
SIR ROYALTY INCOME FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

FOR THE YEAR ENDED DECEMBER 31, 2006

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YEAR ENDED DECEMBER 31, 2006
(For the 12-month periods ended December 31, 2006)

Executive Summary

Highlights for the 3-month periods ended December 31, 2006 ("Q4") and the 12-month periods ended December 31, 2006 ("YTD"), include:

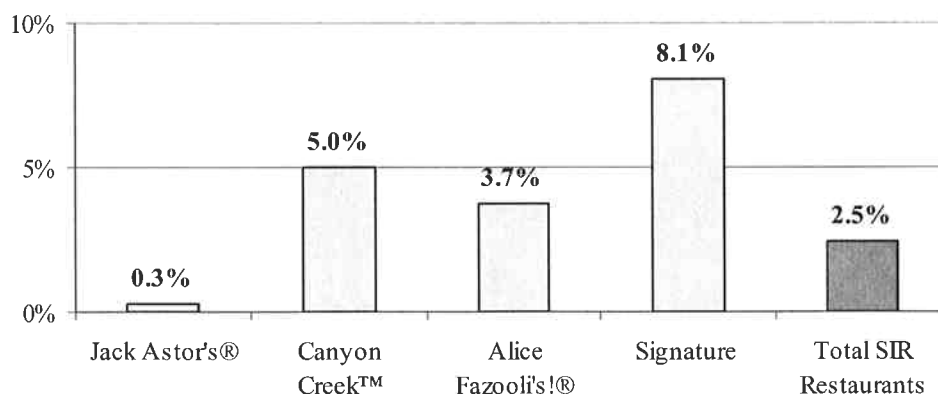
- Annual net earnings increased to \$6.9 million in 2006, from \$6.5 million in 2005 and in Q4 of 2006 decreased to \$1.6 million, from \$1.8 million in Q4 of 2005.
- Annual net earnings per Fund Unit increased to \$1.29 in 2006, from \$1.21 in 2005 while net earnings per Fund Unit decreased to \$0.31 in Q4 of 2006, from \$0.33 in Q4 of 2005.
- The annual payout ratio was 96.1% in 2006, compared to 99.4% in 2005 while the payout ratio for Q4 of 2006 was 102.8%, compared to 91.0% in Q4 of 2005. Please refer to footnotes 10 and 12 on page 11 for the definition and calculation of payout ratio.
- The net earnings, distributable cash, and payout ratios for the fourth quarter were affected by the \$0.23 million Priority Special Conversion Distribution ("Conversion Distribution") paid by the SIR Royalty Limited Partnership (the "Partnership"). This distribution was paid on the Class B GP Units that were converted to Class A GP Units, effective January 1, 2007 related to the Second Incremental Adjustment for the restaurants added to the Royalty pool effective January 1, 2006. As no new restaurants were added to the Royalty pool effective January 1, 2005, there was no similar adjustment in the fourth quarter of 2005.
- Pooled Revenue increased by 9.9% in Q4 of 2006 to \$38.7 million, from \$35.2 million in Q4 of 2005 and YTD Pooled Revenue increased by 14.8% to \$149.5 million in 2006, from \$130.2 million in 2005.
- Same store sales growth⁽¹⁾ ("SSSG⁽¹⁾") for restaurants in the Royalty pool for Q4 of 2006 was 2.5% compared to Q4 of 2005 and SSSG⁽¹⁾ was 5.9% for the YTD of 2006 compared to 2005.
- SSSG⁽¹⁾ was positive in Q4 and the YTD of 2006 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 compared to prior year: Jack Astor's SSSG⁽¹⁾ was 0.3% for Q4 and 5.5% YTD; Canyon Creek SSSG⁽¹⁾ was 5.0% for Q4 and 7.4% YTD, Alice Fazooli's! SSSG⁽¹⁾ was 3.7% for Q4 and 8.3% YTD, and the Signature Restaurants' SSSG⁽¹⁾ was 8.1% for Q4 and 4.2% YTD.
- Three Jack Astor's evolutions were completed YTD in 2006 (none in Q4). All but one of the Jack Astor's currently operating has now been evolved.
- reds® was closed for 11 days in Q3 for renovations. Management is pleased with the results of these renovations.
- During 2006, two Alice Fazooli's! restaurants were renovated (one completed in the first quarter and the second completed in Q4). Now, all five Alice Fazooli's! restaurants have been renovated since the Initial Public Offering ("IPO"). The renovated Alice Fazooli's! restaurants are averaging revenue increases in the first full year after the renovation in excess of 10%.
- The two Jack Astor's restaurants that opened in 2005 became part of the Royalty pool effective January 1, 2006.
- Subsequent to year-end, SIR opened a Jack Astor's in Hamilton, Ontario on March 26, 2007. SIR has also secured two additional sites for Jack Astor's restaurants, one of which is planned to open in 2007 and the other is planned to open in 2008.

(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 except for the Jack Astor's® locations in Whitby, on Front Street in Toronto and in Don Mills, Ontario because they were not open for the entire year of both 2005 and 2006. SSSG is the percentage increase in SSS over the prior comparable period.

- Three new Canyon Creek restaurants were opened in 2006. Each of these three restaurants was added to the Royalty pool effective January 1, 2007.
- On May 24, 2006 the Trustees authorized a 5.0% distribution increase to Unitholders. The monthly distributions increased from \$0.100 per Unit to \$0.105 per Unit beginning with the distribution paid in June 2006. This will increase the estimated annualized distribution from \$1.20 to \$1.26.
- During Q2 of 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 a new Jack Astor's would open in this location at that time. SIR was required to pay a Make-Whole Payment for this location from the date of the closure until December 31, 2006. On January 1, 2007, 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 determine 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 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 so long as the Fund meets the requirements for "normal growth". On December 21, 2006, the Federal Department of Finance issued draft legislation on the proposed taxation legislation for public comment. On March 27, 2007, the Minister of Finance issued a Notice of Ways and Means Motion to implement the draft legislation. The Trustees of the Fund and senior management of SIR will continue to monitor this development.
- While SIR is not owned by the Fund, the Fund is economically dependent upon SIR. SIR files it's interim and annual consolidated financial statements and MD&A which, can be found on SEDAR under the Fund's listing named "Other". SIR's Q2 consolidated financial statements and MD&A are listed having a filing date of March 28, 2007.

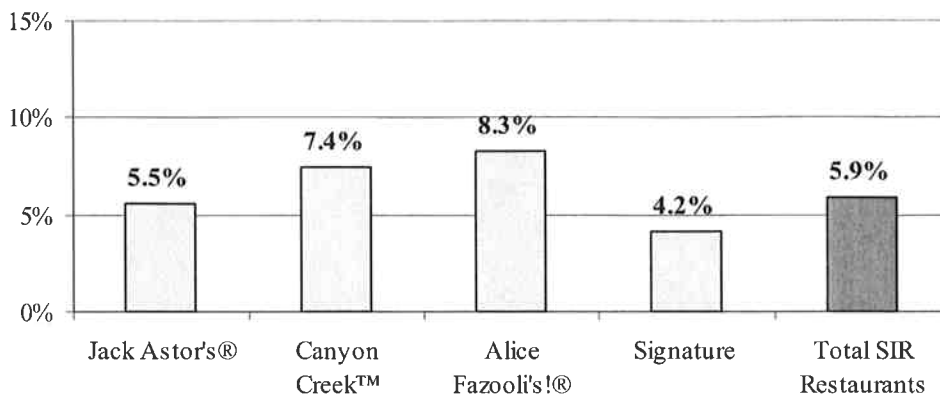
Same Store Sales Growth⁽¹⁾
(unaudited)

**Same Store Sales Growth for the 3-month period ended December 31,
2006 vs same period in prior year**



(1) See footnote (1) on page 3.

Same Store Sales Growth for the 12-month period ended December 31,
 2006 vs same period in prior year



SIR reported to the Fund that SSSG⁽¹⁾ was 2.5% and 5.9% respectively for the Q4 of 2006 and YTD of 2006 versus the comparable periods in the prior year.

SIR's Management attributes the strong YTD performance of Jack Astor's in large part due to evolutions of existing restaurants. The 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 average SSSG⁽¹⁾, 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⁽¹⁾ 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 anticipates that the effect will be lessened during the summer months when patios are open.

Canyon Creek continues to perform well, with SSSG⁽¹⁾ of 5.0% during Q4 2006 compared to the prior year. SSSG⁽¹⁾ was 7.4% for the YTD of 2006 compared to the YTD of 2005.

The performance of Alice Fazooli's! continues to improve. SSSG⁽¹⁾ in Q4 of 2006 was 3.7%. YTD SSSG⁽¹⁾ was 8.3% compared to the prior year. This YTD growth was achieved even though the dining room of the Alice Fazooli's! in downtown Toronto was closed for nine days during the first quarter for renovations and during Q4, the Alice Fazooli's! in Mississauga was closed also for nine days for renovations and an expansion of the bar. All five of the Alice Fazooli's! locations have now been renovated since the IPO.

During Q4, the Signature Restaurants, which are located in downtown Toronto, had SSSG⁽¹⁾ of 8.1%. Brasserie Frisco™ and Armadillo Texas Grill®/the Loose Moose® revenues were below the prior year during Q4. These declines in Q4 were offset by positive SSSG⁽¹⁾ at Far Niente®/Soul of the Vine® and reds. On a YTD basis the SSSG⁽¹⁾ for the Signature Restaurants remains positive at 4.2%. During Q3 of 2006, reds was closed 11 days for renovations. During Q4 of 2005, Far Niente was closed for approximately three weeks for renovations.

During Q1 and part of Q2 of 2005, the NHL lockout had a significant negative effect on the revenue of the Signature Restaurants. The same group of restaurants benefited from the end of the lock-out over the same period in 2006. In addition, Signature Restaurants' sales benefited from increased sales at Far Niente after the major renovations in the fall of 2005.

(1) See footnote (1) on page 3.

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⁽¹⁾. As at December 31, 2006 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. The renovations at the five Alice Fazooli's! restaurants which were completed during 2005 and 2006 have also delivered strong SSSG⁽¹⁾ on average, in excess of 10% in the first full year after the renovation. A renovation was completed at reds during Q3 of 2006 (from August 28 to September 7, 2006). During mid-October 2005 through November 7, 2005, extensive renovations were completed at Far Niente in downtown Toronto. These renovations are driving increased guest counts and SSSG⁽¹⁾ going forward.

Since the IPO, SIR has increased its investment in marketing initiatives. In particular, Jack Astor's with 22 restaurants (which in Q4 of 2006 represents approximately 61.5% of Pooled Revenue) has benefited from radio-based campaigns created by a leading North American advertising agency.

New and Closed Restaurants

SIR opened two new restaurants during the Fund's fiscal 2005 year: Jack Astor's at Front Street and University Avenue in downtown Toronto in February 2005, and Jack Astor's in Whitby, Ontario, at the end of August 2005. These restaurants became part of the Royalty Pooled Restaurants on January 1, 2006, at which time 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 License and Royalty Agreement. This adjustment for new revenues that will be part of the Royalty pool is designed to be accretive for Fund Unitholders.

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 subsequent to year-end on January 1, 2007.

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 License and Royalty 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.

Subsequent to year-end, SIR opened a Jack Astor's in Hamilton, Ontario on March 26, 2007. SIR has also secured two additional sites for Jack Astor's restaurants, one of which is planned to open in Dartmouth, Nova Scotia during 2007 and the other at the corner of Dundas and Yonge Streets in Toronto, Ontario during 2008.

Distributions

Distributions to Unitholders are intended to be made monthly in arrears based on distributable cash 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 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. The monthly distributions increased from \$0.10 per Unit to \$0.105 per Unit beginning with the distribution paid in June 2006. This will increase the estimated annualized distribution from \$1.20 to \$1.26.

The payout ratio of cash distributed to distributable cash is intended to average 100% per annum over the longer term. Since the Fund pays even monthly distributions when it's 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 may exceed 100%. The payout ratio for the fourth quarter of 2006 was affected by the \$0.23 million Conversion Distribution paid by the Partnership. YTD, the payout ratio in 2006 was 96.1% compared to 99.4% for the same period in 2005.

(1) See footnote (1) on page 3.