mature between 2009 and 2013. The mortgages are secured by fixed charges over specified hotel properties and property under development.

As at December 31, 2006, Royal Host has drawn \$Nil (December 31, 2005 - \$0.1 million) on credit facilities totalling \$12.0 million, secured by first charges over two hotels. Interest is payable on a floating rate basis at rates ranging from prime plus 1.0% to prime plus 2.0%.

Debt issuance costs are deferred and amortized over the term of the related debt. During the year, \$1.6 million (2005 - \$1.7 million) was included in depreciation and amortization expense.

**8. CONVERTIBLE DEBENTURES**

	<i>(in \$000's)</i>	
	<u>December 31, 2006</u>	<u>December 31, 2005</u>
9.25% Convertible Unsecured Subordinated Debentures	<b>38,021</b>	39,712
7.90% Convertible Unsecured Subordinated Debentures, Series A	<b>35,000</b>	35,000
6.00% Convertible Unsecured Subordinated Debentures, Series B	<b>58,464</b>	58,340
6.25% Convertible Unsecured Subordinated Debentures, Series C	<b>58,225</b>	-
	<b>189,710</b>	133,052
Less: current portion	<b>38,021</b>	-
	<b>151,689</b>	133,052

The convertible debentures' maturity dates are as follows: the 9.25% debentures - March 1, 2007; the 7.90% debentures - April 30, 2009; the 6.00% debentures - October 31, 2015 and the 6.25% debentures - September 30, 2013.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 8. CONVERTIBLE DEBENTURES (continued)

##### (a) 9.25% Convertible Unsecured Subordinated Debentures

The convertible debentures of \$38.0 million 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 TSX for the twenty (20) consecutive trading days ending on the fifth (5) trading day preceding the date of redemption or maturity.

After March 1, 2005, the debentures are 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.

Commencing on July 17, 2006, Royal Host initiated a normal course issuer bid to repurchase up to \$3.9 million in principal of its issued and outstanding 9.25% convertible debentures. During the year ended December 31, 2006, Royal Host repurchased and cancelled \$0.9 million of debentures (average cost of \$101.88) pursuant to this bid. Subsequent to December 31, 2006, no debentures were repurchased pursuant to this bid.

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. During the year ended December 31, 2006, Royal Host repurchased and cancelled \$0.8 million of debentures (average cost of \$104.00 per debenture) pursuant to this bid. During the year ended December 31, 2005, Royal Host repurchased \$0.3 million of debentures (average cost of \$104.00 per debenture) all of which were cancelled in 2006. The normal course issuer bid expired on July 15, 2006. Royal Host repurchased and cancelled \$1.1 million of debentures from the commencement of this bid.

Subsequent to December 31, 2006, \$5.6 million of the debentures were converted into 0.8 million trust units and \$32.5 million of the debentures were repaid upon maturity (see Note 19).

##### (b) 7.90% Convertible Unsecured Subordinated Debentures, Series A

The convertible debentures of \$35.0 million 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.

Commencing on November 23, 2006, Royal Host initiated a normal course issuer bid to repurchase up to \$3.5 million in principal of its issued and outstanding 7.90% convertible debentures. No debentures have been repurchased pursuant to this bid.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 8. CONVERTIBLE DEBENTURES (continued)

##### (c) 6.00% Convertible Unsecured Subordinated Debentures, Series B

In October 2005, \$60.0 million of convertible unsecured subordinated debentures were issued with a term of ten years. These debentures bear interest at 6.00% per annum and are payable semi-annually in arrears on April 30 and October 31 in each year commencing April 30, 2006.

The Series B debentures may not be redeemed by Royal Host prior to October 31, 2009. On or after October 31, 2009, but prior to October 31, 2011, the debentures are 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 \$6.85 per unit. After October 31, 2011, but prior to the maturity date of October 31, 2015, the debentures are redeemable without stipulation. 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 redemption or maturity.

On redemption or at maturity on October 31, 2015, 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.

Based on certain conditions, the debentures are convertible, at the holders' discretion, at \$6.85 per trust unit at any time from the date of issue to close of business on the day prior to the maturity date, October 31, 2015.

In accordance with EIC ("Emerging Issues Committee") 158, *Accounting for Convertible Debt Instruments*, the principal amount of the debenture has been allocated between its liability and equity elements and classified separately on the balance sheet. As a result, \$58.3 million was recorded as a long-term liability with the balance of \$1.7 million recorded as Conversion Option in equity. The long-term liability will increase to the \$60.0 million face value of the debenture over its ten year term, with the accretion being included in interest on convertible debentures on the consolidated statements of net earnings.

##### (d) 6.25% Convertible Unsecured Subordinated Debentures, Series C

In September 2006, \$60.0 million of convertible unsecured subordinated debentures were issued with a term of seven years. These debentures bear interest at 6.25% per annum and are payable semi-annually in arrears on March 31 and September 30 in each year commencing March 31, 2007.

The Series C debentures may not be redeemed by Royal Host prior to September 30, 2009. On or after September 30, 2009, but prior to September 30, 2011, the debentures are 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. After September 30, 2011, but prior to the maturity date of September 30, 2013, the debentures are redeemable without stipulation. 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 redemption or maturity.

On redemption or at maturity on September 30, 2013, 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.

Based on certain conditions, the debentures are convertible, at the holders' discretion, at \$7.00 per trust unit at any time from the date of issue to close of business on the day prior to the maturity date, September 30, 2013.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**8. CONVERTIBLE DEBENTURES** (continued)

In accordance with EIC 158, "Accounting for Convertible Debt Instruments", the principal amount of the debenture has been allocated between its liability and equity elements and classified separately on the balance sheet. As a result, \$58.2 million was recorded as a long-term liability with the balance of \$1.8 million recorded as Conversion Option in equity. The long-term liability will increase to the \$60.0 million face value of the debenture over its seven year term, with the accretion being included in interest on convertible debentures on the consolidated statements of net earnings.

**9. 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 December 31, 2006 are as follows:

	<i>(in \$000's)</i>	
	<u>December 31, 2006</u>	<u>December 31, 2005</u>
Present value of future minimum lease payments	617	1,103
Less: current portion of principal payments	<u>375</u>	<u>443</u>
	<u>242</u>	<u>660</u>

Total repayments required for the years ending December 31:

	<i>(in \$000's)</i>	
	2007	2008
	414	247
Future minimum lease payments	661	44
Less: amounts representing interest	<u>44</u>	<u>617</u>
Present value of future minimum lease payment:	<u>617</u>	

The leases outstanding at December 31, 2006 bear interest at a weighted average annual rate of 8.59% per annum (December 31, 2005 - 8.75%).

**10. UNITHOLDERS' EQUITY****(a) Trust Units**

As at December 31, 2006, a total of 24,500,976 trust units (December 31, 2005 - 26,595,545) were issued and outstanding.

Commencing on December 29, 2006, Royal Host initiated a normal course issuer bid to repurchase a maximum of 2.0 million of its issued and outstanding trust units. During the year ended December 31, 2006, no trust units were repurchased pursuant to this bid. Subsequent to December 31, 2006, 28,100 trust units with an aggregate cost of \$0.2 million (average cost of \$6.49 per unit) were repurchased pursuant to this bid.

Commencing on December 29, 2005, Royal Host initiated a normal course issuer bid to repurchase a maximum of 1.8 million of its issued and outstanding trust units. During the year ended December 31, 2006, Royal Host repurchased 1.8 million trust units with an aggregate cost of \$11.1 million (average cost of \$6.19 per unit) pursuant to this bid. As at December 31, 2006, 1.6 million of these units were cancelled with the remaining 0.2 million units being cancelled in 2007.

Commencing on December 21, 2004, Royal Host initiated a normal course issuer bid to repurchase a maximum of 1.2 million of its issued and outstanding trust units. During the year ended December 31, 2005, Royal Host repurchased 1.2 million trust units at an aggregate cost of \$7.1 million (average cost of \$5.90 per unit) pursuant to this bid. As at December 31, 2005, 1.0 million of these units were cancelled with the remaining 0.2 million units being cancelled in January 2006.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

### Notes to the Consolidated Financial Statements

#### 10. UNITHOLDERS' EQUITY (continued)

##### (b) Redeemable Partnership Units

In May 2005, 3.2 million redeemable partnership units were redeemed by way of a combination of the issuance of 2.7 million Royal Host trust units and \$2.4 million in cash. The redeemable partnership units were held by entities controlled by certain officers and trustees, and former 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 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.

As at December 31, 2006, no redeemable partnership units were outstanding (December 31, 2005 - 10).

##### (c) Unit Options

As at December 31, 2006, Royal Host has unit options outstanding to certain consultants to purchase an aggregate of 0.1 million units (December 31, 2005 - 0.1 million units) at an exercise price of \$10.00 per unit (December 31, 2005 - \$10.00). All unit options were fully vested and exercisable at December 2006 and December 31, 2005. The options currently outstanding expire on October 31, 2007.

During the years ended December 31, 2006 and 2005, no unit options were issued or exercised and no unit options expired.

##### (d) Employee Unit Purchase Program

As at December 31, 2006, 0.1 million units (December 31, 2005 - 0.1 million units) were allotted pursuant to the Trust's Employee Unit Purchase Plan. During the year ended December 31, 2006, 0.3 million unallotted trust units were cancelled.

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 \$0.5 million (2005 - \$0.6 million) with respect to the program. These loans bear interest at a fixed rate of 3.0% per annum (2005 - 3.0%). This plan structure does not meet the definition of stock based compensation plans, and therefore does not fall under CICA Handbook Section 3870, "*Stock Based Compensation Plans*".

In accordance with EIC 132, "*Share Purchase Financing*", for accounting purposes, these employee loans receivable have been offset against the corresponding unit capital.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**11. PROPERTY IMPAIRMENT PROVISION**

During the fourth quarter of 2006, the Trust recorded a property impairment provision in discontinued operations of \$0.7 million relating to a hotel property in Orillia, Ontario.

During the third quarter of 2005, the Trust recorded a property impairment provision in discontinued operations of \$0.6 million relating to a timeshare property in Cabo San Lucas, Mexico. Royal Host sold its timeshare business effective December 31, 2006.

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.

**12. PER UNIT CALCULATIONS**

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 \$Nil (December 31, 2005 - \$378,000).

<b>For the year ended December 31, 2006:</b>	<u>(in \$000's)</u>	<u>Weighted Average Units (in 000's)</u>	<u>Per Unit (\$)</u>
Basic earnings - continuing operations	13,476		0.53
Basic earnings - discontinued operations	782		0.03
<b>Basic earnings - total operations</b>	<b>14,258</b>	<b>25,654</b>	<b>0.56</b>
Net earnings - continuing operations	13,476		
Add: notional conversion of convertible debentures	7,495	17,175	
Diluted earnings - continuing operations	20,971		0.49
Diluted earnings - discontinued operations	782		0.02
<b>Diluted earnings - total operations</b>	<b>21,753</b>	<b>42,829</b>	<b>0.51</b>
For the year ended December 31, 2005:	<u>(in \$000's)</u>	<u>Weighted Average Units (in 000's)</u>	<u>Per Unit (\$)</u>
Net earnings - continuing operations	1,838		
Less: distributions on redeemable partnership units	(378)		
Basic earnings - continuing operations	1,460		0.05
Basic earnings - discontinued operations	508		0.02
<b>Basic earnings - total operations</b>	<b>1,968</b>	<b>26,115</b>	<b>0.07</b>

The diluted earnings per unit for the year ended December 31, 2006 exclude trust units related to the conversion of the \$38.0 million 9.25% convertible debenture into trust units because the conversion was determined to be anti-dilutive.

The diluted earnings per unit for the year ended December 31, 2005 is the same as the basic amounts presented as all items that can result in units being issued are anti-dilutive.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**13. CHANGES IN NON-CASH WORKING CAPITAL**

	Years Ended (in \$000's)	
	December 31, 2006	December 31, 2005
<b>(Increase) decrease in:</b>		
Accounts and notes receivable	3,965	(4,032)
Prepaid expenses	247	202
Inventories	(24)	(157)
	<u>4,188</u>	<u>(3,987)</u>
<b>Increase (decrease) in:</b>		
Accounts payable and accrued liabilities	(8,550)	2,110
Interest accrued on convertible debentures	961	743
Other liabilities	202	(163)
Deferred revenue	(222)	(49)
Future income taxes	(127)	(408)
	<u>(7,736)</u>	<u>2,233</u>
	<u>(3,548)</u>	<u>(1,754)</u>

**14. FUTURE INCOME TAXES**

The net future income tax liability is calculated as follows:

	(in \$000's)	
	December 31, 2006	December 31, 2005
Tax assets relating to subsidiary operating losses and temporary differences on current items	931	3,100
Tax liabilities relating to temporary differences in long-term items	(7,479)	(9,041)
	<u>(6,548)</u>	<u>(5,941)</u>

The Trust conforms to an income tax status that allows it to deduct the distributions that are paid to Unitholders. The result is that no future income tax liabilities or assets are recognized on the temporary differences that occur within the Trust. As of December 31, 2006 the net book value of assets exceeded the tax value of assets within the Trust by \$1.4 million (2005 - \$1.8 million).

The Trust has tax losses of approximately \$3.1 million (2005 - \$8.6 million) available to reduce future taxable income within the subsidiaries owned by the Trust. The losses begin to expire in 2008 (\$0.1 million) with the majority of losses expiring in 2011 (\$1.6 million), 2015 (\$0.6 million) and 2026 (\$0.8 million). In 2005, additional deductions for tax purposes were identified and recorded. The 2005 corporate income tax returns for the subsidiaries of the Trust reflect this. The result was an increase in the losses available for carry forward in the subsidiaries of the Trust which increased the future income tax asset and resulted in a future income tax recovery. In 2006, the activities of the Trust resulted in the realization of some of the losses in the subsidiaries thereby reducing the loss carryforward amounts.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

## Notes to the Consolidated Financial Statements

**14. FUTURE INCOME TAXES** (continued)

The effective tax rate in the provision for income taxes differs from the combined federal and provincial statutory income tax rate for the following reasons:

	<i>(in \$000's)</i>	
	<u>December 31, 2006</u>	<u>December 31, 2005</u>
Earnings from continuing operations before future income taxes	<b>14,198</b>	(163)
Statutory income tax rate	<b>34.93%</b>	35.02%
<b>Calculated income tax provision based on statutory rates</b>	<b>4,959</b>	(57)
Increase (decrease) resulting from:		
Net income attributable to the Trust	<b>(3,544)</b>	(2,242)
Tax rate reductions	<b>(476)</b>	(131)
Non-deductible permanent differences	<b>27</b>	21
Other items	<b>(244)</b>	408
<b>Future income tax expense (recovery)</b>	<b>722</b>	(2,001)

On December 21, 2006 the Minister of Finance released for comment draft legislation concerning the taxation of certain publicly traded trusts and partnerships. The legislation reflects proposals originally announced by the Minister on October 31, 2006. Under the proposed legislation, certain distributions will not be deductible to publicly traded income trusts and partnerships with the exception of real estate investment trusts and, as a result, these entities will in effect be taxed as corporations on the amount of non-deductible distributions. For entities in existence on October 31, 2006, such as the Trust, the proposed rules, if passed into law, would not apply until 2011. Due to ambiguity in the proposed legislation, it is currently unclear whether the Trust will qualify as a real estate investment trust under the proposed rules.

**15. COMMITMENTS, CONTINGENCIES AND GUARANTEES**

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 definition of a guarantee pursuant to CICA Accounting Guideline 14 "Disclosure of Guarantees" ("AcG-14"). AcG-14 define 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.

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 32 of the 37 hotels owned by Royal Host (2005 - 34 of the 37 hotels). The franchise royalties and membership fees paid to external parties are calculated based upon percentages of defined revenue.

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**ROYAL HOST REAL ESTATE INVESTMENT TRUST**

Notes to the Consolidated Financial Statements

**16. OPERATING LEASES**

Certain property and equipment is leased under operating lease agreements expiring at varying intervals. Total future minimum rental payments required under these leases are as follows:

Years ending December 31:	<u>(in \$000's)</u>
2007	580
2008	461
2009	413
2010	379
2011	436
Thereafter	<u>1,628</u>
	<u>3,897</u>

**17. FINANCIAL INSTRUMENTS****(a) Fair Values**

Current assets and liabilities approximate their carrying values at December 31, 2006, 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:

	<b>December 31, 2006</b>		December 31, 2005	
	<i>(in \$000's)</i>		<i>(in \$000's)</i>	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Mortgages	<b>123,820</b>	<b>133,498</b>	126,922	137,474
Convertible debentures	<b>151,689</b>	<b>155,833</b>	133,052	138,400
Capital leases	<b>242</b>	<b>252</b>	660	664

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.

**(b) Credit Risk Management**

Credit risks arising from receivables from corporate accounts are minimized, as amounts due from any one debtor are not significant and routine credit assessments are carried out prior to credit being granted.

**18. CHANGES IN ACCOUNTING POLICIES****(a) Financial Instruments and Comprehensive Income**

The CICA has issued new sections related to financial instruments that are effective for the Trust starting January 1, 2007.

CICA Handbook Section 3855, "*Financial Instruments - Recognition and Measurement*" provides guidance on when a financial instrument must be recognized on the balance sheet and how it is to be measured. It also provides guidance on the presentation of gains and losses on financial instruments. The initial adoption of this new section will result in the Trust: (i) measuring financial assets classified as loans and receivables, and held to maturity, at their amortized cost, (ii) measuring financial assets and financial liabilities classified as held for trading, if any, at fair value with the related gains or losses on measurement recognized in net earnings, (iii) measuring financial assets classified as available-for-sale at fair value, with the related gains and losses on measurement recognized in "other comprehensive income", a new account introduced with the application of Section 1530 discussed below.

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## ROYAL HOST REAL ESTATE INVESTMENT TRUST

Notes to the Consolidated Financial Statements

### 18. CHANGES IN ACCOUNTING POLICIES (continued)

#### (a) Financial Instruments and Comprehensive Income (continued)

CICA Handbook Section 1530, "*Comprehensive Income*" requires an entity to recognize certain unrealized gains and losses in "other comprehensive income", an account included in unitholders' equity, until such gains and losses are realized and then recognized in net earnings, and requires the introduction of a statement of comprehensive income.

The transitional impact of these new standards is being evaluated by the Trust.

### 19. SUBSEQUENT EVENTS

Effective January 1, 2007, the Trust completed the sale of its US management business, resulting in a gain on disposition of approximately \$3.4 million US (Note 4).

Subsequent to December 31, 2006, \$5.6 million of Royal Host's 9.25% convertible unsecured subordinated debentures were converted into 0.8 million trust units and \$32.5 million of the 9.25% convertible unsecured subordinated debentures were redeemed upon maturity (see Note 8). Subsequent to December 31, 2006, \$1.6 million of Royal Host's 7.90% convertible unsecured subordinated debentures were converted into 0.3 million trust units and \$0.5 million of Royal Host's 6.00% convertible unsecured subordinated debentures were converted into 0.1 million trust units.

### 20. COMPARATIVE FIGURES AND RESTATEMENT

Certain comparative figures have been reclassified to conform to the presentation adopted for 2006.

Royal Host's financial statements for the periods ended December 31, 2002 through June 30, 2006 included changes in property under development and minority interest in cash from investing activities on Royal Host's Consolidated Statements of Cash Flows. Changes in property under development and minority interest have been retroactively restated to be included in cash from operating activities. The effects of the restatement are as follows: cash from operating activities for the year ended December 31, 2005 decreased by \$20,374,000 to (\$5,826,000), and cash from investing activities for the year ended December 31, 2005 increased by \$20,374,000 to \$3,646,000.

Royal Host's financial statements for the periods ended June 30, 2004 through June 30, 2006 included property held for sale in current assets on its Consolidated Balance Sheets. Property held for sale of \$2.7 million as at December 31, 2005 has been retroactively restated to be included in long-term assets.

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