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# **SIR ROYALTY INCOME FUND**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

### **SECOND QUARTER**

**UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2007**

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**SIR ROYALTY INCOME FUND**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
*(For the 3 and 6-month periods ended June 30, 2007)*

***Executive Summary***

Highlights for the 3-month period ended June 30, 2007 ("Q2") and 6-month period ended June 30, 2007 ("YTD"), for SIR Royalty Income Fund (the "Fund") include:

- On May 23, 2007, the Trustees authorized a 4.8% distribution increase to Unitholders. The monthly distributions increased from \$0.105 per unit to \$0.110 per unit beginning with the distribution paid in June 2007. This will increase the annualized distribution from \$1.26 to \$1.32.
- Net earnings before income taxes were \$1.8 million and \$3.5 million for Q2 and YTD 2007, respectively. Net earnings were \$0.9 million and \$2.7 million for Q2 2007 and YTD 2007, respectively as compared to \$1.8 million and \$3.5 million for Q2 2006 and YTD 2006, respectively. Net earnings per Fund Unit were \$0.18 and \$0.50 for Q2 2007 and YTD 2007, respectively as compared to \$0.33 and \$0.65 for Q2 2006 and YTD 2006 respectively. The decline in net earnings in Q2 and YTD 2007 is the result of the substantive enactment of the Department of Finance's proposed legislation on the taxation of certain publicly listed flow-through entities as described below.
- On October 31, 2006, the Federal Department of Finance announced a plan that proposes changes to the manner in which distributions from certain publicly listed flow-through entities ("FTE's") including income funds are taxed. However, existing Income Trusts would not be subject to this proposed taxation of distributions until the 2011 taxation year as long as the Fund meets the requirements for "normal growth". The proposed legislation has since received a third reading and therefore is considered to be substantively enacted. As a result, future income taxes have been calculated and recorded in the Q2 and YTD financial statements of the Fund.
- The payout ratio was 95.5% in Q2 of 2007 and 96.5% for YTD 2007, compared to 92.6% in Q2 of 2006 and 93.0% for YTD 2006. Please refer to footnotes 2 and 9 on page 5 and page 10, respectively for the definition and calculation of payout ratio.
- Pooled Revenue increased by 9.2% in Q2 of 2007 to \$41.0 million, from \$37.5 million in Q2 of 2006. YTD Pooled Revenue increased 8.1% to \$80.4 million from \$74.4 million in the same period last year.
- Same store sales growth<sup>(1)</sup> ("SSSG<sup>(1)</sup>") for restaurants in the Royalty pool for Q2 of 2007 was 4.1%, and 3.5% for YTD of 2007.
- SSSG<sup>(1)</sup> was positive in Q2 of 2007 and YTD 2007 for all of SIR Corp.'s ("SIR") Concept Restaurants (Jack Astor's®, Canyon Creek®, and Alice Fazooli's!®) as well as for the downtown Toronto Signature Restaurants: Jack Astor's SSSG<sup>(1)</sup> was 3.3% for Q2 and 2.4% YTD; Canyon Creek SSSG<sup>(1)</sup> was 4.5% for Q2 and 5.3% YTD; Alice Fazooli's! SSSG<sup>(1)</sup> was 6.5% for Q2 and 6.2% YTD; and the Signature Restaurants' SSSG<sup>(1)</sup> was 5.8% for Q2 and 5.3% YTD.
- On January 1, 2007, the Jack Astor's restaurant in Don Mills, Ontario was removed from the Royalty Pooled Restaurants and the three new Canyon Creek restaurants that opened in 2006 were added to the Royalty Pooled Restaurants.
- SIR opened Jack Astor's restaurants in Hamilton, Ontario on March 26, 2007 and in Dartmouth, Nova Scotia on May 7, 2007. It is expected that these two new restaurants will be added to the Royalty Pooled Restaurants on January 1, 2008.
- SIR has secured new sites for four new restaurants: three new Jack Astor's restaurants and a new Canyon Creek restaurant. One of the new Jack Astor's restaurants will replace an existing restaurant and as such, SIR anticipates closing one existing Jack Astor's location during the year upon opening of the new location.
- SIR has advised the Trustees that they have entered into a seven year, \$16.0 million maximum principal amount credit agreement. The credit agreement is designed primarily to facilitate the construction of new restaurants.
- While SIR is not owned by the Fund, the Fund is economically dependent upon SIR. SIR files its interim and annual consolidated financial statements and Management's Discussion and Analysis which, can be found on SEDAR under the Fund's listing named "Other". SIR's Q3 unaudited consolidated financial statements and MD&A are listed having a filing date of June 20, 2007.

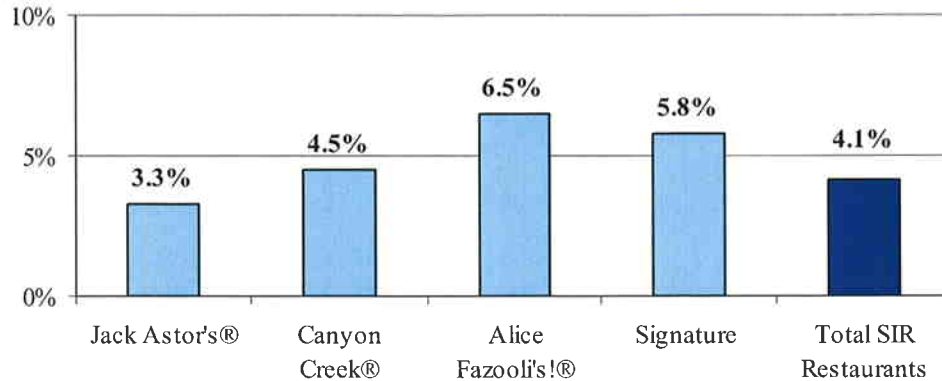
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(1) Same store sales ("SSS") and same store sales growth ("SSSG") are non-GAAP financial measures that do not have standardized meanings prescribed by GAAP. However, the Fund believes that SSS and SSSG are useful measures and provide investors with an indication of the change in year-over-year sales. The Fund's method of calculating SSS and SSSG may differ from those of other issuers and, accordingly, SSS and SSSG may not be comparable to measures used by other issuers.

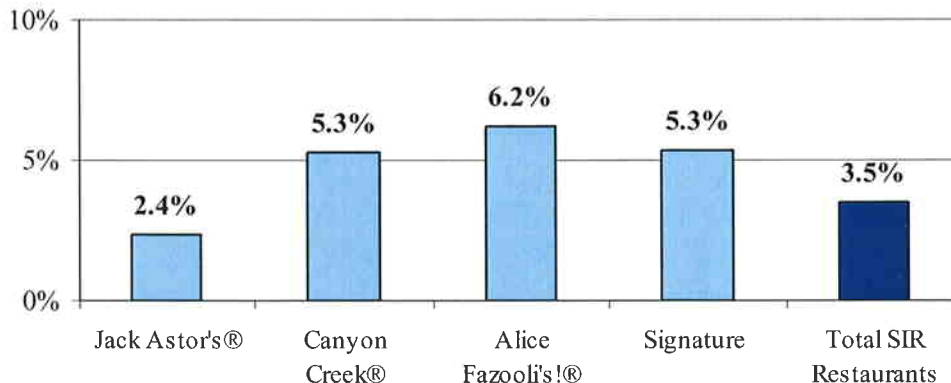
SSS includes revenue from all SIR Restaurants included in Pooled Revenue except for the Jack Astor's® location in Don Mills, Ontario and the Canyon Creek® locations in Scarborough, Vaughan, and at the Fallsview Casino Resort in Niagara Falls, Ontario because they were not open for the entire period of both 2007 and 2006. SSSG is the percentage increase in SSS over the prior comparable period.

**Same Store Sales Growth<sup>(1)</sup>**  
 (unaudited)

**Same Store Sales Growth<sup>(1)</sup> for the 3-month period ended  
 June 30, 2007**



**Same Store Sales Growth<sup>(1)</sup> for the 6-month period ended  
 June 30, 2007**



SIR reported to the Fund that SSSG<sup>(1)</sup> was 3.5% for YTD 2007, which is over and above the exceptional SSSG<sup>(1)</sup> of 9.1% experienced in the prior year (please see the table on the following page).

SSSG<sup>(1)</sup> for Jack Astor's was 2.4% YTD of 2007. This growth was achieved on top of the SSSG<sup>(1)</sup> of 9.6% experienced in the prior year. The Jack Astor's evolution program started in 2004 and now only one of the Jack Astor's currently operating remains to be evolved. The evolved Jack Astor's restaurants experienced strong SSSG<sup>(1)</sup>, averaging over 10% in the first year following the year of evolution. Now that the program is near completion and most of the evolved restaurants have been evolved for more than one year, the velocity of Jack Astor's SSSG<sup>(1)</sup> driven by evolutions is reduced. SIR's management believes that changes in smoking legislation in Ontario and Quebec are negatively affecting bar sales, particularly in those restaurants that previously benefited from Designated Smoking Rooms in their bars. SIR's management believes that the effect of the Smoke-Free Ontario Act will be mitigated over time and believes that the effect will be lessened during the summer months when patios are open. Initial results support the second premise, as we begin to see our patio sales rebounding in the second quarter of 2007.

(1) See footnote (1) on page 2.

Canyon Creek continues to perform well, with SSSG<sup>(1)</sup> of 5.3% during YTD 2007 again on top of strong SSSG<sup>(1)</sup> of 8.5% in YTD 2006. The Canyon Creek restaurant located in Etobicoke, Ontario (across from Sherway Gardens) was closed for 11 days during the Quarter for a major renovation. This location was SIR's first Canyon Creek restaurant and it celebrated its 10<sup>th</sup> anniversary this summer. This update to both, the interior and exterior of the restaurant better reflects Canyon Creek's positioning within the market as a chophouse and shows SIR's continued dedication to operating restaurants that are best in their class. The restaurant reopened on June 29, 2007.

The performance of Alice Fazooli's! is strong with SSSG<sup>(1)</sup> in YTD 2007 of 6.2%. This growth is on top of the SSSG<sup>(1)</sup> of 9.5% experienced in the prior year.

During YTD 2007, the Signature Restaurants, which are located in downtown Toronto, had SSSG<sup>(1)</sup> of 5.3%. The revenues for Brasserie Frisco™ were marginally better than the prior year and Armadillo Texas Grill®/the Loose Moose® revenues were below the prior year. These results are offset by positive SSSG<sup>(1)</sup> at Far Niente®/Soul of the Vine® and reds®. SSSG<sup>(1)</sup> was 6.7% in the prior year.

SSSG <sup>(1)</sup> for Restaurants in the Royalty pool	6-month period ended	6-month period ended
	June 30, 2007 (unaudited)	June 30, 2006 (unaudited)
Jack Astor's®	2.4%	9.6%
Canyon Creek Chop House®	5.3%	8.5%
Alice Fazooli's! ®	6.2%	9.5%
Signature Restaurants	5.3%	6.7%
<b>Overall SSSG<sup>(1)</sup></b>	<b>3.5%</b>	<b>9.1%</b>

### ***Restaurant Renovations and Advertising***

SIR used a significant portion of the proceeds of the Fund's IPO to invest in its existing restaurants to drive SSSG<sup>(1)</sup>. As at June 30, 2007 evolutions of 19 Jack Astor's restaurants had been completed (four of these had been completed prior to the IPO). These evolutions continue to drive sales in Jack Astor's restaurants. The renovations at the five Alice Fazooli's! restaurants which were completed during 2005 and 2006 have also delivered strong SSSG<sup>(1)</sup> on average, in excess of 10% in the first full year after the renovation. A renovation was completed at reds during Q3 of 2006. During Q4 of 2005, extensive renovations were completed at Far Niente in downtown Toronto. These renovations are driving increased guest counts and SSSG<sup>(1)</sup>. During Q2 of 2007, a major renovation was completed at the Canyon Creek located across from Sherway Gardens in Etobicoke, Ontario.

Since the IPO, SIR has increased its investment in marketing initiatives. In particular, Jack Astor's with 24 restaurants (which in YTD of 2007 represented approximately 59.8% of Pooled Revenue) has benefited from radio-based campaigns created by a leading North American advertising agency. For the 2006 campaigns, Jack Astor's earned Gold recognitions at the London International Advertising Awards (for its Italian Festival) and also at the Canadian Marketing Association Awards. During Q2 of 2007, Alice Fazooli's! ran its first multiple station radio campaign. The campaign aired on two major radio stations in the Greater Toronto Area and focused on the casual and inviting atmosphere that our newly renovated restaurants offer as well as the fresh and flavourful Italian food that guests enjoy at SIR's five Alice Fazooli's! locations. Subsequent to Q2 of 2007, Canyon Creek ran its first multiple station radio campaign. The campaign focused on Canyon Creek's attention to details and its 10<sup>th</sup> anniversary and aired on three major radio stations in the Greater Toronto Area.

### ***New and Closed Restaurants***

During 2006, SIR opened three Canyon Creek restaurants (Scarborough, Ontario in Q1, Vaughan, Ontario in Q2, and at the Fallsview Casino Resort in Niagara Falls, Ontario in Q3). Each of these three restaurants was added to the Royalty Pooled Restaurants on January 1, 2007. In return, SIR Royalty Limited Partnership ("the Partnership") paid SIR, in Partnership securities exchangeable for Units of the Fund, an amount intended to reflect the value to the Partnership of the increased future Royalty stream related to these restaurants, in accordance with the formula described in the Limited Partnership Agreement of SIR Royalty Limited Partnership (the "Partnership Agreement"). These adjustments for new revenues that will be part of the Royalty pool are designed to be accretive for Fund Unitholders.

(1) See footnote (1) on page 2.

One Royalty Pooled Restaurant has been closed since the IPO was completed. On May 27, 2006 the Jack Astor's in Don Mills, Ontario was closed. This location has been demolished by the landlord and is to be redeveloped into a major "lifestyle mall". It is expected that this project will be completed in the second half of 2008 and that a new Jack Astor's would open in this location at that time. Under the terms of the License and Royalty Agreement, SIR paid a Make-Whole Payment for this location from the date of the closure until December 31, 2006. In accordance with the Partnership Agreement, the revenue of the closed restaurant was netted against the revenue of the new SIR Restaurants opened from November 2, 2005 to November 1, 2006, to reduce the number of Class B GP Units of the Partnership, held by SIR, which were converted into Class A GP Units of the Partnership on January 1, 2007.

During Q1 of 2007, SIR opened a new Jack Astor's restaurant in Hamilton, Ontario on March 26, 2007. During Q2 2007, SIR opened a new Jack Astor's restaurant, in Dartmouth, Nova Scotia on May 7, 2007. It is expected that these new restaurants would be added to the Royalty Pooled Restaurants on January 1, 2008.

SIR has also secured new sites for three new Jack Astor's restaurants and a new Canyon Creek restaurant. One of these new sites is for a Jack Astor's restaurant at the corner of Dundas and Yonge Streets in Toronto, Ontario, which is expected to open in fiscal 2008. A new site has been secured near the Toronto Pearson International Airport for a Jack Astor's and a Canyon Creek which are also expected to open in fiscal 2008. And lastly, a new site is located in Burlington, Ontario. It is expected that the existing Jack Astor's restaurant in Burlington will be closed and a new Jack Astor's would open at the new site in Burlington. In respect of the closed Burlington restaurant, SIR would be required to pay a Make-Whole Payment from the date of closure to December 31, 2007. Effective January 1, 2008, the closed restaurant would be removed from the Royalty Pooled Restaurants' as a New Closed Restaurant. The new site is expected to provide higher revenues and therefore a greater Royalty stream to the Partnership. The new Jack Astor's restaurant in Burlington is expected to open in Q4 of 2007 and provided that it opens before November 1, 2007, it would be added to the Royalty Pooled Restaurants effective January 1, 2008.

### ***Distributions***

Distributions to Unitholders are intended to be made monthly in arrears based on distributable cash<sup>(2)</sup> and cash redemptions of Fund Units and subject to the Fund retaining such reasonable working capital and other reserves as may be considered appropriate by the Trustees of the Fund. The Fund's intention, with the assistance of SIR, is to pay even distributions, and if possible, allow the Fund to maintain consistent monthly distributions to Unitholders. The Fund intends to make monthly distributions of its available distributable cash<sup>(2)</sup> to the extent possible and has paid its expected monthly cash distribution of \$0.10 per Unit per month since inception. On May 24, 2006 the Trustees authorized a 5.0% distribution increase to Unitholders and on May 23, 2007, the Trustees authorized a further 4.8% increase in distributions to the Unitholders. The monthly distributions increased from \$0.10 per Unit to \$0.105 per Unit beginning with the distribution paid in June 2006 and to \$0.110 per Unit beginning with the distribution paid in June 2007. The estimated annualized distribution is now \$1.32.

The payout ratio<sup>(2)</sup> of cash distributed to distributable cash<sup>(2)</sup> is intended to average 100% per annum over the longer term. Since the Fund pays even monthly distributions when its underlying cash flow from the Partnership is subject to seasonal fluctuations (as experienced by SIR), there are times during the year when the payout ratio<sup>(2)</sup> may exceed 100%. The payout ratio<sup>(2)</sup> for the fourth quarter of 2006 was affected by the \$0.23 million Priority Special Conversion Distribution ("Conversion Distribution") paid by the Partnership. The payout ratio<sup>(2)</sup> in Q2 of 2007 was 95.5% compared to 92.6% for the same period in 2006.

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(2) *Distributable cash and payout ratio are non-GAAP financial measures and do not have a standardized meaning prescribed by GAAP. However, the Fund believes that distributable cash and the payout ratio are useful measures as they provide investors with an indication of cash available for distribution. The Fund's method of calculating distributable cash and the payout ratio may differ from that of other issuers and, accordingly, distributable cash and the payout ratio may not be comparable to measures used by other issuers. Investors are cautioned that distributable cash and the payout ratio should not be construed as an alternative to the statement of cash flows as a measure of liquidity and cash flows of the Fund. The payout ratio is calculated as cash distributed for the period as a percentage of the distributable cash for the period. Distributable cash represents the amount of money which the Fund expects to have available for distribution to Unitholders of the Fund, and is calculated as cash provided by operating activities of the Fund, adjusted for the net change in non-cash working capital items.*