

STABILITY

THROUGH

Discipline



Profile Incorporated in 1996, H&R Real Estate Investment Trust owns, manages and acquires income-producing properties, and provides mezzanine financing for development projects that are substantially pre-leased. A significant portion of H&R's cash is distributed to unitholders each month and much of it is tax deferred. H&R manages a diversified portfolio of office, industrial and retail properties under the direction of a Board of Trustees, and investment opportunities are subject to specific guidelines and approval of the Trustees. Units of the trust have traded since 1996 on the Toronto Stock Exchange (symbol: HR.UN).

Primary Objectives H&R REIT pursues two primary objectives: to provide unitholders with reliable and growing cash distributions from its portfolio of income-producing properties, and to increase the value of units through active management of H&R's assets, accretive acquisition of additional properties, and funding of new developments in which the REIT holds a purchase option. H&R is committed to maximizing cash distributions and capital appreciation for unitholders while maintaining prudent risk management and conservative use of financial leverage.

Diversification of Rental Area

	Ontario	United States	Alberta	Quebec & other	Total
Office	16%	1%	4%	2%	22%
Industrial	25%	18%	5%	9%	58%
Retail	3%	11%	2%	5%	20%
Total	43%	30%	11%	16%	100%

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2005 Highlights

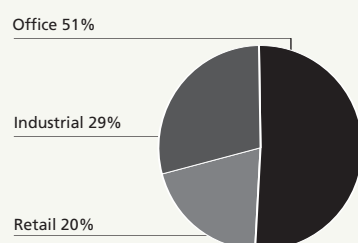
Stability

- Maintained portfolio occupancy rate at 99% for the eighth consecutive year
- Increased Distributable Income 16% through quality acquisitions
- Distributions per unit rose 5%
- Reached milestones of \$3.8 billion in net book value of assets, \$150 million in distributable income, \$1.2 billion in unitholders' equity, a market price of \$20 per unit, and \$2.3 billion in market capitalization

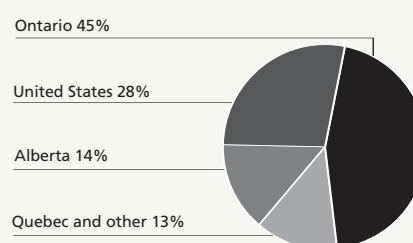
Through Discipline

- Maintained long terms to maturities for leasing (12.3 years) and financing (11.1 years) at year end
- Added 4.7 million square feet to portfolio with \$618 million of acquisitions, generating 11% return on investment
- Raised \$250 million through two financings to maintain sound capital structure

Operating Income by Type of Asset



Book Value by Geographic Region



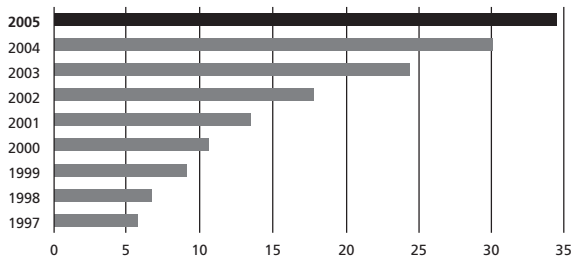
	2005	2004	2003
Rental income (millions)	\$ 486	\$ 402	\$ 319
Net earnings (millions)	\$ 87	\$ 89	\$ 91
NE per unit (basic)	\$ 0.91	\$ 1.00	\$ 1.21
Distributable income* (millions)	\$ 150	\$ 129	\$ 104
Distributable income per unit (basic)*	\$ 1.46	\$ 1.44	\$ 1.40
Distributions to unitholders (millions)	\$ 135	\$ 113	\$ 92
Distributions per unit (basic)	\$ 1.30	\$ 1.24	\$ 1.22
Assets (billions)	\$ 3.8	\$ 3.3	\$ 2.7
Unitholders' equity (billions)	\$ 1.2	\$ 1.0	\$ 1.0
Weighted average number of units, basic (millions)	102	90	75

* Distributable income is a non-GAAP measure described in the MD&A.

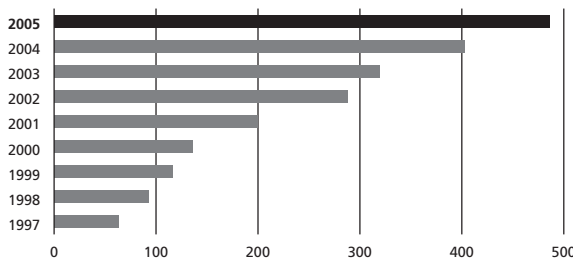
Long-term Financial Performance

As one of the first diversified REITs in Canada, H&R has an enviable track record of solid financial performance. We have built a strong, diversified portfolio by applying a strict discipline to our investment decision-making. As a result, H&R unitholders have been rewarded with stable, growing distributions and continual capital appreciation.

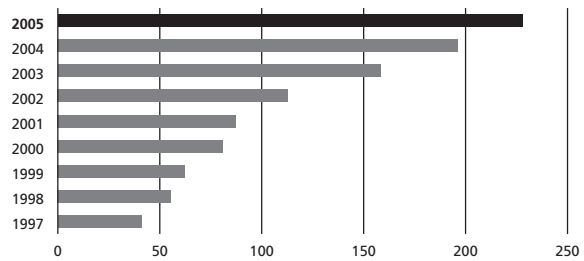
Leasable Area (square feet, millions)



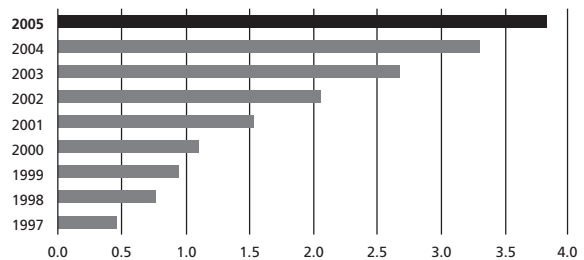
Rentals from Income Properties (\$ millions)



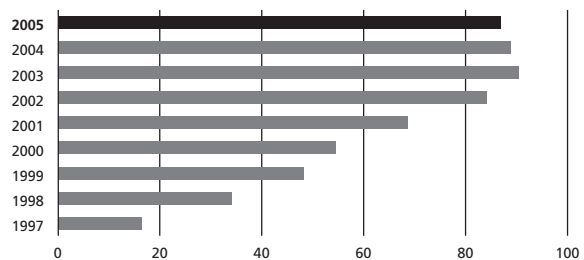
Number of Properties



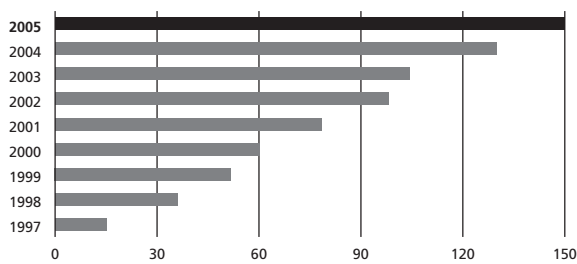
Assets (\$ billions)



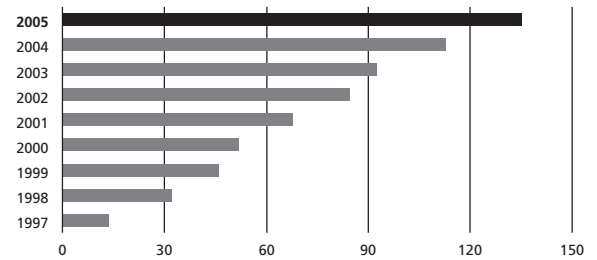
Net Earnings (\$ millions)



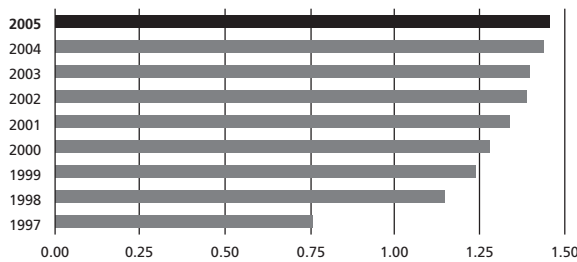
Distributable Income* (\$ millions)



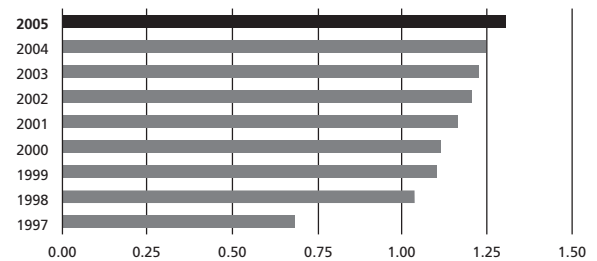
Distributions to Unitholders (\$ millions)



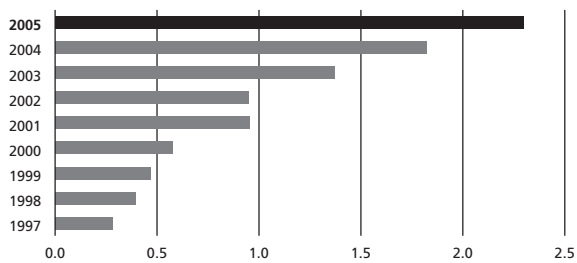
Distributable Income Per Unit* (\$)



Cash Distributions per Unit (\$)



Market Capitalization (\$ billions, year end)



* Distributable income is a non-GAAP measure described in the MD&A.

President's Message to Unitholders

SINCE INCEPTION TEN YEARS AGO, H&R HAS PRODUCED AN AVERAGE ANNUAL 18% RETURN ON INVESTMENT FOR UNITHOLDERS.

We deliver Expected Results

With steady, profitable growth, H&R Real Estate Investment Trust is placed among the fastest-growing and most highly valued REITs in Canada. H&R produced a return on investment to unitholders of 16% in 2005 and a compound average annual 18% since inception in 1996, including both capital appreciation and distributions.

Year after year, H&R has delivered consistent and dependable financial performance; 2005 was no exception. After kick-starting the year with a nearly 5% increase in distributions to unitholders, we continued to expand and strengthen our portfolio with investments across North America totalling \$618 million. The additional properties, together with higher overall portfolio occupancy and contractual rental increases, contributed to H&R's 16% growth in distributable income last year. We closed off 2005 announcing the \$229-million purchase of two state-of-the-art Canadian Tire distribution facilities in Toronto and Calgary, which expanded our portfolio by almost 6%. Unitholders may also remember 2005 as the one when we reached \$150 million in distributable income and \$20 in unit price. And early this year, they received another 2.3% increase in distributions per unit.

We are committed to a Disciplined Strategy

Our success over the past decade has been founded on a well proven, conservative strategy that churns out reliable and growing distributable income. We have an experienced and diligent management team that has executed and fine-tuned our two-part strategy, which ultimately provides **stability through discipline**.

We believe in Locking in Yield

Our first strategic focus is on establishing strong, stable cash flow by locking in our portfolio's income yield regardless of real estate cycles. We do this by signing long-term leases with highly creditworthy tenants, and building in growth in rental income where possible through contractual rental escalations. For example, in

Harbour Place/Commerce Tower office complex

Location: Sydney, Nova Scotia
 Rentable area: 125,000 square feet

Highlights: This is one of two office buildings H&R acquired for \$25 million; approximately 78% of the space is leased long term to provincial and federal government agencies.

**Give & Go freezer building**

Location: Greater Toronto Area
 Rentable area: 114,000 square feet

Highlights: H&R purchased this new, freezer building in Etobicoke, Ontario for \$12 million; it is leased for 15 years to Give & Go Prepared Foods Corp.

**Bi-Lo retail store**

Location: Dayton, Tennessee
 Rentable area: 46,000 square feet

Highlights: This is one of seven Bi-Lo/Bruno free-standing retail stores comprising 316,000 square feet acquired for \$59 million by H&R in the southern United States, and leased for 20 years.

**Angiotech Pharmaceuticals office building**

Location: Vancouver, Canada
 Rentable area: 73,000 square feet

Highlights: H&R purchased this \$21-million, state-of-the-art biotech/office building, which is leased for 15 years to a dual-listed, world leader in the emerging field of drug-coated medical devices and biomaterials.

Average Years to Maturity



addition to all other rental escalations across the portfolio in 2006, the net rental revenue for 1.2 million square feet of space leased to TransCanada Pipelines and TELUS in Calgary will automatically increase on an annualized basis by \$3 million.

We intentionally negotiate for long-term leases so that their maturities are spread out over time. The average term to maturity of our leases was 12 years at year end 2005, with only 15% of space coming up for renewal over the next five years – thereby minimizing our downside exposure to potential adverse market conditions upon expiry. Moreover, we strive to match the long-term leases with long-term financing at all our properties, of which as much as 97% is at fixed interest rates, with an average interest rate of 6.6% and term to maturity of 11 years. Here too, we spread out financing maturities into the future, so that only 24% of our mortgages will mature over the next five years.

We reduce risk through Quality and Diversification

Our second strategic focus is on building a portfolio that can withstand the inevitable economic and real estate cycles in various markets and generate a dependable income stream. We grow the portfolio through acquisitions, new developments or expansions, ensuring that every investment is accretive to the REIT's bottom line – the \$618 million we invested in 2005, in fact, produced an average levered return of 11%. But in the process, we try to maintain a balanced mix of properties, in the industrial, office and retail segments, and in a broad variety of urban markets throughout Canada and the United States.

H&R now owns a critical mass of commercial real estate that ensures stability and minimizes risk. Case in point, the REIT's overall portfolio occupancy rate has been over 99% for the past eight consecutive years – that translates into stability. And with an average building age of 12 years, the portfolio has durability. We are also building quality and resilience into the portfolio through mezzanine financing of development projects and selective pruning of non-core assets. Two industrial facilities we purchased last year – a \$60 million distribution warehouse and an \$11 million freezer building, both in the Greater Toronto Area – were part of our mezzanine financing program.

TransCanada office tower

Location: Calgary, Alberta

Rentable area: 936,000 square feet

Highlights: H&R will benefit from a substantial rental uplift in 2006 resulting from contractual rent escalations that are part of its 20-year lease.



AFTER GROWING A COMPOUND AVERAGE 30% PER YEAR SINCE 1997, H&R'S MARKET CAPITALIZATION REACHED \$2.3 BILLION AT YEAR END 2005.

We maintain Financial Flexibility

While building H&R REIT into a major real estate enterprise, we've been careful to maintain a solid balance sheet that provides us with the financial flexibility to seize attractive acquisition opportunities. Our strong financial position allowed us to raise capital twice in 2005, with \$100-million and \$150-million, bought-deal, public offerings of units. Proceeds of these successful financings were used primarily to fund accretive acquisitions. Our ratio of debt-to-GBV at year end 2005 of 61% was in line with our self-imposed guideline maximum of 65%, which we believe is conservative given our long-term leases and the increasing proportion of total debt that is non-recourse – 56% at year end.

We are increasing Market Value

H&R's unit price has risen progressively as the investment market has applied a premium value to the quality of our portfolio, our disciplined strategy and steady performance. The market capitalization of H&R REIT reached \$2.3 billion by year end 2005, having grown a compound average 30% per year since 1997. The REIT's unit price has also been buoyed by popular demand for tax-efficient, yield investment vehicles, increased capital inflows from pension and index funds and foreigners, and low interest rates. The liquidity of H&R units, as measured by trading volume, has also risen steadily over the years, and we expect that inclusion of H&R's units in the S&P/TSX Composite Index last December will further increase that liquidity and the breadth of our institutional investors.

We are confident Looking Forward

It is increasingly important, yet difficult, to anticipate how the future may unfold. Taking an optimistic view, North American economies and commercial real estate market fundamentals are generally robust. In Canada, occupancy and rental rates are relatively stable in the retail and industrial sectors and expected to rise in most major office markets, and we foresee limited new speculative development occurring in all property sectors.

Nestlé distribution facility

Location: DeKalb, Illinois

Rentable area: 861,000 square feet

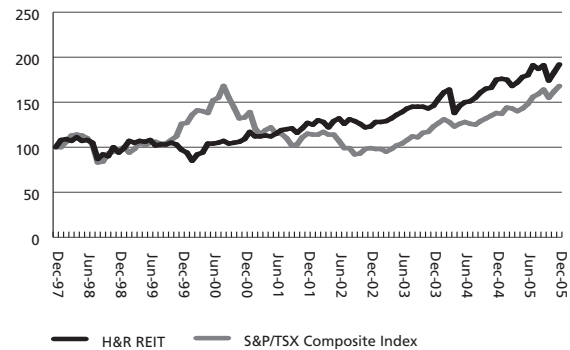
Highlights: This is one of three state-of-the-art distribution centres H&R acquired for \$169 million in the suburbs of Chicago, Atlanta and Dallas with a total 2.2 million square feet leased to Nestlé USA.

**Bell Mobility office complex**

Location: Mississauga, Ontario

Rentable area: 775,000 square feet

Highlights: After providing mezzanine financing for construction, H&R exercised its option to acquire the \$69-million expansion of this metro-suburb, office complex during 2004.

H&R REIT versus S&P/TSX Composite Index

Globalization and securitization of real estate is accelerating as an abundance of capital flows across borders, contributing to the rapid growth of REITs around the world. Well-established income trusts will continue to be very popular with investors large and small, particularly with those entering the older demographic segments that rely on monthly distributions. On the downside, with increasing competitive bidding for prime real estate, we foresee continuing upward pressure on commercial property prices in North America, which will likely curtail our rapid growth by acquisition. H&R knows how to create value incrementally through long-term leasing and financing, but as we expect to see fewer accretive acquisition opportunities in Canada and the US, we will be on the lookout for opportunities to purchase owner-occupied, privately-owned real estate – a huge and relatively untapped source of potential growth. We will also refocus our efforts on expanding the REIT's mezzanine development program.

We are grateful to our stakeholders

This year, H&R REIT will celebrate its 10th anniversary, with a strong track record as its backdrop. We owe this success to the employees who manage and grow H&R's portfolio and to the Trustees who watch over our decisions, and we are very grateful for their diligent efforts. We will continue to strive for superior results in 2006, so as to maintain the confidence of our investors and favourable valuations in our markets.

Tom Hofstedter
 President & CEO
 March 1, 2006

BJ's retail store

Location: Cape Coral, Florida
 Rentable area: 120,000 square feet

Highlights: This is one of three free-standing stores purchased by H&R for \$57 million, which are leased for a weighted average 17 years to a national US merchandiser, and financed with \$44 million of non-recourse mortgages.

**Harmony distribution facility**

Location: Pickering, Ontario
 Rentable area: 716,000 square feet

Highlights: H&R provided mezzanine financing for the land component of this state-of-the-art distribution warehouse, which is leased for 18 years to a major logistics company, then purchased it for \$60 million.

Office Properties *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
160 Elgin St.*** Ottawa, ON	100%	1971	988,689	99%	Bell Canada, Public Works of Canada, Gowling Lafleur Henderson LLP, Accenture
450-1st St., S.W.*** Calgary, AB	100%	2001	936,000	100%	TransCanada PipeLines
411-1st St., S.E. Calgary, AB	50%	1981	705,120	99%	Telus Communications, Public Works of Canada
310-320-330 Front St. W.** Toronto, ON	100%	1989– 1990	593,862	96%	Galileo Canada, National Bank, Royal Bank of Canada
5099 Creekbank Rd.*** Mississauga, ON	100%	2002	525,921	100%	Bell Mobility
100 Wynford Dr.*** Toronto, ON	100%	1970– 1997	459,171	100%	Bell Canada
200 Boul. Bouchard*** Dorval, QC	100%	1969– 1997	451,899	100%	Bell Canada
401-405 The West Mall** Etobicoke, ON	100%	1983– 1985	418,531	94%	Livgroup Investments Inc., Parmalat, Diageo Canada Inc., Blockbuster Canada, Royal Bank of Canada
25 Sheppard Ave. W.** North York, ON	100%	1994	361,741	100%	Nestle Canada, Transcontinental Media Inc., Hewitt & Associates, Association of Professional Engineers of Ontario
5115 Creekbank Rd. Mississauga, ON	100%	2004	249,118	100%	Bell Mobility
160 McNabb St. Markham, ON	100%	1986	220,000	100%	AC Nielsen Company of Canada
26 Wellington St. E.** Toronto, ON	98.5%	1981	172,475	100%	Map Info Canada, United Way, Sceptre Investments
9050 W. Washington Blvd.* Culver City, CA	100%	1996	172,039	100%	Sony Pictures Entertainment Inc.
55 Yonge St.** Toronto, ON	100%	1956– 1989	163,404	100%	CIBC, TransCanada PipeLines
145 Wellington St. W.** Toronto, ON	100%	1987	154,527	100%	American International Group, Aon Consulting
110 Sheppard Ave. E. North York, ON	50%	1993	154,022	83%	Equifax Canada Inc., Eckler Partners
2810 Matheson Blvd. E.** Mississauga, ON	50%	1990	129,103	88%	Credit Union Central of Ontario, Navigant International Canada
649 North Service Rd. Burlington, ON	100%	1991	123,000	100%	Wescam Inc.
2780-2800 Skymark Ave.*** Mississauga, ON	100%	1988– 1990	107,931	66%	CIBC, Fritz Starber Inc., McDonald's, Firkin Pubs
6900 Maritz Dr., Mississauga, ON	100%	2001	104,689	100%	Maritz Canada Inc.
1235 Bay St. Toronto, ON	100%	1973– 2000	97,020	100%	Dental Anesthesia Association, Interac Business Centres, Toy Shop Inc.
2611-3rd Ave. Calgary, AB	50%	1998	95,465	100%	Dominion Information Services Inc.
291-295 The West Mall** Etobicoke, ON	100%	1978	90,718	78%	The Pace Law Firm, Investors Group Financial Services
200 Jameson Dr.*** Peterborough, ON	100%	2001	89,405	100%	AmeriCredit
5901 E. Fowler Ave.* Temple Terrace, FL	100%	1991	85,725	100%	Coca-Cola Enterprises Inc.
69 Yonge St.** Toronto, ON	100%	1914– 1988	80,872	95%	Livingston Group, Shoppers Drug Mart, Union Securities
1 Kenview Blvd. Brampton, ON	100%	1989	79,752	100%	Atlantis Aerospace Corp.
88 McNabb St.** Markham, ON	100%	1987	75,433	100%	Pfizer Canada Inc.
1618 Station St. Vancouver, BC	100%	2001– 2002	73,197	100%	Angiotech Pharmaceuticals Inc.
3625 Dufferin St.** North York, ON	100%	1965– 1985	70,804	100%	H&R Property Management Ltd., Qualified Financial Services
2767-2nd Ave. Calgary, AB	100%	1998	69,630	100%	DeVry Inc.
136 Charlotte St. Sydney, NS	100%	1989	69,500	100%	Province of Nova Scotia
15 Dorchester S. Sydney, NS	100%	1987	55,180	100%	Public Works of Canada, KPMG LLP, Canadian Imperial Bank of Commerce
131 McNabb St. Markham, ON	100%	1989	54,100	100%	Drug Trading Company Ltd.
Total			8,278,043	98%	

* Legal title to each of the U.S. properties is held by a separate legal entity which is 100% owned, directly or indirectly, by H&R REIT (U.S.) Holdings Inc. (the "Company"); the assets of each such separate entity are not available to satisfy the debts or obligations of any other person or entity; each such separate entity maintains separate books and records; the identity of the owner of a particular U.S. property is available from the Company. This does not prevent distributions to the entity owners provided there are no conditions of default.

** Partially held through H&R Portfolio Limited Partnership.

*** Debt related to certain Canadian properties is held in separate legal entities, where the rent received from each property is first used to satisfy the related debt obligations with any balance then available to satisfy the cash flow requirements of H&R Real Estate Investment Trust.

Single-Tenant Industrial Properties *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
110 Circuit City Rd.* Marion, IL	100%	2000– 2001	1,078,450	100%	Circuit City
1915-B Fairview Dr.* DeKalb, IL	100%	1993	860,939	100%	Nestle USA, Inc.
170 Butts St.* South Hill, VA	100%	1998– 2001	817,000	100%	Jones Apparel Group Inc.
One Nestle Ct.* McDonough, GA	100%	1993	782,565	100%	Nestle USA, Inc.
2300 Rue Senkus LaSalle, QC	100%	1972	742,000	100%	Owens-Illinois Canada Corp.
100 Metropolitan Rd. Toronto, ON	100%	1975– 1990	738,102	100%	Hudson's Bay Company
220 Chemin du Tremblay Boucherville, QC	100%	1999	727,966	100%	Rona Inc.
1400 Church St. S. Pickering, ON	100%	2004– 2005	716,261	100%	Harmony Logistics Canada Inc.
12090 Sage Point Ct.* Reno, NV	100%	1997	690,000	100%	Sherwin Williams
13600 Independence Pkwy.* Fort Worth, TX	100%	1993	524,252	100%	Nestle USA, Inc.
55 West Dr. Brampton, ON	100%	1969– 1981	505,565	100%	Winners Apparel Ltd.
950 Stelzer Rd.* Columbus, OH	100%	1966– 2004	480,762	100%	Dr. Pepper/7Up Bottling Group
1880 Matheson Blvd. E. Mississauga, ON	100%	2003	389,313	100%	Eagle Global Logistics (Canada), UPS SCS Inc.
930 Sherwin Pkwy.* Buford, GA	100%	2003	358,771	100%	Sherwin Williams
500 Palladium Dr. Kanata, ON	100%	2000– 2001	329,612	100%	Breconridge Manufacturing Solutions Corporation
4441-76th St. Calgary, AB	100%	1980– 1991	323,796	100%	UPS Logistics Group Canada, Cascades Tissue Group Inc.
137 Horner Ave. Etobicoke, ON	100%	1962	320,000	100%	Livingston Investments Ltd.
2121 Cornwall Rd. Oakville, ON	100%	1997– 1998	314,166	100%	UPS Logistics Group Canada
1600 Lionell Boulet Varenes, QC	100%	1971	311,103	100%	Asea Brown Boveri Inc.
7830 Tranmere Dr. Mississauga, ON	100%	1985– 1987	265,469	100%	Paperboard Industries Corporation
1595 North Service Rd. Oakville, ON	100%	2002	254,891	100%	UPS SCS Inc.
1 Chandaria Pl. Kitchener, ON	100%	1967	254,719	100%	Truserv Canada Co-Operators Inc.
6580 Millcreek Dr. Mississauga, ON	100%	1999	249,634	100%	UPS Logistics Canada Ltd.
75 Frontenac Dr. Markham, ON	100%	1986	243,614	100%	Hyundai Auto Canada
901 Guelph Line Burlington, ON	100%	1955	227,444	100%	International Truck and Engine Corporation
1801 Blairtown Rd.* Rock Springs, WY	100%	2004	226,639	100%	Halliburton Energy Services
6590 Millcreek Dr. Mississauga, ON	100%	1999	225,694	100%	Hershey Canada Inc.
475 Admiral Blvd. Mississauga, ON	100%	1994– 1999	219,886	100%	CFM Corporation
2695 Meadowvale Blvd. Mississauga, ON	100%	1999– 2003	219,220	100%	CFM Corporation
1616 Rue Eiffel Boucherville, QC	100%	1989– 2001	186,793	100%	Corporate Express Canada Inc.
30 Aero Dr. Calgary, AB	100%	2001	184,377	100%	Purolator Courier Limited
2390 Argentia Rd. Mississauga, ON	100%	1984	179,054	100%	CRL Company, Golder Associates
3900 Gantz Rd.* Grove City, OH	100%	1992	172,300	100%	Borders, Inc.
16900-107th Ave., N.W. Edmonton, AB	100%	1961– 1988	172,070	100%	Finning International Inc.
650 Catarauqui Woods Dr. Kingston, ON	100%	1988– 2003	165,916	100%	Sysco Food Services of Canada, Inc.
6660 Financial Dr. Mississauga, ON	100%	1998– 1999	164,236	100%	Servi-Logistix Inc.
7575 Brewster Ave.* Philadelphia, PA	100%	1981	164,150	100%	Georgia Pacific Corporation
6735-11th St., N.E. Calgary, AB	100%	1979	163,899	100%	Finning International Inc.

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Single-Tenant Industrial Properties (continued) *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
2928-16th St., N.E. Calgary, AB	100%	1981– 1994	163,280	100%	Nova Chemicals Corporation
1330 Martin Grove Ave. Mississauga, ON	100%	1972– 2000	162,775	100%	2072013 Ontario Inc. and Paramount Pallet, Inc.
351 Passmore Ave. Scarborough, ON	100%	1986– 1997	161,137	100%	Samuel, Son & Company Limited
10910-170th St., N.W. Edmonton, AB	100%	1977– 1999	154,721	100%	Finning International Inc.
20600 Rue Clark-Graham Montreal, QC	100%	2003	140,000	100%	Warnaco of Canada
11 Kenview Blvd., Brampton, ON	100%	1989	139,548	100%	Para Paints Canada Inc.
1, 4 & 8 Prince Andrew Pl. Toronto, ON	100%	1966– 1985	139,520	100%	Symcor Inc.
400 Traders Blvd. E Mississauga, ON	100%	1985– 1999	126,790	100%	Wentworth Technologies
5550 Skyline Way, Calgary, AB	100%	1984	124,805	100%	Hunting Oilfield Services (Canada) Ltd.
510 East Courtland St.* Morton, IL	100%	2000	123,090	100%	Georgia Pacific Corporation
17718-114th Ave., Edmonton, AB	100%	2000	121,315	100%	Purolator Courier Limited
7000 Rue Armand Quebec City, QC	100%	2000	120,584	100%	Purolator Courier Limited
300 Humber College Blvd. Etobicoke, ON	100%	2005	114,316	100%	Give and Go Prepared Foods Corp.
19100-94th Ave. Surrey, BC	100%	1998– 2001	112,819	100%	Finning International Inc.
525 Boxwood Dr., Cambridge, ON	100%	2003	111,996	100%	United Auto Parts Inc.
1350-1380 Matheson Blvd. E. and 5391 Ambler Dr., Mississauga, ON	100%	1987	110,059	100%	Minuk Construction and Engineering
1 Duck Pond Rd. Lakeside, NS	100%	1968– 2000	105,975	100%	Sysco Food Services of Canada, Inc.
6740 Campobello Rd.*** Mississauga, ON	100%	1980– 1985	94,700	100%	Maxxam Analytics
9300 Airport Rd., Hamilton, ON	100%	2000	93,357	100%	Purolator Courier Limited
200 Chisholm Dr., Milton, ON	100%	1991	91,828	100%	Asea Brown Boveri Inc.
1550 Creditstone Rd., Vaughan, ON	100%	2000	88,584	100%	Purolator Courier Limited
2600 Meadowvale Rd., Mississauga, ON	100%	2000	84,486	100%	Purolator Courier Limited
97 Thames Rd. E. Exeter, ON	100%	1973– 1994	84,000	100%	Andex Metal Products Limited
10300 Rue Henri Bourassa St. Laurent, QC	100%	1976– 1989	81,500	100%	Asea Brown Boveri Inc.
380 Markland St., Markham, ON	100%	1992	81,222	0%	–
10 Old Placentia Rd. Mount Pearl, NL	100%	1989– 2003	80,730	100%	Sysco Food Services of Canada, Inc.
388 Markland St., Markham, ON	100%	1996	79,039	100%	2057412 Ontario Inc.
2 East Beaver Creek Rd.** Richmond Hill, ON	100%	1988	79,024	69%	Country Style, Acura Technology
460 MacNaughton Ave. Moncton, NB	100%	1979– 1995	76,303	100%	Sysco Food Services of Canada, Inc.
10430-178th St., N.W. Edmonton, AB	100%	1979	70,676	100%	Finning International Inc.
940 Gateway Dr., Burlington, ON	100%	1982	70,218	100%	Cygnal Technologies
6315 Kenway Dr. Mississauga, ON	100%	1999	68,678	100%	Katoen Natie Canada Company
John G. Diefenbaker Airport Saskatoon, SK	100%	2001	66,355	100%	Purolator Courier Limited
118 MacDonald Cres. Fort McMurray, AB	100%	1977	65,169	100%	Finning International Inc.
3620-32nd St., N.E. Calgary, AB	100%	1983– 1998	65,120	100%	Nova Chemicals Corporation
1764 & 1776 Kelly Douglas Rd. Kamloops, BC	100%	1965– 1989	64,271	100%	Finning International Inc.
611 Ferdinand Blvd., Dieppe, NB	100%	1997	63,053	100%	Sysco Food Services of Canada, Inc.
9201 Rue de l'Innovation, Anjou, QC	100%	2000	62,691	100%	Purolator Courier Limited
6520 Kestrel Rd., Mississauga, ON	100%	2000	62,217	100%	Purolator Courier Limited
2005 Boul. Dagenais, Laval, QC	100%	2000	62,217	100%	Purolator Courier Limited
550 York Rd. Niagara-on-the-Lake, ON	100%	2000	62,185	100%	Purolator Courier Limited
3104-97th St., Edmonton, AB	100%	2000	62,169	100%	Purolator Courier Limited
880 Milner Ave. Scarborough, ON	70%	1990	60,028	100%	House of Electrical, Lombardi Direct Marketing
2860 Plymouth Dr., Oakville, ON	100%	1989	59,396	100%	Kraft Canada Inc.
1 Moyal Ct.** Vaughan, ON	100%	1991	52,792	100%	Wajax Industries
115 Belfield Rd. Toronto, ON	100%	1968– 1980	47,990	100%	Wentworth Technologies

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Single-Tenant Industrial Properties (continued) *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
Industrial Park W., Peace River, AB	100%	1970	44,668	100%	Finning International Inc.
72 Plant Farm Blvd. Brantford, ON	100%	1990– 2001	44,500	100%	Wentworth Technologies
5321-11th St. N.E., Calgary, AB	100%	1991	43,000	100%	Olympic Seismic Ltd.
360 Spinnaker Way** Vaughan, ON	75%	1995	41,944	100%	The Packaging Group
2815 Matheson Blvd. E.** Mississauga, ON	94%	1987	40,000	100%	ADT Security Services
380 Spinnaker Way** Vaughan, ON	75%	1995	33,017	100%	Topax Export Packaging
4248-14th Ave.** Markham, ON	100%	1994	32,708	100%	Linsey Foods Limited
749 Douglas Fir Rd., Sparwood, BC	100%	1978	31,784	100%	Finning International Inc.
300 Biscayne Cres.** Brampton, ON	100%	1996	31,606	100%	Dicom Express Inc.
6740-67th Ave., Red Deer, AB	100%	1975	30,655	100%	Finning International Inc.
1604 & 1720 Willow St. Campbell River, BC	100%	1980	30,000	100%	Finning International Inc.
19498-92nd Ave., Surrey, BC	100%	1992	28,621	100%	Finning International Inc.
45 Bodrington Ct.** Markham, ON	100%	1992	28,089	100%	Canada Bread Company Limited
450 Mackenzie Ave. & 265 Fifth Ave. S. Williams Lake, BC	100%	1959– 1978	27,321	100%	Finning International Inc.
2400 Matheson Blvd. E.** Mississauga, ON	100%	1993	25,273	100%	Givaudan Canada Co.
5230 Orbitor Dr.** Mississauga, ON	100%	1994	22,000	100%	The Oak Manufacturing Co.
Mile 49.5 Alaska Hwy., Fort St. John, BC	100%	1979	21,259	100%	Finning International Inc.
4750-101 St. N.W., Edmonton, AB	100%	1978	20,457	100%	Finning International Inc.
700 Vanalman Ave., Victoria, BC	100%	1990	14,411	100%	Finning International Inc.
R.R. #1, Mile 295, 2600 Alaska Hwy. Fort Nelson, BC	100%	1980	12,399	100%	Finning International Inc.
Total			19,867,068	99%	

Retail Properties *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
14111-14300 Entertainment Blvd. and 14140 Triangle Road, Richmond, BC	100%	1994– 1997	314,033	100%	Famous Players, City of Richmond
720 Blvd. Maloney W. Gatineau, QC	100%	1995– 1998	283,970	100%	Wal-Mart, Canadian Tire, Metro Richlieu
NorthPointe Towne Centre, Calgary, AB	100%	2000	199,502	100%	Famous Players, Canadian Tire
7500 Lundy's Lane Niagara Falls, ON	100%	1999– 2001	172,800	99%	Tommy Hilfiger, Levi's, Roots Canada, Nike, Danier Leather, Sony
10450-42nd Ave., Edmonton, AB	100%	1993	150,457	100%	Rona Revy Inc.
615 George Wallace Dr.* Gadsden, AL	100%	2002	146,730	100%	Lowe's Companies, Inc.
220 Chain Lake Dr. Halifax, NS	100%	1996– 1998	138,027	100%	Wal-Mart
1701 Frederick Rd.* Opelika, AL	100%	1999	135,197	100%	Lowe's Companies, Inc.
2301 Woodmont St.* Columbus, MS	100%	2001	135,197	100%	Lowe's Companies Inc.
3505 North Memorial Pkwy.* Huntsville, AL	100%	2002	135,039	100%	Lowe's Companies Inc.
575 Molly Lane* Woodstock, GA	100%	1997	132,847	100%	Lowe's Companies, Inc.
733 Pleasant Hill Rd.* Lilburn, GA	100%	1997	132,847	100%	Lowe's Companies, Inc.
2650 Dallas Hwy.* Marietta, GA	100%	1997	132,847	100%	Lowe's Companies, Inc.
8199 Pearl Rd.* Strongsville, OH	100%	1997	132,448	100%	Home Depot

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Retail Properties (continued) *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
2495 Gulf To Bay Blvd.* Clearwater, FL	100%	1997	131,946	100%	Home Depot
200 Weis Lane off Susquehanna Blvd.* West Hazelton, PA	100%	1997	131,575	100%	Lowe's Companies, Inc.
2343 Princess St., Kingston, ON	100%	2003	129,181	100%	Rona Home & Garden
10580 Duke Dr.* Alpharetta, GA	100%	1998	129,044	100%	Lowe's Companies, Inc.
4855 Stone Mountain Hwy.* Lilburn, GA	100%	1999	128,997	100%	Lowe's Companies, Inc.
1701-1711 Merivale Rd., Ottawa, ON	100%	2002	127,489	100%	Loeb's, Best Buy, Linens 'N Things
1 Boul. Bouthillier, Rosemère, QC	100%	1998	124,851	100%	Reno Depot
225 Joseph-Casavant Ave., Beauport, QC	100%	1990	124,182	100%	Reno Depot
775 Panet Rd., Winnipeg, MB	100%	1997	121,962	100%	Rona Revy, Inc.
1929 NE Pine Island Rd.* Cape Coral, FL	100%	2005	119,598	100%	BJ's Wholesale Club
1880 Innes Rd., Ottawa, ON	100%	1999	118,526	100%	Rona Home & Garden
5035 Boul. Cousineau, St-Hubert, QC	100%	1996	117,765	100%	Reno Depot
2435 East-West Connector* Austell, GA	100%	2003	115,396	100%	BJ's Wholesale Club
6344 Cash Crt.* Norcross, GA	100%	2004	115,367	100%	BJ's Wholesale Club
1711 Springfield Rd., Kelowna, BC	100%	1995	110,178	100%	Rona Revy Inc.
7277 Rue St-Jacques, Montréal, QC	100%	2000	110,004	100%	Reno Depot
29659 Seven Mile Rd.* Livonia, MI	100%	1994	109,800	100%	Farmer Jack
38272 Colorado Ave.* Avon, OH	100%	1999	108,532	100%	BJ's Wholesale Club
1677 Home Ave.* Akron, OH	100%	1998	108,510	100%	BJ's Wholesale Club
3712 Call Field Rd.* Wichita Falls, TX	100%	1992	108,178	100%	Kohl's
5555 S. Buckner Blvd.* Dallas, TX	100%	1991- 1997	107,927	100%	Sam's Club
730 Ottawa St. S., Kitchener, ON	100%	2004	105,978	100%	Rona Home & Garden
275 Boul. Rideau Rouyn-Noranda, QC	20%	1996- 1998	104,222	100%	Wal-Mart
7350 Catherine St., Windsor, ON	100%	2002	102,997	100%	Building Box
711 Creek View Dr.* Columbus, IN	100%	1994	95,120	100%	Lowe's Companies, Inc.
2665-32nd St. N.E., Calgary, AB	100%	1998	89,438	100%	Rona Revy Inc.
906 East North Ave.* Belton, MO	100%	2004	88,248	100%	Kohl's
1333 Sargent Ave., Winnipeg, MB	100%	1998	87,769	100%	Rona Revy Inc.
Interstate 640 at Washington Pike* Knoxville, TN	100%	1997	86,584	100%	Kohl's
110 Bloor St. W. Toronto, ON	100%	1997- 1998	86,164	100%	Indigo Books, Nike, Escada
1058-1100 10th St., Hanover, ON	100%	2001	78,114	100%	Wal-Mart
124 & 128 Boston Post Rd.* Waterford, CT	100%	1996- 2002	65,506	100%	Shaw's
8150 Rockville Rd.* Indianapolis, IN	100%	1995	61,614	100%	Kroger
9950 Berberich Dr.* Florence, KY	100%	1997	60,835	100%	Kroger
4478 Market St.* Marianna, FL	100%	1997	58,100	100%	Winn Dixie Stores Inc.
1309 Decatur Hwy.* Gardendale, AL	100%	1977- 1995	56,665	100%	Bruno's Grocery Store
4211-137 Ave. & 4204-137 Ave. Edmonton, AB	100%	1996- 1998	55,900	95%	Cineplex Odeon Corporation
521 Highway 80 E.* Demopolis, AL	100%	1987	49,580	100%	Bruno's Grocery Store
6951 Lee Hwy.* Chattanooga, TN	100%	1980- 1996	48,261	100%	Bi-Lo Grocery Store
205 Oakbrook Dr.* Mt. Washington, KY	100%	1998	47,311	100%	Associated Wholesale Group
3100 East Meighan Blvd.* East Gasden, AL	100%	1985	45,998	100%	Bruno's Grocery Store
420 Market St.* Dayton, TN	100%	1999	45,983	100%	Bi-Lo Grocery Store
5428 Dogwood Dr.* Milton, FL	100%	1984- 1996	43,750	100%	Winn Dixie Stores Inc.
61st Ave. & Barlow Trail S.E. Calgary, AB	100%	1998- 1999	40,480	100%	Business Depot

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Retail Properties (continued) *As at December 31, 2005*

Properties	Ownership Interest	Year Built/ Renovated	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
9320 Hwy. 93 Midland, ON	100%	1976– 2003	40,000	100%	Rona Building Centre
342 Blue Ridge St.* Blairsville, GA	100%	2001	36,524	100%	Bi-Lo Grocery Store
Sunridge Plaza, Calgary, AB	100%	2000	35,332	100%	Mark's Work Wearhouse, CIBC
819 West Carolina Ave.* Hartsville, SC	100%	1989– 1999	32,998	100%	Bi-Lo Grocery Store
8754 Highway 60, Eganville, ON	100%	2001	25,296	100%	IGA
State Bridge & Morton Rd.* Alpharetta, GA	100%	2003	18,529	100%	Shell Oil Products
46651 & 46655 Algonkian Pkwy.* Sterling, VA	100%	2002	16,838	100%	Shell Oil Products
901 Supermall Rd.* Auburn, WA	100%	2001	16,465	100%	Shell Oil Products
4845 & 4865 Alabama Rd. N.W.* Roswell, GA	100%	2002	16,406	100%	Shell Oil Products
593 Summit Blvd.* Broomfield, CO	100%	2000	15,732	100%	Shell Oil Products
1546 E. Ray Rd.* Gilbert, AZ	100%	2002	14,916	100%	Shell Oil Products
22994 East Smoky Hill Rd.* Aurora, CO	100%	2000	14,533	100%	Shell Oil Products
1459 Tiger Park Lane* Gulf Breeze, FL	100%	2002	14,490	100%	Walgreens Company
1157 Azalea Ave.* Richmond, VA	100%	1997	13,905	100%	Walgreens Company
1225 East Ridge Rd.* Griffith, IN	100%	1997	13,905	100%	Walgreens Company
42285 & 44245 Farmwell Rd.* Ashburn, VA	100%	2005	13,815	100%	Shell Oil Products
3332 Arapahoe Rd.* Eric, CO	100%	1999	13,713	100%	Shell Oil Products
7520 Village Square Dr.* Castle Rock, CO	100%	2000	13,713	100%	Shell Oil Products
Highway 20 & Samples Rd.* Cumming, GA	100%	2003	13,597	100%	Shell Oil Products
1947 & 1959 South Greenfield Rd.* Mesa, AZ	100%	2004	13,498	100%	Shell Oil Products
4901 & 4951 W. Eldorado Pkwy.* McKinney, TX	100%	2002	13,404	100%	Shell Oil Products
16542 Keystone Blvd.* Parker, CO	100%	1999	13,368	100%	Shell Oil Products
83rd Ave. & Thunderbird Rd.* Peoria, AZ	100%	2002	11,811	100%	Shell Oil Products
7112 Hwy. 98* Panama City, FL	100%	1997	11,200	100%	CVS Pharmacy, Inc.
1347 West 15th St.* Panama City, FL	100%	1997	11,200	100%	CVS Pharmacy, Inc.
6217 Silver Star Rd.* Orlando, FL	100%	1997	11,200	100%	CVS Pharmacy, Inc.
302 N. Tyndall Pkwy.* Callaway, FL	100%	1997	11,200	100%	Eckerd Corporation
2701 Dick Pond* Surfside Beach, SC	100%	1997	10,908	100%	Eckerd Corporation
800 North Glynn St.* Fayetteville, GA	100%	2000	10,908	100%	Eckerd Corporation
502 37th Ave S.E.* Puyallup, WA	100%	2004	10,102	100%	Shell Oil Products
3990 Red Cedar Dr.* Highlands Ranch, CO	100%	2004	9,332	100%	Shell Oil Products
Total			6,964,404	99%	

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Mezzanine Financing for Development *As at December 31, 2005*

Properties	Property Type	Ownership Option	Expected Completion	Net Rentable Area (Square Feet)	Occupancy	Major Tenants
Eglinton Ave. E. & Dixie Rd. Mississauga, ON	Office	100%	N/A	N/A	N/A	Bell Mobility

Management's Discussion and Analysis

For the year ended December 31, 2005

SECTION I

1. Forward Looking Disclaimer

Management's discussion and analysis ("MD&A") of the consolidated financial position and the consolidated results of operations of H&R Real Estate Investment Trust ("H&R" or the "Trust") for the year ended December 31, 2005 should be read in conjunction with the Trust's consolidated financial statements and the notes thereto for the years ended December 31, 2005 and 2004. Historical results, including trends which might appear, should not be taken as indicative of future operations or results. Certain prior year items have been reclassified to conform with the presentation adopted in the current year.

Certain information in this MD&A contains forward-looking statements with the meaning of applicable securities laws including, among others, statements made or implied under the headings "Results of Operations", "Financial Condition" and "Outlook" relating to the Trust's objectives, strategies to achieve those objectives, the Trust's beliefs, plans, estimates, and intentions, and similar statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts. Forward-looking statements generally can be identified by words such as "outlook", "objective", "may", "will", "expect", "intend", "estimate", "anticipate", "believe", "should", "plans" or "continue" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect the Trust's current beliefs and are based on information currently available to management.

These statements are not guarantees of future performance and are based on the Trust's estimates and assumptions that are subject to risk and uncertainties, including those described below under "Risks and Uncertainties" and those discussed in the Trust's materials filed with the Canadian securities regulatory authorities from time to time, which could cause the actual results and performance of the Trust to differ materially from the forward-looking statements contained in this MD&A. Those risks and uncertainties include, among other things, risks related to: price of the Units; real property ownership; availability of cash flow; competition for real property investments; government regulation; interest rates and financing; environmental matters; redemption of the Units; unitholder liability; co-ownership interest in properties; reliance on one corporation for management of a significant number of the Trust's properties; dependence on key personnel; potential conflicts of interest; changes in legislation; investment eligibility; construction risks; currency risk; tax treatment of income trusts; dilution; ability to access capital markets; cash distributions; indebtedness of the Trust; and statutory remedies. Material factors or assumptions that were applied in drawing a conclusion or making an estimate set out in the forward-looking statements include that the general economy remains stable; interest rates are relatively stable; acquisition capitalization rates are stable; competition for acquisitions of high quality office, industrial and retail properties remains strong; and equity and debt markets continue to provide access to capital. The Trust cautions that this list of factors is not exhaustive. Although the forward-looking statements contained in this MD&A are based upon what the Trust believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements.

All forward-looking statements in this MD&A are qualified by these cautionary statements. These forward-looking statements are made as of March 1, 2006 and H&R, except as required by applicable law, assumes no obligation to update or revise them to reflect new information or the occurrence of future events or circumstances. All information for the three months ended December 31, 2005 and 2004 was neither audited nor subject to a review engagement. In addition, information for the three months ended March 31, 2004 was neither audited nor subject to a review engagement.

2. Overview

H&R is an unincorporated open-ended trust created by a Declaration of Trust and governed by the laws of the Province of Ontario. The Trust completed its conversion into an "open-ended" mutual fund trust under the provisions of the *Income Tax Act* (Canada) effective July 21, 2005. As a result of the conversion, Unitholders are entitled to have their units redeemed at any time on demand payable in cash (subject to monthly limits) and/or in specie. The Trust obtained an advance income tax ruling to confirm, among other things, that the conversion would not result in Unitholders being considered to have disposed of their units for tax purposes. The units of the Trust trade on the Toronto Stock Exchange under the symbol HR.UN.

The Trust commenced operations on December 23, 1996 with the initial acquisition of a 70% undivided interest in a portfolio of 27 properties, principally located in the Greater Toronto Area (the "GTA"). As at December 31, 2005, the Trust owned and operated a portfolio of 227 properties, comprising an aggregate leaseable area of 34.4 million square feet (as calculated at the Trust level of ownership).

H&R has two primary objectives:

- to provide Unitholders with stable and growing cash distributions, generated by the revenue it derives from investments in income producing real estate properties; and
- to maximize unit value through ongoing active management of the Trust's assets, acquisition of additional properties and the provision of mezzanine financing for selected development projects.

The Trust focuses on investing in a diversified real estate portfolio of office, industrial and retail properties in both Canada and the United States to meet its objectives. The Trust's strategy is to purchase quality properties leased primarily to highly creditworthy tenants on a long-term basis, and to place long-term financing on the properties matching the term of the financing to that of the lease wherever economically feasible.

The geographic diversification of H&R's portfolio as at December 31, 2005 is outlined in the charts below:

	Ontario properties	United States properties	Alberta properties	Quebec properties	Other properties	Total properties
Office	24	2	4	1	3	34
Industrial	53	12	16	9	14	104
Retail	10	62	6	6	5	89
Total	87	76	26	16	22	227

(000's)	Ontario sq. ft.	United States sq. ft.	Alberta sq. ft.	Quebec sq. ft.	Other sq. ft.	Total sq. ft.
Office	5,420	258	1,406	452	198	7,734
Industrial	8,568	6,279	1,810	2,435	736	19,828
Retail	987	3,769	571	782	772	6,881
Total	14,975	10,306	3,787	3,669	1,706	34,443

The Trust provides mezzanine financing for development projects that are consistent with its objectives and philosophy. Participation in these projects enables the Trust to acquire high quality, new properties at higher yields than would otherwise be available. As at December 31, 2005, the Trust had invested \$2.6 million as land under development for one development project. Also, the Trust had taken back mortgage receivables totalling \$24.0 million on the sale of one industrial property and on the Trust relinquishing its option to purchase a property upon repayment in full of the mezzanine financing that was previously provided by the Trust.

The average term to maturity of our leases of 12.3 years at December 31, 2005 (December 31, 2004 – 12.5 years) closely matches the average term to maturity of our mortgages of 11.1 years at December 31, 2005 (December 31, 2004 – 12.0 years). These statistics are evidence that our objective of providing long-term stable income is being met.

The following chart outlines our lease expiries over the next 5 years highlighting the fact that only 15.0% of our leases expire over that period. This is a further illustration of the long-term nature of management's outlook which is designed to stabilize cash flow.

	Office		Industrial		Retail		Total	
	% of sq. ft.	Rent per sq. ft. (\$) on expiry	% of sq. ft.	Rent per sq. ft. (\$) on expiry	% of sq. ft.	Rent per sq. ft. (\$) on expiry	% of sq. ft.	Rent per sq. ft. (\$) on expiry
2006	0.45	16.09	0.56	6.15	0.05	21.02	1.06	11.05
2007	0.39	16.55	1.62	4.44	0.03	24.51	2.04	7.05
2008	1.25	16.71	3.18	3.94	0.14	25.11	4.57	8.08
2009	1.29	21.37	3.48	5.05	0.15	19.77	4.92	9.78
2010	0.88	17.24	1.22	6.47	0.35	27.69	2.45	13.37
Total	4.26	18.14	10.06	4.83	0.72	24.94	15.04	9.57

SECTION II

1. Selected Annual Information

The following tables summarize certain financial information of the Trust for the periods indicated below:

<i>(000's, except per unit amounts)</i>	Year ended December 31, 2005 ⁽¹⁾	Year ended December 31, 2004 ⁽¹⁾⁽³⁾	Year ended December 31, 2003 ⁽¹⁾⁽³⁾
Rentals from income properties	\$ 486,252	\$ 402,418	\$ 313,948
Mortgage interest and other income	1,917	8,104	7,862
Property operating income	92,990	96,197	88,716
Net earnings from continuing operations	80,258	89,328	83,873
Net earnings per unit from continuing operations			
(basic)	0.84	1.01	1.12
(diluted) ⁽²⁾	0.84	1.01	1.11
Net earnings	\$ 86,653	\$ 88,781	\$ 90,553
Net earnings per unit			
(basic)	0.91	1.00	1.21
(diluted) ⁽²⁾	0.90	1.00	1.20
Total assets	3,826,948	3,300,913	2,681,787
Mortgages payable	2,396,894	2,053,168	1,614,994
Distributable income per unit (excluding gains and losses) ⁽⁴⁾	1.46	1.44	1.40
Cash distributions per unit	1.30	1.24	1.22

Notes:

- (1) The financial information set forth under "Year Ended December 31, 2005", "Year Ended December 31, 2004" and "Year Ended December 31, 2003" include the operating results of those properties that were acquired in 2005, 2004 and 2003, respectively.
- (2) The calculation to determine "net earnings per unit from continuing operations (diluted)" and "net earnings per unit (diluted)" gives effect to the issue of Units pursuant to outstanding options and non-controlling interest conversion to units.
- (3) Certain items have been reclassified to conform with the presentation adopted in the current year.
- (4) Distributable Income is not a measure recognized under Canadian generally accepted accounting principles ("GAAP") and does not have a standardized meaning prescribed by GAAP. See Section II (2) (b).

Over the last three years, total assets of the Trust have increased substantially principally due to property acquisitions. As a result, rentals from income properties and operating income have increased reflecting the greater number of income-producing properties owned by the Trust. In addition, mortgages payable have also increased due to property acquisitions and to take advantage of the low cost of debt. It is expected that these figures will continue to increase as the Trust continues to manage and grow its activities to meet its business objectives.

Changes in accounting policy implemented during 2005 that impacted the financial information outlined above include the application of variable interest entities (see Section IV (2) (a)). During 2004, numerous changes in accounting policies were adopted impacting the financial information listed above. These changes included accounting policies for property acquisitions, depreciation, stock based compensation, recognition of rental revenue and hedging relationships, as more fully described in the Trust's MD&A for the year ended December 31, 2004.

2. Results of Operations

(in thousands of dollars except per unit amounts)

(a) Net Earnings

	Three months ended		Year ended	
	December 31, 2005 <i>(unaudited)</i>	December 31, 2004 <i>(unaudited)</i>	December 31, 2005	December 31, 2004
Operating revenue				
Rentals from income properties	\$ 126,398	\$ 109,276	\$ 486,252	\$ 402,418
Mortgage interest and other income	198	1,289	1,917	8,104
	\$ 126,596	\$ 110,565	\$ 488,169	\$ 410,522
Operating expenses				
Property operating costs	38,698	34,411	153,256	127,012
Mortgage and other interest	39,562	33,351	149,400	121,637
Depreciation of income properties	19,749	15,502	69,907	56,783
Amortization of deferred expenses and intangible costs	6,802	3,547	22,616	8,893
	104,811	86,811	395,179	314,325
Property operating income	\$ 21,785	\$ 23,754	\$ 92,990	\$ 96,197
Trust expenses	918	1,728	6,866	5,796
Net earnings before discontinued operations and non-controlling interests	\$ 20,867	\$ 22,026	\$ 86,124	\$ 90,401
Non-controlling interest	(1,347)	(1,073)	(5,866)	(1,073)
Net earnings from continuing operations	\$ 19,520	\$ 20,953	\$ 80,258	\$ 89,328
Net earnings (loss) from discontinued operations	3,962	65	6,395	(547)
Net earnings	\$ 23,482	\$ 21,018	\$ 86,653	\$ 88,781
Basic net earnings (loss) per unit				
Continuing operations	\$ 0.19	\$ 0.24	\$ 0.84	\$ 1.01
Discontinued operations	0.04	–	0.07	(0.01)
	\$ 0.23	\$ 0.24	\$ 0.91	\$ 1.00
Diluted net earnings (loss) per unit				
Continuing operations	\$ 0.19	\$ 0.23	\$ 0.84	\$ 1.01
Discontinued operations	0.04	–	0.06	(0.01)
	\$ 0.23	\$ 0.23	\$ 0.90	\$ 1.00

Net earnings for the three months ended December 31, 2005 of \$23.5 million or \$0.23 per unit increased by 11.7% on a dollar basis and decreased by 4.2% on a per unit basis compared to net earnings of \$21.0 million or \$0.24 per unit for December 31, 2004.

For the year ended December 31, 2005 compared to December 31, 2004, net earnings decreased by 2.4% from \$88.8 million to \$86.7 million on a dollar basis and by 9.0% from \$1.00 to \$0.91 on a per unit basis.

These changes are due mainly to the increase in the amortization of deferred expenses and intangible costs, the amortization of above and below market rents and the increase in trust expenses as described below (see “Section II (2) (a) (vi) and (vii)”), which were partially offset by the impact of the asset acquisition program of the Trust as outlined below in “Rentals from Income Properties – Section II (2) (a) (i)” as well as the gains on the sale of certain income properties realized in Q3 and Q4 of 2005 (see “Section II (2) (a) (ix)” below) as compared to a loss on sale realized in the year ended December 31, 2004.

Details of the impact of the implementation of changes to significant accounting policies (see "Section IV (2) (a)") for the three months and year ended December 31, 2005 are described in detail as follows:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Net earnings before accounting changes	\$ 22,544	\$ 21,018	\$ 86,043	\$ 88,781
Adjustments relating to accounting policy changes:				
Variable Interest Entities – reversal of interest income	(348)	–	(1,508)	–
Variable Interest Entities – capitalization of interest expense	227	–	1,059	–
Variable Interest Entities – gain on sale	1,059	–	1,059	–
Net earnings	\$ 23,482	\$ 21,108	\$ 86,653	\$ 88,781

The impact of each individual component comprising net earnings is discussed below.

(i) Rentals from income properties

Rentals from income properties ("rentals") include all amounts earned from tenants related to lease agreements, including basic rent, parking income, operating cost recoveries and realty tax recoveries.

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Same-asset	\$ 94,767	\$ 93,687	\$ 379,541	\$ 377,020
Acquisitions	31,631	15,589	106,711	25,398
Total	\$ 126,398	\$ 109,276	\$ 486,252	\$ 402,418

"Same-asset" refers to those properties owned by the Trust for the entire year ended December 31, 2005 and for the entire year ended December 31, 2004, i.e. any acquisitions since January 1, 2004 to December 31, 2005 are considered "acquisitions" for the purpose of this analysis. Acquisitions include the acquisition of substantially all of the remaining 30% of the original portfolio as described in detail in the MD&A for the year ended December 31, 2004.

Rentals from income properties increased 15.7% from \$109.3 million in Q4 2004 to \$126.4 million in Q4 2005. For the year ended December 31, 2005, rentals from income properties increased by \$83.8 million or by 20.8% over the comparative 2004 period. As highlighted above, the increase is primarily the result of the Trust's ongoing strategy of adding to its properties either through acquisitions or mezzanine financing programs. A total of 74 properties were added and five were disposed of between January 1, 2004 and December 31, 2005.

However, rentals were reduced in Q4 2005 by \$1.1 million (Q4 2004 – \$0.3 million) as the result of the amortization of above and below market rents as required by EIC-140 (See "Critical Accounting Estimates, Property Acquisitions – Section (IV) (1) (c)") which was implemented by the Trust in 2004. This reduction was offset by the increase in straight lining of rents of \$1.0 million between Q4 2004 and 2005.

For the year ended December 31, 2005 rentals were reduced by \$4.1 million and for the year ended December 31, 2004 rentals were reduced by \$0.1 million as a result of amortization of above and below market rents. This reduction was partially offset by the net increase in straight lining of rents of \$3.4 million between the years ended December 31, 2004 and 2005.

Rentals continue to be affected by contractual rental escalations in existing leases offset by the general soft conditions in the multi-tenant office market in the GTA. This weakness in the market is still giving rise to lower net effective rents on lease renewals and new leasing. As an example, during Q4 2005, rental income was reduced by \$0.6 million due to a non-recurring two month rent free period granted to a tenant at 145 Wellington Street West as part of their renewal incentives (which had a 100% impact during Q4 2005). Despite such weakness in the market, however, due in part to acquisitions and to the proactive management of the Trust's portfolio, vacancies have remained constant in the portfolio on an overall and same-asset basis across all asset categories.

As a result of all these factors, rentals from same-asset properties have increased from \$93.7 million for Q4 2004 to \$94.8 million for Q4 2005, a 1.2% increase. For the year ended December 31, 2004 as compared to the year ended December 31, 2005, rentals from same-asset properties also increased from \$377.0 million to \$379.5 million.

Occupancy levels and the average rent per square foot in the portfolio are summarized in the table below:

	Year Ended	Office	Industrial	Retail	Weighted Average Total
Occupancy – all assets	2005	98.2%	99.5%	99.9%	99.3%
	2004	97.5%	100.0%	99.9%	99.4%
Occupancy – same assets	2005	98.4%	99.9%	99.9%	99.5%
	2004	97.7%	100.0%	99.9%	99.4%
Average rent per square foot	2005	\$ 17.75	\$ 5.22	\$ 13.16	\$ 9.62
	2004	\$ 17.42	\$ 5.11	\$ 11.94	\$ 9.44

The above statistics reflect the net ownership position of H&R.

Currently there still does not appear to be any significant core-inflationary pressure on the Canadian or US economies. However, it is possible that such pressures could surface in the near term future as North American economies continue to improve and oil prices remain high. The cash flow of the Trust is protected to a large degree as most leases in the Trust's Canadian assets contain periodic rental escalation clauses to take expected inflation into account and in the US, the vast majority of leases are over 15 years in length which, in management's view, removes the uncertainty that can arise in shorter term economic cycles. The Trust's long-term, strong credit philosophy should therefore insulate the Trust from any impact that inflation may have on the rental streams from its portfolio as compared to a portfolio with short-term lease expiries. In addition, most of the Trust's leases are net leases where all operating costs of the properties are recovered from the tenants. Therefore, even if operating and tax costs do increase due to inflationary pressure, such additional costs will be passed through to the tenants, with negligible impact being felt by the Trust on its net earnings.

Rentals from properties sold or where a sale has been initiated during the years ended December 31, 2005 and December 31, 2004 have been recorded under net earnings (loss) from discontinued operations in Section II (2) (a) (ix) below.

(ii) Mortgage interest and other income

This revenue item comprises the following:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Mortgage interest and other income before accounting change	\$ 546	\$ 1,289	\$ 3,425	\$ 8,104
Accounting change: Accounting for variable interest entities	(348)	–	(1,508)	–
Mortgage interest and other income	\$ 198	\$ 1,289	\$ 1,917	\$ 8,104

Mortgage interest and other income is earned mainly on funds provided in the Trust's mezzanine financing program, which allows H&R to access properties earlier on in the development cycle and to obtain better returns.

This income decreased 84.6% for the fourth quarter ended December 31, 2005 (\$0.2 million) as compared to the fourth quarter of 2004 (\$1.3 million) due primarily to the decrease in the average mortgage receivable balance between the two quarters (see "Mortgages Receivable – Section II (3) (a) (iii)" below) and the accounting changes required for variable interest entities (see "Section IV (2) (a)").

When comparing the year ended December 31, 2005 to the year ended December 31, 2004, mortgage interest and other income decreased by \$6.2 million to \$1.9 million, a 76.3% decrease also due mainly to the decrease in the average mortgage receivable balance between the two years. This reduction is due in large part to two transactions; (i) the decrease in the mezzanine loan that was advanced on Phase II of the Bell Canada Complex in the first half of 2004, and was converted to an income property when the Trust exercised its option on June 30, 2004 and (ii) the repayment of a \$31.1 million mortgage receivable during July 2005 whereupon the option to purchase 50% of that particular development project was relinquished.

(iii) Property operating costs

Total property operating costs include costs relating to such items as cleaning, interior and exterior building repairs and maintenance, elevator, HVAC, insurance (collectively, "building operating costs"); realty taxes; utilities and property management fees among other items. These costs increased by 12.5% from \$34.4 million to \$38.7 million in the fourth quarter of 2005 as compared with the same 2004 period. For the year ended December 31, 2005 compared to the same period in 2004, property operating costs increased by \$26.2 million or 20.7% to \$153.3 million.

For Q4 2005, building operating costs, realty taxes, utilities and property management fees represented 23.8%, 46.5%, 12.7%, and 6.3% respectively of total property operating costs and for the year ended December 31, 2005, these costs represented 19.8%, 50.5%, 12.8% and 6.0% on the same basis. These percentages have not changed materially from Q4 2004 and the year ended December 31, 2004.

Almost all the leases in the portfolio are triple net leases to the landlord whereby the tenants are responsible for all costs incurred in the upkeep and operations of the properties.

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Same-asset operating costs	\$ 31,407	\$ 30,144	\$ 124,653	\$ 120,526
Acquisitions	7,291	4,267	28,603	6,486
	\$ 38,698	\$ 34,411	\$ 153,256	\$ 127,012

On a same-asset basis, property operating costs increased by 4.2% between the corresponding Q4 periods ended December 31, 2005 and 2004, and increased 3.4% between the corresponding year ended December 31, 2005 and 2004. This change for both periods is attributable to regular fluctuations in the normal course of business operations due primarily to the differing timing and quantum of the amounts payable and the actual payments made.

The bulk of the increase, however, as shown above, results from the additional properties added to the Trust's portfolio over the past 24 months.

Same-asset operating income (representing rentals from income properties less property operating costs) appears to have decreased marginally between Q4 2005 and Q4 2004 as well as between the years ended December 31, 2005 and 2004. However, this calculation is affected by the US exchange rate as Canadian income reduces when the Canadian dollar improves against the US dollar (as was the case between Q4 2005 and Q4 2004 and between the years ended December 31, 2005 and 2004), without actually accounting for the benefit incurred with respect to the natural hedge provided by the US dollar mortgage interest payments made. In absolute dollar terms or after accounting for mortgage interest payments, same-asset operating income has marginally increased for Q4 2005 and for the year ended December 31, 2005 over the respective 2004 periods.

Property operating costs from properties sold or where a sale has been initiated during the fourth quarter and the year ended December 31, 2005 have been recorded under net earnings (loss) from discontinued operations and are disclosed in Section II (2) (a) (ix) below for both 2005 and 2004.

(iv) Mortgage and other interest

Mortgage and other interest increased 18.6% from \$33.4 million for the quarter ended December 31, 2004 to \$39.6 million for Q4 2005. An increase of 22.8% from \$121.6 million to \$149.4 million for the years ended December 31, 2004 and 2005 respectively also occurred. These increases are due to increased levels of debt required to finance acquisition activity in 2004 and 2005 (see "Mortgages Payable – Section II (3) (b) (i)" below). The impact of the accounting changes required for variable interest entities was not material (see "Section IV (2) (a)"), requiring a Q4 2005 decrease in this expense of \$0.2 million (Q4 2004 – nil) and a reduction in the year ended December 31, 2005 of \$1.1 million (2004 – nil).

As at December 31, 2005 and 2004, H&R's weighted average cost of mortgage debt was 6.6% and 6.9%, respectively.

(v) Depreciation of income properties

H&R depreciates its income properties on a straight-line basis over their remaining estimated life.

Depreciation increased 27.4% or \$4.2 million from \$15.5 million for the three months ended December 31, 2004 to \$19.7 million for the same period ended December 31, 2005. For the year ended December 31, 2005 compared to the same 2004 period, depreciation increased by \$13.1 million to \$69.9 million. All of the increase is due to the continued acquisition of properties during 2004 and 2005. Depreciation expense will continue to increase as more properties are added to the Trust's portfolio.

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Depreciation	\$ 19,769	\$ 15,580	\$ 70,192	\$ 57,181
Depreciation included in discontinued operations	(20)	(78)	(285)	(398)
Net depreciation	\$ 19,749	\$ 15,502	\$ 69,907	\$ 56,783

(vi) Amortization of deferred expenses and intangible costs

Amortization expense increased by 91.8% from \$3.5 million for Q4 2004 to \$6.8 million for Q4 2005 and by 154.3% from \$8.9 million for the year ended December 31, 2004 to \$22.6 million for the year ended December 31, 2005. Amortization expense is comprised of the following:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Amortization of deferred leasing expenses	\$ 1,282	\$ 1,057	\$ 4,185	\$ 3,658
Amortization of deferred financing expenses	420	322	1,510	1,029
Amortization of deferred maintenance costs	506	329	1,750	914
Amortization of intangible assets on acquisitions of properties	4,594	1,848	15,181	3,409
	\$ 6,802	\$ 3,556	\$ 22,626	\$ 9,010
Amortization included in discontinued operations	–	(9)	(10)	(117)
	\$ 6,802	\$ 3,547	\$ 22,616	\$ 8,893

Amortization of deferred leasing expenses have increased from \$1.1 million in Q4 2004 to \$1.3 million in Q4 2005, an increase of 21.3%. Amortization of these costs have increased from \$3.7 million for the year ended December 31, 2004 to \$4.2 million for the year ended December 31, 2005, a 14.4% increase. The increase is due in large part to the increase in expenditure in this asset class (see “Deferred Expenses – Section II (3) (a) (iv)” for further details).

Amortization of deferred financing expenses did not change materially between Q4 2004 and Q4 2005 nor between the year ended December 31, 2004 and 2005. The increase is due to the increased levels of debt required to finance acquisition activity in 2004 and 2005 (see “Mortgages Payable – Section II (3) (b) (i)” below).

Amortization of deferred maintenance costs have increased from \$0.3 million in Q4 2004 to \$0.5 million in Q4 2005. Amortization of deferred maintenance costs have increased from \$0.9 million for the year ended December 31, 2004 to \$1.8 million for the year ended December 31, 2005. These increases are due to the increase in expenditures in this line item (see “Income Properties – Section II (3) (a) (i)” for further details).

For acquisitions of properties after September 12, 2003, the acquisition cost is allocated to land, buildings and intangible costs. These intangible costs include the value of above and below market leases, in-place leasing costs and costs attributable to tenant relationship value. In-place leasing costs are those costs that would be incurred to lease up the property had it been vacant upon acquisition, and include commissions, tenant allowances and inducements, etc. Amortization of these intangible costs has been separately disclosed above from on-going operating activities to highlight the significant impact of the accounting policy change between Q4 2004 and Q4 2005 as well as the respective years ended December 31, 2004 and 2005 (see “Critical Accounting Estimates – Property Acquisitions, Section IV (1) (c)”). The accelerated amortization of these costs when compared to depreciation that would have been recorded had this guideline not been implemented has resulted in a reduction of net earnings of approximately \$5.2 million in Q4 2005 (Q4 2004 – \$1.8 million) and \$12.3 million for the year ended December 31, 2005 (2004 – \$3.4 million). The continued acquisition of properties will result in an increase of this expense each quarter for the foreseeable future.

(vii) Trust expenses

Trust expenses (which principally include salary, professional fees and trustee fees) decreased by 46.9% from the \$1.7 million for the three months ended December 31, 2004 to \$0.9 million for the same period ended December 31, 2005, but increased by 18.5% from \$5.8 million for the year ended December 31, 2004 to \$6.9 million for the year ended December 31, 2005.

This decline in Q4 2005 is attributable to a reduction in overall professional fees and other costs incurred as well as a decrease in salaries based on a revised bonus estimate for the 2005 year of which the entire amount was recorded in the fourth quarter of 2005.

The overall increase for the twelve month comparative periods was mainly as a result of an increase in professional fees. This was due to additional services required due to accounting policy changes, corporate governance changes, the conversion of the Trust to an open-ended Trust as well as the timing of certain recurring expenditures. Professional fees are expected to stabilize over the next few quarters when non-recurring items diminish.

For the three months ended December 31, 2005, salaries, professional fees and trustee fees represented approximately 13.6%, 43.9% and 10.4%, respectively, of overall trust expenses after the revised bonus estimate for the 2005 year (Q4 2004 – 66.8%, 7.1%, 2.6% respectively). For the year ended December 31, 2005, salaries, professional fees and trustee fees represented approximately 53.0%, 23.4% and 3.4% respectively of overall trust expenses (2004 – 67.2%, 9.8%, 3.1% respectively). Prior to the revised bonus estimate, salaries, professional fees and trustee fees for Q4 2005 represented 58.6%, 21.0% and 5.0% respectively, of overall trust expenses and for the year ended December 31, 2005, salaries, professional fees and trustee fees represented 59.0%, 20.4% and 2.9% respectively.

For Q4 2005 total trust expenses amounted to 0.7% of rentals from income properties (Q4 2004 – 1.6%). These expenses were unchanged for the equivalent years ended December 31, 2005 and 2004 being 1.4% of rentals from income properties for both years respectively.

(viii) Non-controlling interest

As a result of the November 2004 acquisition of substantially all of the 30% interest of the remaining properties in which the Trust acquired an initial 70% as part of its 1996 Initial Public Offering (see “Section II (3) (c)”) net earnings attributable to the Class B unitholders of a subsidiary partnership have been segregated and deducted from the net earnings of the Trust. As and when these Class B units are exchanged into Trust units, the non-controlling interest and net earnings related thereto will reduce accordingly.

The non-controlling interest is separated between continuing operations and discontinued operations. The amount of non-controlling interest deducted from income from continuing operations for Q4 2005 is \$1.3 million (Q4 2004 – \$1.1 million) and \$5.9 million for the year ended December 31, 2005 (December 31, 2004 – \$1.1 million) (see “Net earnings (loss) from discontinued operations” below for the non-controlling interest deducted from income from discontinued operations). The adjustment was made for the entire year ended December 31, 2005, however, for comparable purposes, it is only applicable to the months of November and December in 2004.

In calculating distributable income and distributable income per unit and funds from operations and funds from operations per unit, the non-controlling share of net earnings is added back as the equivalent Trust units have been issued and are included in the per unit calculations (see “Distributable Income – Section II (2) (b)” and “Funds from Operations – Section II (3) (e) (i)” below).

(ix) Net earnings (loss) from discontinued operations

When the Trust decides to dispose of an asset or initiates the sale of an asset, the property operating income, any gain or loss as a result of the sale and the attributable portion of non-controlling interest for those properties are combined on the income statement into net earnings (loss) from discontinued operations as per the chart below:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Property operating income	\$ 300	\$ 68	\$ 746	\$ 532
Gain (loss) on sale of income properties and land under development	3,939	–	6,116	(1,076)
Non-controlling interest	(277)	(3)	(467)	(3)
	\$ 3,962	\$ 65	\$ 6,395	\$ (547)

The Trust's philosophy is to dispose of assets that no longer fit its investment strategy and then re-deploy the proceeds in more attractive opportunities. In other cases, disposals may occur when a tenant has an option to purchase a property under the terms of their lease.

During Q3 2005, the Trust disposed of a 184,266 square foot single tenant industrial property and initiated the sale of 81,222 square foot single tenant industrial building, both of which are located in the GTA.

In December 2005, the Trust disposed of a 123,529 square foot industrial building and had a tenant exercise its option to purchase a 65,284 square foot industrial building, both of which are located in the GTA.

The Trust also relinquished its option to purchase a property located at Front and John Streets in Toronto, Ontario upon the repayment in full of the mezzanine financing provided by the Trust.

During 2004, the Trust disposed of 2 properties in the first quarter; an office building in Los Angeles, CA and an industrial building located in the GTA.

The effect of these transactions has resulted in net earnings from discontinued operations of \$4.0 million in Q4 2005 (Q4 2004 – \$0.1 million). For the year ended December 31, 2005, net earnings from discontinued operations totalled \$6.4 million, as compared to a loss of \$0.5 million for the year ended December 31, 2004.

Property operating income of \$0.3 million for Q4 2005 was recognized as compared to \$0.1 million for Q4 2004. For the year ended December 31, 2005, property operating income was \$0.7 million, as compared to \$0.5 million for the year ended December 31, 2004.

A gain on sale was recorded in Q4 2005 of \$3.9 million (Q4 2004 – nil) resulting from these transactions and included \$0.5 million earned by the Trust for relinquishing its option to purchase the property located at Front and John Streets in Toronto. Offsetting this amount is a write down of \$0.5 million the Trust was required to record to ensure that the carrying value of the asset listed for sale approximates the selling price. The gain on sale for the year ended December 31, 2005 was \$6.1 million, as compared to a loss on sale of \$1.1 million for the year ended December 31, 2004.

As described in Section II 2 (a) (viii), the portion of net earnings attributable to non-controlling interest must be segregated and deducted from net earnings from discontinued operations. The amounts of this deduction for Q4 2005 and the year ended December 31, 2005 are \$0.3 million and \$0.5 million, respectively, as compared to \$0 for the corresponding periods of 2004. The adjustment was made for the entire year ended December 31, 2005, however, for comparable purposes, it is only applicable to the months of November and December in 2004.

(b) Distributable Income

Management uses Distributable Income (“DI”) to reflect distributable cash which is defined in the Declaration of Trust and of which at least 80% must be distributed to Unitholders. The Trust currently distributes not less than 80% of its distributable income to Unitholders on a monthly basis. Readers are cautioned that DI is not a measure recognized under GAAP and does not have a standardized meaning prescribed by GAAP. DI should not be construed as an alternative to net earnings determined in accordance with GAAP as an indicator of the Trust’s performance. H&R’s method of calculating DI may differ from other issuer’s methods and accordingly, DI may not be comparable to measures used by other issuers.

As a primary objective of the Trust is to provide Unitholders with stable growing cash distributions, management considers DI to be an indicative measure in evaluating the Trust’s performance. Depreciation, accrued rent, gains on sales and other non cash items are added to, or deducted from, net earnings to determine the amount of income available for distribution. The most substantial adjustment to calculate DI is the adding back of depreciation to net earnings as it is management’s belief that properly maintained and managed commercial real estate should not depreciate substantially over time and therefore no deduction is required.

In addition to the transaction described in Section II (2) (a) (viii) above, the Trust has also issued Trust units to mirror these Class B Units which gave rise to the non-controlling interest adjustment in determining net earnings. As these units have legally been issued and monthly distributions are made thereon as with all other units, DI will be adjusted by adding back these non-controlling interest amounts and the weighted and diluted weighted average number of units outstanding will be amended accordingly to reflect the actual number of units issued as outlined in the table below.

Weighted Average Units Outstanding:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Weighted average units outstanding	100,891	88,805	95,429	88,445
Non-controlling interest conversion to units	6,975	4,549	6,975	1,146
Weighted average units with assumed conversions	107,866	93,354	102,404	89,591
Effect of dilutive securities:				
Unit option plan	655	725	651	607
Adjusted weighted average units with assumed conversions	108,521	94,079	103,055	90,198

Calculation of Distributable Income:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Net earnings	\$ 23,482	\$ 21,018	\$ 86,653	\$ 88,781
Add (deduct)				
Depreciation of income properties	19,749	15,502	69,907	56,783
Depreciation of income properties included within discontinued operations	20	78	285	398
Net variable interest entity adjustment	121	–	449	–
Straight-lining of rents	(7,270)	(6,271)	(25,744)	(22,352)
Straight lining of rents included within discontinued operations	(17)	(12)	54	(54)
Expense re stock based compensation	–	100	175	398
Amortization of intangible costs on acquisition of properties	4,594	1,848	15,241	3,409
Amortization of intangible costs on acquisition of properties included within discontinued operations	–	–	(60)	–
Amortization of above and below market rent	1,128	320	4,068	64
Amortization of above and below rent included within discontinued operations	–	–	(27)	–
Amortization of mortgage premium	(485)	(229)	(1,719)	(229)
Amortization of mortgage premium included within discontinued operations	–	–	(52)	–
Net income attributable to non-controlling interest	1,624	1,076	6,333	1,076
Loss (gain) on sale of income properties and land under development	(3,939)	–	(6,116)	1,076
Option fee earned (included in gain on sale of income properties)	500	–	500	–
	\$ 16,025	\$ 12,412	\$ 63,294	\$ 40,569
Distributable income	\$ 39,507	\$ 33,430	\$ 149,947	\$ 129,350
Distributions to unitholders	\$ 33,415	\$ 28,695	\$ 126,108	\$ 111,251
Distributions to non-controlling interest	2,274	1,447	9,097	1,447
Total distributions paid	\$ 35,689	\$ 30,142	\$ 135,205	\$ 112,698
Total distributions paid as a % of DI	90.3%	90.2%	90.2%	87.1%
Weighted average number of units	107,866	93,354	102,404	89,591
Diluted weighted average number of units	108,521	94,079	103,055	90,198
Basic (adjusted for conversion of non-controlling interest) DI per unit	\$ 0.366	\$ 0.358	\$ 1.464	\$ 1.444
Diluted DI per unit	\$ 0.364	\$ 0.355	\$ 1.455	\$ 1.434
Distributions paid per unit	\$ 0.326	\$ 0.311	\$ 1.304	\$ 1.244

Effective January 1, 2005, distributions were increased from 10.37 cents per month to 10.87 cents per month representing annualized distributions per unit of \$1.3044 for the year ending December 31, 2005, compared to the \$1.2444 per unit actual 2004 annualized distributions. Distributions made for the respective three months ended December 31, 2005 and 2004 amounted to \$35.7 million and \$30.1 million and for the respective years ended December 31, 2005 and 2004 amounted to \$135.2 million and \$112.7 million.

Diluted DI per unit has increased in Q4 2005 as compared to Q4 2004 by approximately \$0.008 per unit due primarily to the asset acquisitions occurring during 2005 offset partially by the dilutive impact of the October 2005 equity offering (\$0.005) described in detail in Section II (3) (d) (i) below.

DI was also affected by a number of other items in Q4 2005 including the previously mentioned reduction in rental income due to free rental periods granted in Q4 2005 (see "Section II (2) (a) (i)"), the \$0.5 million earned for relinquishing an option to purchase a development property, as well as fluctuations in trust expenses (see "Section II (2) (a) (vii)").

Diluted DI per unit increased for the year ended December 31, 2005 as compared to the year ended December 31, 2004 by \$0.02 also primarily due to the asset acquisitions occurring during 2005 offset partially by the dilutive impact of the March 2005 and October 2005 equity offerings described in "Section II (3) (d) (i)" below. Total dilution from these two offerings approximated \$0.02 per unit in 2005 when the Trust was unable to deploy proceeds from these two equity offerings as quickly as it had done in the past, due in part to the competitive conditions existing in the acquisition side of the market during the year.

The percentage of distributions to DI outlined above increased quarter over quarter and for the respective years ended December 31, 2005 and 2004 mainly due to the dilutive impact of the March and October 2005 equity offerings described above.

The tax deferred portion of distributions is 64% for the 2005 fiscal year as compared to 65% for the year ended December 31, 2004. This deferral will vary in any given year due to factors such as the size and timing of unit offerings, the amount and timing of acquisition of properties, the provision of mezzanine financing for development projects and capital gains or losses incurred in any one year.

(c) Segmented Information

H&R invests in three asset classes, being office, industrial and retail properties in both Canada and the United States.

The Trust is not required to report in its financial statements on the performance of each class of asset separately due to management's assessment that all assets effectively adhere to the same investment policy of being leased on a long-term basis to creditworthy tenants and financed where possible on a matching long-term basis and the fact that the Trust manages all assets on a similar basis.

However, for further clarification, a breakdown of operating income by class of asset before interest, depreciation and amortization is set out below.

Operating Income by Asset Class (before interest, depreciation and amortization)

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Office	51.3%	54.3%	51.6%	54.5%
Industrial	28.6%	28.7%	28.6%	29.2%
Retail	20.1%	17.0%	19.8%	16.3%
	100.0%	100.0%	100.0%	100.0%

However, segmented disclosure is provided in the financial statements by operating income on a geographic basis as the property operations in the United States are considered to be a geographic segment. This segmented information on property operating income from income properties is outlined below:

Property operating income for the three months ended December 31, 2005

	Canada	United States	Total
Operating revenue	\$ 106,902	\$ 19,694	\$ 126,596
Property operating costs	(37,653)	(1,045)	(38,698)
Mortgage and other interest	(28,792)	(10,770)	(39,562)
Depreciation of income properties	(13,790)	(5,959)	(19,749)
Amortization of deferred expenses and intangible costs	(5,169)	(1,633)	(6,802)
Property operating income	\$ 21,498	\$ 287	\$ 21,785

Property operating income for the three months ended December 31, 2004

	Canada	United States	Total
Operating revenue	\$ 98,551	\$ 12,014	\$ 110,565
Property operating costs	(33,753)	(658)	(34,411)
Mortgage and other interest	(26,922)	(6,429)	(33,351)
Depreciation of income properties	(12,378)	(3,124)	(15,502)
Amortization of deferred expenses and intangible costs	(2,982)	(565)	(3,547)
Property operating income	\$ 22,516	\$ 1,238	\$ 23,754

Property operating income for the year ended December 31, 2005

	Canada	United States	Total
Operating revenue	\$ 420,903	\$ 67,266	\$ 488,169
Property operating costs	(149,766)	(3,490)	(153,256)
Mortgage and other interest	(112,532)	(36,868)	(149,400)
Depreciation of income properties	(52,136)	(17,771)	(69,907)
Amortization of deferred expenses and intangible costs	(17,932)	(4,684)	(22,616)
Property operating income	\$ 88,537	\$ 4,453	\$ 92,990

Property operating income for the year ended December 31, 2004

	Canada	United States	Total
Operating revenue	\$ 364,094	\$ 46,428	\$ 410,522
Property operating costs	(124,750)	(2,262)	(127,012)
Mortgage and other interest	(97,460)	(24,177)	(121,637)
Depreciation of income properties	(44,663)	(12,120)	(56,783)
Amortization of deferred expenses and intangible costs	(7,208)	(1,685)	(8,893)
Property operating income	\$ 90,013	\$ 6,184	\$ 96,197

Operating revenue from income properties in the United States has increased significantly by \$7.7 million or 63.9% for the quarter ended December 31, 2005 compared to the same period in 2004 and by \$20.8 million or 44.9% for the year ended December 31, 2005 compared to the same 2004 period. This is due to numerous acquisitions that occurred in the United States over the past 24 months. This is further illustrated by the fact that the total value of U.S. assets in the portfolio increased by \$340.1 million or 50.1% between the end of Q4 2004 and Q4 2005.

(d) Use of Proceeds from Financing

Financing	Disclosed Use of Proceeds	Actual Use of Proceeds
Public offering of \$100.3 million of units completed on March 16, 2005	To fund the acquisition of additional properties, reduce H&R's indebtedness (where applicable), provide mezzanine financing and for general trust purposes. Proceeds intended to fund the acquisition of additional properties or provide mezzanine financing and not initially used for such purposes were to be used to reduce the Trust's bank indebtedness.	These entire proceeds were used to pay down the Trust's bank indebtedness on March 16, 2005 which included an acquisition line primarily used to fund previously announced acquisitions. The equity component of acquisitions from that date forward was obtained from the bank acquisition line as required until the Trust's overall percentage indebtedness was raised to a level which warranted a new public offering that closed on October 31, 2005, as described below.
Public offering of \$150.0 million of units completed on October 31, 2005	To fund the acquisition of additional properties. Proceeds intended to fund the acquisition of additional properties and not initially used for such purposes were to be used to reduce the Trust's bank indebtedness.	These entire proceeds were used on October 31, 2005 to pay down the Trust's bank indebtedness (as described above) leaving net excess cash available of approximately \$22.8 million. On November 1, 2005, approximately \$59.0 million US dollars (\$69.0 Cdn) of excess cash and bank indebtedness was utilized (in addition to assumption of debt) to purchase the three property industrial portfolio in the United States as described in Section II (3) (a) (i). The equity component of acquisitions after November 1, 2005 will be obtained from the bank acquisition line until the Trust's overall percentage indebtedness is raised to a level which warrants a new public offering.

3. Financial Condition

(a) Assets

(i) Income properties

Acquisitions of income properties during the year ended December 31, 2005 were in accordance with the Trust's investment strategy of acquiring quality assets occupied by long term creditworthy tenants. Funds for these acquisitions were obtained primarily from the proceeds of a \$100.3 million trust unit issue completed on March 16, 2005, proceeds of a \$150.0 million trust unit issue completed on October 31, 2005, as well as from the Trust's bank acquisition line and mortgages secured or assumed at closing or shortly thereafter.

During the first quarter of 2005, the Trust acquired two properties in Canada and one in the United States as follows:

In January 2005, the Trust purchased a 115,000 square foot retail property in Georgia for a cost of \$20.4 million. A non-recourse mortgage of \$15.8 million was secured on the property on closing.

In January 2005, the Trust exercised an option to acquire a 716,000 square foot state-of-the-art distribution centre in Pickering, Ontario for which it previously provided mezzanine financing for a total cost of approximately \$60 million. A 10 year \$52 million mortgage was secured on the property shortly after closing.

The Trust also completed the acquisition for \$7.2 million of an 81,000 square foot industrial property in Markham, Ontario on a 10 year sale-and-leaseback basis, and a mortgage of \$3.6 million was assumed on closing.

During the second quarter of 2005, the Trust acquired 18 single tenant retail properties in the United States.

During April 2005, the Trust purchased in two separate transactions, an additional ten Shell Oil Company retail/gas/convenience car wash facilities located throughout the United States for \$84.3 million, bringing the total number of similar properties in the portfolio to 17. These new additions had 18.3 years remaining on their lease terms at the time of acquisition. Mortgages totalling \$73.7 million maturing simultaneously with the leases were assumed on closing.

In June 2005, the Trust acquired a 109,800 square foot single tenant retail property in Detroit, Michigan leased on a long-term basis for \$19.1 million. A mortgage of \$14.2 million was placed on this property in July 2005. In addition, on June 30, 2005, the Trust acquired a portfolio of seven retail grocery stores in the southern United States comprising approximately 316,000 square feet for a cost of \$59.4 million. Mortgages totalling \$41.2 million were secured on closing.

During the third quarter of 2005, the Trust purchased six properties in Canada and disposed of one property as well as acquiring two properties in the United States.

During July 2005, the Trust purchased one property in the United States and two in Canada, as well as disposed of one property in Canada. A 108,510 square foot single tenant retail store located in Akron, Ohio was purchased for \$15.6 million. A ten year mortgage financing in the amount of \$11.7 million and bearing interest at 5.54% was secured for this property during September 2005. Two office properties totalling 124,680 square feet and located in Sydney, Nova Scotia were purchased for \$24.8 million with mortgages totalling \$12.7 million being assumed on closing. The federal and provincial governments occupy 78% of the leasable area of those two properties. The disposition of one industrial building totalling 184,266 square feet, located in the GTA, was completed in July 2005 resulting in a gain of \$2.2 million.

During August 2005, the Trust purchased three properties in Canada. Firstly, two single tenant retail properties comprising 209,731 square feet and located in Winnipeg, Manitoba were purchased for \$32.7 million with mortgages of \$13.2 million being assumed on closing. Secondly, the Trust acquired a 314,033 square foot retail and entertainment complex in Richmond, British Columbia for approximately \$83.0 million. A 10-year \$62.1 million mortgage bearing interest at 5.06% was secured on completion of the transaction. The tenants at this property include the City of Richmond and Famous Players.

During September 2005, the Trust purchased one retail asset in Canada and one in the United States. The Canadian asset is a 25,296 square foot property located in Eganville, Ontario purchased for a price of \$3.6 million. The Trust also acquired a 119,598 square foot single tenant retail store located in Cape Coral, Florida for \$20.7 million. A 10-year \$16.6 million mortgage bearing interest at 5.35% was secured on the closing of this property.

During the fourth quarter of 2005, the Trust acquired one property and disposed of two properties in Canada, as well as acquiring four properties in the United States.

During October 2005, the Trust completed the purchase of the Etobicoke industrial project previously shown on the financial statements as a mortgage receivable for a total purchase price of \$11.5 million. A ten year \$8.6 million mortgage was secured on this project.

During November 2005, the Trust purchased three industrial distribution centres, in the United States. The properties, comprising 2,168,000 square feet of leasable area in the aggregate and located near Chicago, Illinois, Dallas, Texas and Atlanta, Georgia were purchased for a total consideration of approximately \$169.0 million. Mortgages totalling approximately \$100.0 million were assumed on closing. The properties have a weighted average lease term to maturity of 12.0 years and are leased to an international investment grade rated tenant.

In December 2005, the Trust purchased a 47,311 square foot retail store in Mount Washington, Kentucky, for a total cash consideration of approximately \$5.7 million.

Also in December, the Trust disposed of two industrial properties located in the GTA. A 123,529 square foot industrial property located in Vaughan, Ontario was sold for total proceeds of \$10.0 million while a 65,284 square foot industrial property located in Mississauga, Ontario was disposed of for total proceeds of \$3.8 million when the tenant exercised its option to purchase the property. As a consequence of these sales, one mortgage of \$3.2 million was repaid in full while a second mortgage of \$2.1 million was assumed by the purchaser.

After accounting for these transactions and for depreciation expensed, income properties increased by 15.7% to \$3.637 billion at December 31, 2005 (including income properties held for sale) from \$3.145 billion at December 31, 2004. The allocation of costs to income properties was done in accordance with the requirements of Canadian Institute of Chartered Accountants ("CICA") EIC 140 (see "Section IV (1) (c)") and all additional categories are included in the total comparison above. The dollar figures shown above for US acquisitions are in Canadian dollars and are based on the currency exchange rates at the time of such acquisitions.

Capital expenditure and non-recoverable maintenance required on the Trust's portfolio has been relatively immaterial in the past. However, the Trust is committed to continuously maintain and improve the quality of the assets in its portfolio through the implementation of its capital improvements program. The objective of this program is to regularly assess all properties to determine what improvements may be required to upgrade the quality or class of the asset and to enhance efficiencies in the operations of the property to improve cost control or obtain future cost savings. Currently, the majority of the program is aimed at the Trust's multi-tenant office portfolio which has experienced relative weakness over the last two years in terms of leasing demand and rental rates. In order to properly position these properties in their markets and provide them with a competitive leasing edge, the Trust has accelerated this aspect of the program to be largely completed by the end of 2007 to be able to capitalize on the expected office market recovery.

The amount of deferred capital expenditures undertaken during 2005 was \$12.6 million. Total expenditure in 2004 amounted to \$8.6 million. Currently, the budget for 2006 is \$11.9 million, for 2007 is \$9.7 million and thereafter this expenditure is expected to reduce to lower regular levels consistent with 2003 and prior years.

The portion of the above expenditure comprising deferred maintenance costs, which are major items of repair or replacement, are amortized on a straight-line basis over the period of recovery or, if not recoverable, over the expected useful life of such major repairs or replacement. If such cost is not recoverable in the current year from tenants, the unamortized balance is included in deferred charges. Those costs which relate to the redevelopment of and upgrading of the quality and class of the asset have been capitalized to income properties.

Of the above costs, \$7.2 million have been allocated to income producing properties for the year ended December 31, 2005 (2004 – \$2.8 million) while \$5.4 million (2004 – \$5.8 million) has been included in deferred expenses against which future applicable recoveries from tenants will be applied.

Notwithstanding the above, the portfolio remains relatively new and should require minimal capital expenditure in the future. The average age of the total portfolio is 12.1 years at December 31, 2005 (December 31, 2004 – 11.9 years) and the split between asset class by age of property is as follows:

<i>(years)</i>	December 31, 2005	December 31, 2004
Office	15.0	14.1
Industrial	12.6	12.7
Retail	7.4	6.3
Total	12.1	11.9

(ii) Segmented information – income properties (including income properties held for sale)

The make up of the book value of income properties (including income properties held for sale) expressed by asset class and by region is as follows:

Book value by Asset Class

<i>(millions)</i>	December 31, 2005	December 31, 2004
Office	\$ 1,473	\$ 1,480
Industrial	1,111	911
Retail	1,053	754
	\$ 3,637	\$ 3,145

Book value by Region

<i>(millions)</i>	December 31, 2005	December 31, 2004
Ontario	\$ 1,623	\$ 1,591
Alberta	521	532
Other	241	104
Quebec	234	240
Sub Total	\$ 2,619	\$ 2,467
United States	1,018	678
Total	\$ 3,637	\$ 3,145

(iii) Mortgages receivable

The Trust provides mezzanine financing for development projects that are consistent with the Trust's objectives and philosophy. These projects are secured through mortgage financing provided by the Trust, which receives an option to acquire an equity interest in the project. Construction financing is only provided after 70% of the project has been pre-leased. Participation in development projects enables the Trust to acquire high quality, new properties at higher yields than would otherwise be available.

At December 31, 2005, there was one project for which the Trust had provided mezzanine financing compared to four projects at December 31, 2004. In addition, in Q4 2005, the Trust provided regular mortgage financing on two properties totalling \$24.0 million with a weighted average interest rate of 5.2%, with no option to purchase the properties. All the financing was provided for assets in Canada.

The Trust provided a \$16.0 million mortgage maturing in 2009 on the Front and John, Toronto project to the purchaser of the land once the Trust had relinquished its option to purchase the development. Further, the Trust provided a vendor take back mortgage in the amount of \$8.0 million to the purchaser of an industrial property sold by the Trust in December 2005 which matures in May 2006. This mortgage was repaid during February 2006.

Mortgages receivable (as analyzed before accounting policy change described below) reduced significantly from \$54.8 million at December 31, 2004 to \$26.6 million at December 31, 2005, a 51.4% decline. The majority of the decrease occurred when the Trust relinquished an option to acquire a 50% interest in a retail development upon repayment of a mortgage receivable of \$31.1 million during July 2005.

Details of mortgages receivable are as follows:

	Option %	Type	December 31, 2005	December 31, 2004
Front and John, Toronto	0%	N/A	\$ 15,985	\$ 12,981
Langstaff Industrial project	0%	N/A	8,000	-
Bell Canada Complex (Phase III), Mississauga	100%	Office	2,648 ⁽¹⁾	2,790
Vaughan – Wal-Mart	0%	N/A	-	31,102
Pickering Industrial	0%	Industrial	-	7,895
			\$ 26,633	\$ 54,768
(1) Less: reallocated in accordance with variable interest entity accounting policy changes			2,648	-
			\$ 23,985	\$ 54,768

(iv) Deferred expenses

Deferred expenses are comprised of the following components:

	December 31, 2005	December 31, 2004
Deferred leasing	\$ 43,387	\$ 23,580
Deferred financing	15,801	13,969
Deferred maintenance	11,164	7,570
	\$ 70,352	\$ 45,119

Deferred leasing expenses relate to those expenditures incurred to lease up new premises or re-lease premises once they become vacant through lease expiries or upon lease renewals and include costs such as legal fees, brokers' commissions, tenant inducements and allowances. These costs are deferred and amortized over the term of the specific lease to which they relate. These expenses increased by a net \$19.8 million (after amortization) or 84.0% between December 31, 2004 and December 31, 2005 mainly as a result of numerous lease renewals and lease extensions that occurred during the year as follows:

During Q1 2005, the net increase was a minimal \$0.8 million.

During Q2 2005, these deferred expenses increased by a net \$9.3 million for numerous specific lease renewals and extensions including:

- an extension of two Bell Canada leases comprising 911,000 square feet for five years
- an extension of two Bell Mobility leases comprising 775,000 square feet for approximately 1.5 years
- a renewal of the AIG lease at 145 Wellington Street West in Toronto comprising 102,000 square feet for 10 years
- a renewal of a lease comprising 39,600 square feet for 10 years at 320 Front Street West in Toronto

Further expenditure of a net amount of \$5.9 million was incurred during Q3 2005 and related to additional renewals and extensions mainly across the office portfolio including such properties as:

- 320 Front Street West, Toronto
- 145 Wellington Street West, Toronto
- 88 McNabb Street, Markham
- 160 Elgin Street, Ottawa
- 7500 Lundy's Lane, Niagara Falls
- 25 Sheppard Avenue West, Toronto

Additional net expenditures of \$3.7 million was incurred in Q4 2005 including approximately \$1.5 million at each of the Telus Tower in Calgary and 145 Wellington Street West in Toronto, whereby the final payment to AIG was accrued for in Q4 2005. Other properties experiencing lease renewals and extensions requiring tenant inducements in Q4 2005 included:

- 2800 Skymark Avenue, Toronto
- 401/405 The West Mall, Etobicoke
- 160 Elgin Street, Ottawa
- 1235 Bay Street, Toronto

Management believes 2005 was highly unusual in the amount required to be expensed in this asset category as these costs can vary greatly from quarter to quarter and from year to year depending on the timing of lease expiries, lease renewals and other factors. Payments are expected to reduce significantly in 2006 and beyond to more normalized levels consistent with prior years and is expected to be between \$5.0 million and \$6.0 million per annum.

Deferred financing expenses represent expenditures incurred in securing financing on a property including legal fees, brokers' commissions and loan commitment fees. These costs are deferred and amortized over the term of the specific mortgage to which they relate. The increase between December 31, 2004 and December 31, 2005 for this category reflects the normal increase in activity resulting from additional properties added to the portfolio offset by the ongoing amortization of this asset.

Deferred maintenance expenses represent those costs incurred under the Trust's capital improvement program (see "Income Properties – Section II (3) (a) (i)") which are to be deferred and amortized over the expected recovery period from tenants.

(v) Land under development

CICA Accounting Guideline AcG-15 (as defined in "Section IV (2) (a)" below) issued June 2003 provides guidelines for applying consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. This guideline became effective for all accounting projects commencing on or after November 1, 2004.

The impact at December 31, 2005 has been to reallocate one transaction previously disclosed as a mortgage receivable to a new asset category entitled land under development.

This change resulted in a reduction to unitholders' equity of \$1.2 million effective January 1, 2005. For the year ended December 31, 2005 interest income of \$1.5 million (2004 – \$0) earned on loans made by the Trust in the course of these transactions has been reversed out of mortgage interest and other income while mortgage and other interest expense has been reduced in 2005 by \$1.1 million (2004 – \$0) and capitalized to the cost of the development in accordance with the guideline. During the fourth quarter, the repayment of the mezzanine financing on the Front John project in Toronto required a reversal of \$1.1 million of the total adjustment described above. The overall effect was a net reduction of unitholders' equity of \$0.5 million for the year ended December 31, 2005 due to the implementation of this new policy.

(vi) Other assets

Certain leases call for rental payments that increase over their term. Accrued rent receivable records the rental revenue from these leases on a straight-line basis, resulting in accruals for rents that are not billable or due until future years. Accrued rent receivable has increased by 73.3% or \$25.6 million from \$34.9 million at December 31, 2004 to \$60.5 million at December 31, 2005 with a corresponding adjustment to rental revenue from income properties.

Prepaid expenses and sundry assets increased from \$9.6 million at December 31, 2004 to \$18.1 million at December 31, 2005, an increase of 88.5%. The \$8.5 million increase is primarily a result of purchase deposits on three transactions in the US and one transaction in Canada totalling approximately \$11.2 million that existed at December 31, 2005.

Accounts receivable were virtually unchanged between December 31, 2004 and December 31, 2005. The slight decrease is due to fluctuations arising during the normal course of business operations offset by the fact that the property portfolio continues to increase in size each quarter.

Cash and cash equivalents increased to \$9.3 million at December 31, 2005 from \$6.6 million at December 31, 2004. Included in the balance at December 31, 2005 is \$4.3 million related to funds being held in escrow until the expiry of certain non-recourse public mortgage bonds and other non-recourse US mortgages. Of the \$9.3 million approximately \$2.1 million represents rents paid in advance which fluctuates monthly depending on the timing of receipt of such rental payments.

(b) Liabilities

H&R's Declaration of Trust limits the indebtedness of the Trust to a maximum of 65% of the gross book value ("GBV") of the Trust. Within this limitation, debt that is recourse to the Trust cannot exceed 60% of the GBV of those assets to which the recourse debt pertains. The Trust's allocation of debt, including bank indebtedness, is as follows:

	December 31, 2005	December 31, 2004
Total debt to GBV	61.1%	62.6%
Recourse debt to GBV of subject assets	50.1%	53.0%
Non-recourse debt to GBV of subject assets	74.0%	74.3%
Non-recourse debt as a percentage of total debt	55.8%	53.7%
Floating rate debt as a percentage of total debt	2.7%	4.2%

There were no material changes in the allocation of debt as outlined above. The increase of the percentage of non-recourse debt in the Trust's portfolio is a deliberate strategy adopted by the Trust to reduce risk within the property portfolio.

(i) Mortgages payable

Mortgages payable (including mortgages payable on income properties held for sale) increased 16.7% from the December 31, 2004 figure of \$2.053 billion to \$2.397 billion at December 31, 2005. This increase is mainly a result of numerous transactions described in detail in "Income Properties – Section II (3) (a) (i)" above as well as a number of additional transactions relating only to mortgages payable not previously mentioned totalling a net \$19.2 million. The dollar figures shown for US transactions are based on the currency exchange rates at the time of such transactions.

All mortgages were financed at market rates existing at the time the mortgages were obtained. Certain mortgages have been assumed on property acquisitions where the rates were above market rates prevailing at the time of the acquisition. After determining the fair value of these mortgages a mark-to-market premium was recorded on the financial statements to increase income properties and mortgages payable. The premium recorded during the year ended December 31, 2005 was \$1.7 million (2004 – \$14.3 million).

These transactions, offset by the regular monthly self amortizing principal payments made in the normal course of business operations accounted for the \$343.7 million net increase in the mortgages payable balance from December 31, 2004.

The mortgages bear interest at the weighted average rate of 6.6% (December 31, 2004 – 6.9%) and mature between 2006 and 2035. To reduce risk, management's strategy is to, wherever possible, closely match the weighted average term to maturity of the mortgages of 11.1 years (December 31, 2004 – 12.0 years) to the remaining average lease term of 12.3 years (December 31, 2004 – 12.5 years). Going forward, the Trust anticipates being able to refinance all its debt as it matures.

Future principal repayments (including mortgages payable on income properties held for sale) and the balances due on maturity exclusive of the normal periodic self-amortizing principal repayments are as follows:

Years	Periodic Amortized Principal (\$000's)	Principal on Maturity (\$000's)	Total Principal (\$000's)	% of Total Principal	Weighted Average Interest Rate on Maturity
2006	70,875	21,623	92,498	3.9%	6.98%
2007	74,599	43,885	118,484	5.0%	8.10%
2008	77,321	71,099	148,420	6.2%	8.98%
2009	80,690	32,128	112,818	4.7%	7.07%
2010	86,524	9,803	96,327	4.0%	6.45%
Thereafter			1,814,868	76.2%	
			\$ 2,383,415		
Mortgage premiums			13,479		
Total			\$ 2,396,894		

Segmented disclosure by asset class is not considered relevant by management.

Segmented disclosure (including mortgages payable on income properties held for sale) by geographic location is provided as follows:

	December 31, 2005	December 31, 2004
Canada	\$ 1,640,948	\$ 1,539,300
United States	755,946	513,868
Total	\$ 2,396,894	\$ 2,053,168

(ii) Bank indebtedness

H&R's bank facilities include a one year revolving line of credit limited to \$180 million which is secured by a first charge over certain income properties, is due on demand and can be drawn in either Canadian or US dollars (to a maximum of \$100 million Canadian for US borrowings).

Bank indebtedness decreased by \$22.4 million from \$89.5 million at December 31, 2004 to \$67.1 million at December 31, 2005. The change is primarily as a result of equity required for acquisitions made during the year ended December 31, 2005 offset by proceeds from the two public offerings completed in March and October 2005 being applied to the bank indebtedness at that time (see "Section II (3) (d) (i)" below for further details).

The Canadian dollar portion of the debt bears interest at rates approximating the prime rate of a Canadian Chartered bank, while the US portion of the debt (Canadian equivalent of \$30.6 million at December 31, 2005 compared to \$39.8 million at December 31, 2004) bears interest at LIBOR rates. These funds, when drawn, are primarily used for asset purchases and the provision of additional mezzanine financing for development projects.

(iii) Accounts payable and accrued liabilities

Accounts payable decreased by \$6.5 million from \$61.6 million at December 31, 2004 to \$55.1 million at December 31, 2005. The decrease is primarily due to the reduction in certain accruals remaining outstanding on a prior years purchase offset by an increase in the accruals for mortgage interest (which will change proportionately each quarter with the changes in the mortgages payable balance occurring each quarter) as well as an increase in other payables and accruals relating to transactions occurring in the normal course of business operations, which should also increase as the Trust acquires more assets each quarter.

(c) Non-Controlling Interest

During November 2004, as part of the acquisition of substantially all of the 30% interest of the remaining properties in which the Trust acquired an initial 70% as part of its 1996 initial public offering the Trust issued 6,974,555 trust units to its subsidiary H&R Portfolio Limited Partnership ("HRLP"), set up to complete this transaction. The participating vendors exchanged their interest in these properties for 5,696,610 Class B units of HRLP as well as subscribing for an additional 1,277,945 Class B units of HRLP at the same time. These units are exchangeable on a one for one basis for Trust units. As clarified by EIC-151 which was issued in final form in January 2005, since these Class B units can be transferred without requirement to be exchanged first for Trust units, the aggregate outstanding amount at any point in time of the exchangeable Class B units of HRLP shall be recorded as a non-controlling interest on the Trust's financial statements until such time as these Class B units have been exchanged for Trust units. As Class B units are exchanged over time into Trust units, the equivalent dollar value of the conversion will be transferred to unitholders' equity and the non-controlling interest will accordingly be reduced. As at December 31, 2005, no exchange into Trust units had occurred.

(d) Equity

(i) Unitholders' equity

On March 16, 2005, the Trust completed a public offering for gross proceeds of \$100.3 million of Trust units. On October 31, 2005, the Trust completed a second public offering of Trust units in the year for gross proceeds of \$150.0 million. Unitholders' equity increased by \$214.0 million between December 31, 2004 and December 31, 2005 primarily as a result of the receipt of \$240.3 million from these offerings after deducting the underwriters' fee, proceeds from the Trust's distribution reinvestment plan and direct unit purchase plan and the exercise of options by officers and trustees of the Trust during the period. These proceeds were offset by the excess of distributions paid over net earnings for the period, which arose mainly as a result of the effect of the accounting change for depreciation of income properties and amortization of intangible assets which was implemented effective January 1, 2004. There was an opening adjustment of \$1.2 million for variable interest entities to prior years as a result of the adoption of the change in accounting policy previously described. Of this amount, \$1.1 million was reversed due to the repayment of mezzanine financing in December 2005 on the Front and John project.

(ii) Cumulative foreign exchange adjustment

As a result of the strengthening of the Canadian dollar against the US dollar during the year ended December 31, 2004, an unrealized loss of \$22.1 million was recorded on the financial statements at December 31, 2004. As at December 31, 2005, the Canadian dollar strengthened further in relation to the US dollar when compared to the December 31, 2004 exchange rate hence the unrealized loss increased to \$29.7 million.

This cumulative adjustment reflects the net adjustment to the equity invested in US properties, with the Trust's debt being held in US dollars currently acting as a natural hedge against its total investment in US dollars. This amount fluctuates continuously depending on the US exchange rate at the end of the applicable accounting period, but is not a concern to management at this time as all the US assets are long-term in nature and no short-term realization of loss is anticipated. This amount is taken to income only when the net investment in the self-sustaining foreign operations is reduced.

In addition, as part of the Trust's strategy of providing stable distributable income to its Unitholders, H&R has implemented a hedging strategy on its US income to minimize exposure to currency fluctuations, whereby the Trust has purchased forward contracts with a Canadian chartered bank to exchange US dollar cash flows received into Canadian dollars at a set future price to protect the Trust against a material change in the Canadian/US exchange rate. These contracts normally run for period of a year and their maturities are staggered where possible to allow the Trust flexibility in its hedging program.

(e) Liquidity and Capital Resources**(i) Funds from operations**

Funds from operations ("FFO") is not a measure recognized under GAAP and does not have a standardized meaning prescribed by GAAP. FFO should not be construed as an alternative to net earnings determined in accordance with GAAP as an indicator of the Trust's performance. However, FFO is an operating performance measure which is widely used by the real estate industry (and in particular, by a number of other Canadian real estate investment trusts) and the Trust has calculated FFO in accordance with the recommendations of the Real Property Association of Canada. Nevertheless, H&R's method of calculating FFO may differ from other issuers' methods and accordingly may not be comparable to similar measures presented by other issuers.

Management does consider FFO to be a valuable indication of the Trust's liquidity and ability to generate capital resources due to (i) management's belief that if properly maintained, real estate generally does not depreciate predictably over time, and (ii) management's use of FFO as a measure of capital resources available to the Trust (see "Section II (3) (e) (ii)" below). See "Distributable Income – Section II (2) (b)" for a determination of the weighted average and diluted weighted average number of units outstanding at the period end to determine FFO per unit on a basic and diluted basis.

FFO is calculated as follows:

	Three months ended		Year ended	
	December 31, 2005	December 31, 2004	December 31, 2005	December 31, 2004
Net earnings	\$ 23,482	\$ 21,018	\$ 86,653	\$ 88,781
Add (deduct)				
Depreciation of income properties	19,749	15,502	69,907	56,783
Amortization of deferred leasing expenses	1,282	1,050	4,122	3,547
Amortization of intangible assets on acquisitions of properties	4,594	1,848	15,241	3,409
(Gain) loss on sale of income properties and land under development	(3,939)	–	(6,116)	1,076
Option fee earned (included in gain of sale of income properties)	500	–	500	(538)
Operating income from discontinued operations	(300)	(70)	(753)	–
Net earnings attributable to non-controlling interest	1,624	1,076	6,333	1,076
Funds from operations – continuing operations	\$ 46,992	\$ 40,424	\$ 175,887	\$ 154,134
Funds from operations – discontinued operations	320	155	1,041	1,047
Funds from operations	\$ 47,312	\$ 40,579	\$ 176,928	\$ 155,181
Funds from operations per unit				
(basic – adjusted for conversion of non-controlling interest)	\$ 0.439	\$ 0.435	\$ 1.728	\$ 1.732
Funds from operations per unit (diluted)	\$ 0.436	\$ 0.431	\$ 1.717	\$ 1.720

(ii) Capital resources

Cash provided from operations together with proceeds from issuance of units, conventional mortgage financing and short-term bank financing, have been used mainly to fund net property acquisitions and capital expenditures of \$406.3 million and total distributions to Unitholders and non-controlling interest of \$135.2 million for the year ended December 31, 2005.

The cash flow generated from operating the portfolio represents the primary source of funds to service debt, to fund deferred leasing, financing and maintenance costs and to fund distributions on units. There are no material or unusual working capital requirements that currently exist and there are no pending balance sheet conditions or income or cash flow items that may affect liquidity. There are no legal or practical restrictions on the ability of the Trust's subsidiaries to transfer funds to the Trust.

Management expects to be able to meet all of the Trust's ongoing obligations and to finance future growth through the issue of new equity as well as by using conventional real estate debt, short term financing from the banks and the Trust's stable cash flow. The Trust is not in default or arrears on any of its obligations including distribution payments, interest or principal payments on debt and any debt covenant.

Short-term bank financing has been provided by the same chartered bank since the Trust's inception. This acquisition line is adequately secured by income producing properties and management believes this facility will continue to be made available in the future as it represents a typical or standard loan facility provided by numerous financial institutions in the industry. At December 31, 2005, approximately \$93.9 million was still available under this line.

The growth and popularity of income trusts in the Canadian equity markets and the large number of equity financings undertaken by the Trust and others within the last 24 months leads management to believe that equity financings will continue to be available for H&R as a source of future liquidity. As these financings provide the primary source of funds for future acquisitions, should new equity become more scarce, property acquisitions can be accordingly deferred or postponed. On March 16, 2005 and October 31, 2005, the Trust completed two separate public offerings of \$250.3 million of trust units.

There are no unusual covenants in financial instruments that could trigger early repayment of the Trust's debt. The mortgages secured by the Trust are fairly standard in nature with typical default clauses contained therein. There are no debt levered tests outside of the 65% debt to GBV test or other covenants or circumstances that exist that management believes would impair the Trust's ability to operate.

Legislative changes in Ontario that came into effect on December 16, 2004 clarified that unitholders of publicly traded trusts would not be liable for the activities of the Trust – this was expected to foster investor protection and confidence and represented an important step towards the inclusion of Trust's units in the S&P/TSX Composite Index, which was announced in December 2005. This inclusion is expected to broaden the investor base to include institutions such as pension funds, thereby providing additional liquidity.

Property acquisitions are a key component to providing growing but stable cash distributions for Unitholders, a key objective of the Trust. The Trust is currently contemplating acquisitions amounting to a gross value of approximately \$230.0 million (in addition to those transactions described in "Subsequent Events – Section VI (2)" but expects total acquisitions to remain constant on a dollar basis in 2006 as compared to 2005 due to a limited supply of new acquisition opportunities in both Canada and the United States (see "Section VI (1)" below).

The following is a summary of material contractual obligations of the Trust including payments due for the next five years and thereafter:

Contractual Obligations	Payments Due by Period				
	2006	2007–2008	2009–2010	2011 and thereafter	Total
Long Term Debt	\$ 92,498	\$ 266,904	\$ 209,145	\$ 1,814,868	\$ 2,383,415
Purchase Obligations ⁽¹⁾	54,454	–	–	–	54,454
Total Contractual Obligations	\$ 146,952	\$ 266,904	\$ 209,145	\$ 1,814,868	\$ 2,437,869

(1) These purchase obligations represent the equity required only for those transactions where the Trust is legally bound to complete the transaction and are in addition to any transactions listed below in Subsequent Events (see "Section VI (2)").

The Trust has no material capital or operating lease obligations.

(iii) Funding of future commitments

H&R's acquisition capacity to fund future acquisitions and commitments is in excess of \$400.0 million as at December 31, 2005. This represents the amount that can be funded by the Trust from debt (fixed and short term) before the Trust reaches its maximum debt limitation of 65% of debt to its GBV of assets. This capacity has reduced substantially after December 31, 2005 as a result of the completion of a number of acquisitions since year end, as described in "Subsequent Events – Section VI (2)" below.

H&R currently has no additional construction commitments to mezzanine development projects as no project currently requires additional funding, but depending on H&R's circumstances, additional project specific bank financing should be available for each project, requiring no further material outlay of funds by the Trust.

(f) Off-Balance Sheet Items

Normally, mezzanine financing provided by H&R for development projects result in H&R having an option, and not an obligation, to purchase the completed project. Thus, in accordance with GAAP, prior to November 2004, only the loan was recorded as an asset on the balance sheet. The principal amount of the mezzanine financing at December 31, 2005 was \$2.6 million (December 31, 2004 – \$54.8 million).

However, the new CICA guideline AcG-15 "Consolidation of Variable Interest Entities" issued June 2003 provides guidance for applying consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. This guideline became effective for all accounting periods commencing on or after November 1, 2004. After completing its analysis in Q1 2005, the Trust determined that two mortgages receivable totalling \$16.9 million would be eliminated and replaced with land under development and bank indebtedness. As part of this new guideline, H&R had to record an adjustment of \$1.2 million to opening unitholders' equity. Of this amount, \$1.1 million was reversed in Q4 2005 due to the repayment of mezzanine financing on the Front and John project. Therefore at December 31, 2005, there remained only one project impacted by AcG-15, as described previously in "Section II (3) (a) (v) – Financial Condition – Assets – Land under development".

For the twelve months ended December 31, 2005, interest income of \$1.5 million was eliminated, interest expense was reduced by \$1.1 million with a net reduction of \$0.4 million to net earnings and \$0.5 million to unitholders' equity, as a result of applying these guidelines for the year ended December 31, 2005 (2004 – \$0).

The Trust has certain co-owners or partners in various projects. As a rule H&R does not provide guarantees or indemnities for these co-owners pursuant to property acquisitions because should such guarantees be provided, recourse would be available against the Trust in the event of a default of the borrowers, in which case the Trust would have a claim against the underlying real estate investment. However, in certain circumstances, where absolutely required but subject to compliance with the Trust's Declaration of Trust and also, when management has determined that the fair value of the borrower's investment in the real estate investment is greater than the mortgages payable for which the Trust has provided guarantees, such guarantees might be provided.

At December 31, 2005, such guarantees amounted to \$50.0 million, expiring between 2011 and 2016 and no amount has been provided for in the consolidated financial statements for these items. These amounts arise out of only two properties where the Trust is a co-owner in the project. The Trust, however, customarily guarantees or indemnifies the obligations of its nominee companies which hold separate title to each of its properties owned.

(g) Financial Instruments and Other Instruments

All financial instruments have been disclosed and recorded as mortgages receivable or mortgages payable on the consolidated financial statements, and any adjustments required to record these at fair value have been properly accounted for.

The fair value of the mortgages payable has been determined by discounting the cash flows of these financial obligations using year end market rates for debt of similar terms and credit risks. Based on these assumptions, the fair value of mortgages payable at December 31, 2005 has been estimated at \$2.583 billion (2004 – \$2.134 billion) compared with the carrying value of \$2.397 billion (2004 – \$2.053 billion).

As previously disclosed, the Trust uses foreign exchange forward contracts to protect itself from currency fluctuations between the Canadian and US dollar. The Trust currently has forward contracts totalling US \$0.6 million per month of which \$0.1 million will expire in April 2006 and \$0.5 million will expire in December 2006. The fair value of these foreign exchange forward contracts at December 31, 2005 has been estimated at \$0.2 million as quoted by the Trust's banker, taking into account current foreign exchange rates.

The Trust has an electricity swap contract as a cash flow hedge of price volatility of the Trust's electricity costs in Ontario, Canada for a monthly notional amount of 4,000 MWh until June 2008. The fair value of this contract at December 31, 2005 has been estimated at \$2.2 million (2004 – (\$0.1) million).

Where appropriate, the Trust also uses forward contracts to lock in lending rates on certain anticipated mortgages. This strategy provides certainty in the rate of interest on borrowings when H&R is involved in transactions that might only close further into the future than during the normal timeframe of a transaction. At December 31, 2005, H&R had \$160.0 million of such forward contracts in place which were all closed out in January 2006 upon the acquisition of the two Canadian Tire industrial distribution centres as described in Subsequent Events below (see "Section VI (2)").

See also "Risk and Uncertainties – Interest Rate and Financing Risk and Currency Risk", and "Financial Condition – Equity – Cumulative Foreign Exchange Adjustment" for additional information concerning interest rate risks on the Trust's borrowings and foreign exchange fluctuations.

SECTION III**1. Summary of Quarterly Results**

<i>(unaudited)</i>	December 31, 2005	September 30, 2005 ⁽¹⁾	June 30, 2005 ⁽¹⁾	March 31, 2005 ⁽¹⁾
Rentals from income properties	\$ 126,398	\$ 124,658	\$ 117,907	\$ 117,289
Mortgage interest and other income	198	231	755	733
Property operating income	21,785	23,579	24,159	23,467
Net earnings from continuing operations	19,520	20,103	20,485	20,150
Net earnings per unit from continuing operations				
(basic)	0.19	0.21	0.22	0.22
(diluted)	0.19	0.21	0.21	0.22
Net earnings	\$ 23,482	\$ 22,288	\$ 20,520	\$ 20,363
Net earnings per unit				
(basic)	0.23	0.23	0.22	0.23
(diluted)	0.23	0.23	0.21	0.22

<i>(unaudited)</i>	December 31, 2004 ⁽¹⁾	September 30, 2004 ⁽¹⁾	June 30, 2004 ⁽¹⁾	March 31, 2004 ⁽¹⁾
Rentals from income properties	\$ 109,276	\$ 100,838	\$ 97,115	\$ 95,189
Mortgage interest and other income	1,289	1,267	2,867	2,681
Property operating income	23,754	23,949	24,135	24,359
Net earnings from continuing operations	20,953	22,477	22,776	23,122
Net earnings per unit from continuing operations				
(basic)	0.24	0.25	0.26	0.26
(diluted)	0.23	0.25	0.26	0.26
Net earnings	\$ 21,018	\$ 22,641	\$ 22,976	\$ 22,146
Net earnings per unit				
(basic)	0.24	0.25	0.26	0.25
(diluted)	0.23	0.25	0.26	0.25

Changes to the quarterly financial information are not reflective of seasonality or cyclicity but generally from new property acquisitions (see "Financial Condition – Assets – Income Properties – Section II (3) (a) (i)") and changes in accounting policies (see "Changes to Significant Accounting Policies – Section IV (2)").

(1) Certain items for all periods except the current period have been reclassified to conform with the presentation adopted in the current period mainly as a result of the immaterial reclassification of items to discontinued operations.

SECTION IV**1. Critical Accounting Estimates**

The preparation of the Trust's financial statements requires management to make estimates and judgements that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. The Trust's financial statements and, unless otherwise indicated, the financial data contained herein have been prepared in accordance with GAAP.

Management believes the policies which are most subject to estimation and judgements are outlined below. For a detailed description of these and other accounting policies refer to note 1 of the December 31, 2005 audited consolidated financial statements of the Trust.

(a) Impairment of Assets

The Trust is required to write down to fair value any of its income properties that have been determined to have been impaired. The analysis required is dependent upon a review of estimated future cash flows from operations over the anticipated holding period. This review involves subjective assumptions of, among other things, estimated occupancy and rental rates, all of which can affect the ultimate value of the property. In the event these factors result in a carrying value that exceeds the sum of future undiscounted cash flows expected to result from the ongoing use and ultimate residual value of the properties, an impairment would be recognized. During Q3 2005, a writedown of \$0.6 million was recorded for two industrial buildings which were listed for sale representing the accelerated amortization of intangible assets set up on the acquisition of these two properties as the leases to which these intangibles pertain were no longer in effect. An additional writedown of \$0.5 million was recorded in Q4 2005

pertaining to one of these properties (see “Section II (2) (a) (ix)”) bringing the total adjustment in 2005 to \$1.1 million. No impairments were recorded during 2004.

The Trust also evaluates the fair value of mortgages receivable to determine whether any impairment provisions are required. Impairment is recognized when the carrying value of the mortgage receivable will not be recovered as determined by the economic value of the underlying security and/or the financial covenant of the issuer of the security. No impairments of mortgages receivable were recorded during 2004 and 2005.

(b) Depreciation of Income Properties

On the acquisition of a property, a significant portion of the cost is allocated per management’s determination to the building component of the property. In addition, the Trust is required to assess the useful lives of its income properties in order to determine the amount of building depreciation to record on a quarterly and annual basis.

Since January 1, 2004, the Trust depreciates its buildings on a straight-line basis over their estimated useful lives. In the event the allocation to the building component is inappropriate or the estimated useful life of the properties are not correct, the amount of depreciation expensed quarterly and annually which affects the Trust’s future net earnings might not be appropriate.

(c) Property Acquisitions

For acquisitions of properties initiated on or after September 12, 2003, the CICA has issued guidance for accounting for operating leases required in connection with these acquisitions. Through management’s judgment and estimates, the purchase price must be allocated to land site improvements, building, the above or below market value of in-place operating leases, the fair value of tenant improvements, in-place leasing costs and the value of the relationship with the existing tenants.

These estimates will impact rentals from income properties, depreciation expense and amortization expense recorded on both a quarterly and annual basis.

(d) Fair Value of Financial Instruments

The Trust is required to determine annually the fair value of its mortgages payable. In determining the fair value of these financial instruments, the Trust uses current market quotations and internally developed models that reflect estimated market conditions. The Trust’s valuations of financial instruments are based on estimates and the fair value of these instruments may change if its estimates do not turn out to be accurate.

(e) Variable Interest Entities

Accounting Guideline 15, “Consolidation of Variable Interest Entities”, (“AcG-15”) issued September 2003 by the CICA provides guidelines for applying consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. This guideline became effective for all accounting projects commencing on or after November 1, 2004. The Trust implemented AcG-15 effective January 1, 2005 and is now required to consolidate all variable interest entities (“VIE’s”) for which it is determined to be the primary beneficiary. These determinations will impact mortgages receivable, land under development, bank indebtedness or mortgages payable where applicable, interest income and interest expense. Should the incorrect determination be made for VIE’s, the Trust’s assets and liabilities could be misstated and the amount of interest income and expense recognized quarterly and annually which affects the Trust’s future net earnings might not be appropriate.

2. Changes to Significant Accounting Policies

Changes to significant accounting policies in 2005 and changes that will affect the Trust in 2006 are as follows:

(a) Variable Interest Entities

Effective January 1, 2005, the Trust was required, pursuant to AcG-15, to consolidate certain VIE’s that are subject to control on a basis other than through ownership of a majority of voting interest.

AcG-15 defines a VIE as an entity that either does not have sufficient equity at risk to finance its activities without subordinated financial support or where the holders of the equity at risk lack the characteristics of a controlling financial interest. AcG-15 requires the primary beneficiary to consolidate VIE’s and considers an entity to be the primary beneficiary of a VIE if it holds variable interests that expose it to a majority of the VIE’s expected losses or entitle it to receive a majority of the VIE’s expected residual returns or both. Effective January 1, 2005, the Trust implemented AcG-15, retroactively without restatement of prior periods, and as a result, the Trust consolidates all VIE’s for which it is the primary beneficiary.

Upon implementation of AcG-15, the Trust determined that it was required to consolidate two entities for development projects, for which the Trust had provided mezzanine financing, and which the Trust has an option to purchase upon completion. Due to the repayment of the mezzanine financing on one of the projects, (the Front and John property) in December 2005, a gain of \$1.1 million was recorded in net earnings (loss) from discontinued operations in Q4 2005.

(b) Non-Monetary Transactions

In June 2005, the CICA issued Section 3831, “Non-Monetary Transactions”, which introduces new requirements for non-monetary transactions entered into on or after January 1, 2006. The amended requirements will result in non-monetary transactions being measured at fair values unless certain criteria are met, in which case, the transaction is measured at carrying value. As this standard

is to be implemented for non-monetary transactions entered into on or after January 1, 2006, the impact of adoption of this standard will depend upon future non-monetary transactions.

3. Disclosure Controls and Procedures

The Trust's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") are responsible for establishing and maintaining the Trust's disclosure controls and procedures. Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in reports filed with securities regulatory authorities is recorded, processed, summarized and reported on a timely basis to the Trust's management, including the CEO and the CFO, as appropriate, to allow timely decisions regarding required disclosure.

The CEO and CFO evaluated the effectiveness of the Trust's disclosure controls and procedures (as defined in Multilateral Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings*) as at December 31, 2005 and have concluded that such controls and procedures are effective.

SECTION V

1. Risks and Uncertainties

All income property investments are subject to a degree of risk and uncertainty. They are affected by various factors including general market conditions and local market circumstances. An example of general market conditions would be the availability of long-term mortgage financing whereas local conditions would relate to factors affecting specific properties such as an over supply of space or a reduction in demand for real estate in a particular area. Management attempts to manage these risks through geographic, asset class and tenant diversification in the Trust's portfolio. The major risk factors are outlined below.

(a) Interest Rate and Financing Risk

The Trust is exposed to interest rate risk on its borrowings. It minimizes this risk by obtaining long-term, fixed rate debt to replace short-term floating rate borrowings. At December 31, 2005, the percentage of fixed rate debt to total debt was 97.3% (December 31, 2004 – 95.8%). In addition, the Trust matches the terms to maturity of its mortgages on specific properties to the corresponding lease terms to maturity as closely as possible. At December 31, 2005, the weighted average term to maturity of the mortgages was 11.1 years (December 31, 2004 – 12.0 years) compared to the remaining average lease term of 12.3 years (December 31, 2004 – 12.5 years). The Trust also minimizes financing risk by restricting total debt to 65% of aggregate assets as well as by obtaining non-recourse debt wherever possible. At December 31, 2005, the debt to GBV ratio was 61.1% (December 31, 2004 – 62.6%) while the percentage of non-recourse debt to total debt was 55.8% (December 31, 2004 – 53.7%).

(b) Credit Risk and Tenant Concentration

The Trust is exposed to credit risk as an owner of real estate in that tenants may become unable to pay the contracted rents. Management mitigates this risk by carrying out appropriate credit checks and related due diligence on the significant tenants. Management has diversified the Trust's holdings so that it owns several categories of properties (office, industrial and retail) and acquires properties throughout Canada and the United States. In addition, management ensures that no tenant or related group of tenants, other than investment grade tenants, account for a significant portion of the cash flow. The only tenants which account for more than 5% of the rentals from income properties of the Trust are Bell Canada, TransCanada PipeLines Limited and Bell Mobility, but each individually represent less than 11% of the rentals from income properties of the Trust and currently are at least A rated by a recognized rating agency.

The following table illustrates the Trust's 10 largest tenants (based on estimated future annualized gross revenue excluding the straight lining of rents) and the weighted average term remaining on their leases as at December 31, 2005:

Tenant	% of rentals from income properties	Lease term to maturity (years)
1. Bell Canada	10.74%	18.75
2. TransCanada PipeLines Limited	7.29%	15.00
3. Bell Mobility	6.48%	20.00
4. Rona Inc.	4.52%	15.75
5. Royal Bank of Canada	3.23%	5.50
6. Lowes Companies Inc.	2.89%	13.25
7. Nestle USA	2.43%	11.75
8. Purolator Courier	2.01%	15.50
9. Shell Oil Products	1.98%	16.50
10. Nestle Canada	1.96%	13.75
Total	43.53%	

As indicated above, the Trust actively pursues highly creditworthy tenants which is further evidenced by its high occupancy rate of 99% at both December 31, 2005 and December 31, 2004.

(c) Lease Rollover Risk

Lease rollover risk arises from the possibility that H&R may experience difficulty renewing leases as they expire or in re-leasing space vacated by tenants upon lease expiry. Management's strategy is to sign tenants to leases that are long-term in nature which assists in the Trust's attempt to fulfill its primary goal of maintaining a predictable cash flow. The Trust has relatively few short to medium term lease rollovers which is illustrated in the previously disclosed lease rollover schedule (see "Section I (2) – Overview"), being 15.0% over the next 5 years.

(d) Mezzanine Financing Credit Risk

The Trust is also exposed to credit risk as a lender on the security of real estate in the event that a borrower is unable to make the contracted payments. Such risk is mitigated through credit checks and related due diligence of the borrowers and through careful evaluation of the worth of the underlying assets. Risk is further mitigated by the Trust's investment guideline of only providing construction financing after 70% of the project has been pre-leased.

(e) Currency Risk

The Trust is exposed to foreign exchange fluctuations as a result of ownership of assets in the United States. In order to mitigate the risk of significant fluctuations, a hedging program has been implemented to protect income earned in US dollars.

For the year ended December 31, 2005, there was no material difference between the book value and market value of these forward hedge contracts.

(f) Environmental Risk

The Trust's assets and operations are inherently not subject to a high level of environmental risk. However, H&R is subject to various Canadian and US laws, which could cause the Trust, as an owner and operator of real property, to become liable for the costs of removal or remediation of certain hazardous or toxic substances released on or in its properties or disposed of at other locations. The failure to remediate any environmental issue may affect the Trust's ability to sell or finance the affected asset and could potentially also result in claims against the Trust.

The Trust has formal environmental policies in place to manage any exposure. The Trust's guidelines mandate the carrying out of environmental audits and inspections before a property is purchased. Also, the majority of its leases specify that tenants will conduct their businesses in accordance with environmental regulations and be responsible for liabilities arising out of any infractions. In support thereof, tenants' premises are periodically inspected for environmental issues, among other things, to ensure adherence where applicable. Finally, the Trust carries appropriate insurance coverage to cover any environmental mishaps.

(g) Redemption Right

As a result of the Trust's conversion into an open-ended trust, Unitholders are entitled to have their units redeemed at any time on demand (see "Overview – Section I (2)" above). It is anticipated that this redemption right will not be the primary mechanism for Unitholders to liquidate their investments. The aggregate redemption price payable by the Trust is subject to limitations. The notes which may be distributed in specie to Unitholders in connection with a redemption will not be listed on any stock exchange, no established market is expected to develop for such notes and they may be subject to resale restrictions under applicable securities laws.

(h) Liquidity Risk

Real estate investments are relatively illiquid. This fact will tend to limit H&R's ability to vary its portfolio promptly in response to changing economic or investment conditions. If for whatever reason, immediate liquidation of assets is required, there is a risk that sale proceeds realized might be less than the current book value of the Trust's investments.

(i) Unitholder Liability

On December 16, 2004, legislation came into effect in Ontario, which clarified that investors in publicly traded trusts governed by the laws of Ontario would not be liable for the activities of the Trust.

In addition, H&R's Declaration of Trust provides that Unitholders will have no personal liability for actions of the Trust and no recourse will be available to the private property of any Unitholder for satisfaction of any obligation or claims arising out of a contract or obligation of the Trust. The Declaration of Trust further provides that this Unitholder indemnity, where possible, must be provided for in certain contracts signed by the Trust, such as mortgages and leases. Where H&R purchases investments subject to existing contractual obligations that do not include such indemnification provisions, the Trust uses its best efforts to ensure such disclaiming provisions are included at the time of purchase or will be included in the future.

(j) Tax Risk

On September 8, 2005, the Department of Finance (Canada) released a consultation paper entitled "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)" and requested that submissions on the relevant issues be sent to the Department of Finance (Canada) before December 31, 2005. On September 19, 2005, the Minister of Finance (Canada) announced that he had requested that the Canada Revenue Agency postpone providing advance income tax

rulings respecting flow-through entity structures effective immediately, that the Department of Finance (Canada) is closely monitoring developments in the flow-through entity market with a view to proposing tax measures in relation to the consultations and that consideration would be given to what, if any, transitional measures were appropriate. On November 23, 2005, the Minister of Finance (Canada) announced that the public consultation process was ended and he tabled in the House of Commons a Notice of Ways and Means Motion to implement a reduction in personal income tax on dividends with a view to establishing a better balance between the treatment of large corporations and that of income trusts. No measures were announced with respect to the taxation of flow-through entities, including income trusts, and their investors. No assurance may be given that further review of the tax treatment of flow-through entities, including income trusts, will not be undertaken or that Canadian federal income tax law respecting flow-through entities will not be changed in a manner which adversely affects the Trust and its Unitholders.

2. Related Party Transactions

The Trust has entered into an agreement with H&R Property Management Ltd., (the "Property Manager") a company owned by family members of the Chief Executive Officer, to provide property management services including leasing services concerning the properties owned by the Trust for approximately 3% of gross revenue. In addition, the Property Manager provides support services in connection with the acquisition and development activities of the Trust for a fee of 1% of total acquisition costs as defined in the agreement. This fee payment is limited to 1% of gross revenue for any particular year with the balance available for carry forward subject to certain conditions. The current agreement is for four years expiring December 31, 2009, with two automatic five-year extensions. For the year ended December 31, 2005, the Trust accrued fees pursuant to this agreement of \$17.4 million (December 31, 2004 – \$15.8 million), of which \$6.1 million (December 31, 2004 – \$5.9 million) was capitalized to the cost of income properties acquired and \$2.1 million (December 31, 2004 – \$1.9 million) was capitalized to deferred expenses. The Trust has also reimbursed the property manager for certain direct property operating costs.

In March 2006, the Trust and the Property Manager agreed to further amend the fees for property management services and support services, as more fully described below under "Subsequent Events – Section IV (2)".

For the year ended December 31, 2005, a further amount of \$1.3 million (December 31, 2004 – \$2.2 million) has been allocated to the Property Manager in accordance with the annual incentive bonus pool and has been expensed in the consolidated statements of earnings.

Pursuant to the above agreements, as at December 31, 2005, \$2.1 million (December 31, 2004 – \$2.1 million) was payable to the Property Manager.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

3. Outstanding Unit Data

The beneficial interests in the Trust are represented by a single class of units which are unlimited in number. Each unit carries a single vote at any meeting of unitholders. As at March 1, 2006, 110,729,222 trust units were issued and outstanding.

A maximum of 5,800,000 units were authorized to be issued to the Trust's officers, employees and certain trustees. All such options had been issued prior to December 31, 2003. As at March 1, 2006, 1,883,932 options to purchase units were outstanding.

SECTION VI

1. Outlook

A key objective of H&R is to provide growing but stable cash distributions for Unitholders. As discussed previously, property acquisitions are a key component to providing this growth. The Trust is constantly considering new property acquisitions following the same criteria and may from time to time consider a property disposition if such property no longer fits within the Trust's strategy. The Trust is currently contemplating acquisitions amounting to approximately \$230.0 million in addition to the acquisitions discussed in "Subsequent Events – Section VI (2)" below.

The Trust's strategy of purchasing predominantly high quality assets with strong tenants, both leased and financed on a long-term basis has enabled the Trust to meet or exceed objectives in the past and is expected to continue through 2006 and beyond. Certain key statistics in the Trust's portfolio illustrate the effectiveness of the Trust's strategy and highlight its ability to continually produce stable income. The Trust's overall occupancy level of 99%, its lease expiries of 15.0% over the next 5 years and the average term to maturities of its leases and mortgages both close to or in excess of 12 years demonstrates the strength in H&R's strategies.

Cash distributions per unit on a monthly basis have increased by approximately 5% between 2005 and 2004, with annualized distributions in 2005 increasing to \$1.3044 per unit compared to \$1.244 for the year ended December 31, 2004. The percentage payout of 90% for the year ended December 31, 2005 has increased over the prior year's percentage of 87% due to the timing of the equity offerings in the first and last quarter of 2005 and the deployment of those funds in property acquisitions.

Effective January 1, 2006, the Trust announced an increase in the monthly distributions from \$0.1087 to \$0.1112 per unit per month, representing an annualized 2006 distribution of \$1.3344, a 2.3% increase over 2005. Even with this increase, management expects the payout ratio to decline to below 89% for 2006.

One principal challenge faced by the Trust in 2004 and 2005 was the weakness in the office leasing market throughout the GTA, resulting in higher vacancies and lower net effective rental rates. Management believes this trend will continue into 2006. Also, due to a limited supply of new acquisition opportunities in both Canada and the United States, the Trust expects total acquisitions at maximum to remain constant on a dollar basis in 2006 as compared to 2005.

However, despite the above, given the strength of the Trust's existing portfolio, management is confident, that barring unforeseen circumstances. The Trust will perform at approximately the same level for 2006.

2. Subsequent Events

In January 2006, the Trust purchased two Canadian Tire industrial distribution centres located in Brampton, Ontario and Calgary, Alberta totalling 2.1 million square feet for a cash consideration of \$229.1 million. Mortgages totalling approximately \$180.1 million were secured at the time of the acquisition.

In February 2006, the Trust purchased a portfolio of four industrial properties in the United States, totalling 437,000 square feet for a total consideration of \$30.3 million.

In March 2006, the Trust and the Property Manager agreed to further amend the Omnibus Property Management Agreement so that effective January 1, 2006 and for the remaining terms of the agreement, the fees payable by the Trust to the Property Manager (i) for property management services is reduced from 3% to 2% of gross rental revenue, and (ii) for support services is reduced from 1% to 2/3 rds of 1% of the value of real property acquisitions and project development costs, but without the 1% gross revenue limit or the carryforward mechanism. The currently accrued support services fees in the amount of \$3.1 million will be paid out to the Property Manager.

3. Additional Information

Additional information relating to H&R, including H&R's Annual Information Form, is available on SEDAR at www.sedar.com.

Auditors' Report to the Unitholders

We have audited the consolidated balance sheets of H&R Real Estate Investment Trust as at December 31, 2005 and 2004 and the consolidated statements of earnings, unitholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Trust as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants

Toronto, Canada

February 23, 2006,

except as to notes 19(a) and 26(c),

which are as of March 1, 2006,

and except as to notes 26(d) and 26(e),

which are as of May 1, 2006

Management's Responsibility for Financial Reporting

The accompanying consolidated financial statements of H&R Real Estate Investment Trust are the responsibility of management and have been prepared by management in accordance with Canadian generally accepted accounting principles. The significant accounting policies, which management believes are appropriate for the Trust, are described in note 1 to the consolidated financial statements. Management has also ensured that the financial information contained elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

Management is responsible for the integrity and objectivity of the consolidated financial statements and the financial information contained elsewhere in the Annual Report. Estimates are necessary in the preparation of these statements and, based on careful judgements, have been properly reflected. Management has ensured that accounting procedures and related systems of internal control are designed to provide reasonable assurance that its assets are safeguarded and its financial records are reliable.

The Board of Trustees is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Audit Committee of the Board is responsible for reviewing and approving the annual consolidated financial statements and reporting to the Board, making recommendations with respect to the appointment and remuneration of the Trust's Auditors, and reviewing the scope of the audit. Management recognizes its responsibility for conducting the Trust's affairs in compliance with established financial standards and applicable laws and maintaining proper standards of conduct for its activities.

The consolidated financial statements have been audited by KPMG LLP, Chartered Accountants which have full and unrestricted access to the Audit Committee. KPMG's report on the consolidated financial statements is presented herein. These consolidated financial statements and the accompanying Management's Discussion and Analysis have been approved by the Board of Trustees for inclusion in this Annual Report based on the review and recommendation of the Audit Committee.

Toronto, Ontario

March 1, 2006



Thomas J. Hofstedter

President and Chief Executive Officer



Eric Cohen

Chief Financial Officer

Consolidated Balance Sheets

<i>(In thousands of dollars)</i>	December 31, 2005	December 31, 2004
Assets		
Income properties (notes 3 and 20)	\$ 3,637,488	\$ 3,145,045
Land under development	2,648	—
Deferred expenses (note 4)	70,352	45,119
Accrued rent receivable	60,451	34,874
Mortgages receivable (note 5)	23,985	54,768
Prepaid expenses and sundry assets	18,063	9,585
Accounts receivable	4,652	4,891
Cash and cash equivalents (note 6)	9,309	6,631
	\$ 3,826,948	\$ 3,300,913
Liabilities and Unitholders' Equity		
Liabilities:		
Mortgages payable (note 7)	\$ 2,396,894	\$ 2,053,168
Bank indebtedness (note 8)	67,097	89,538
Accounts payable and accrued liabilities	55,128	61,610
	2,519,119	2,204,316
Non-controlling interest (note 9)	116,688	119,452
Unitholders' equity (note 10)	1,191,141	977,145
Commitments and contingencies (note 22)		
Subsequent events (note 26)		
	\$ 3,826,948	\$ 3,300,913

See accompanying notes to consolidated financial statements.

Approved by the Trustees:



Robert Dickson
Trustee



Thomas J. Hofstedter
Trustee

Consolidated Statements of Earnings

(In thousands of dollars, except per unit amounts)

Years ended	December 31, 2005	December 31, 2004
Operating revenue:		
Rentals from income properties (note 11)	\$ 486,252	\$ 402,418
Mortgage interest and other income	1,917	8,104
	488,169	410,522
Operating expenses:		
Property operating costs	153,256	127,012
Mortgage and other interest (note 12)	149,400	121,637
Depreciation of income properties (note 13)	69,907	56,783
Amortization of deferred expenses and intangible costs (note 14)	22,616	8,893
	395,179	314,325
Property operating income (note 20)	92,990	96,197
Trust expenses	6,866	5,796
Net earnings before discontinued operations and non-controlling interests	86,124	90,401
Non-controlling interest (note 9)	(5,866)	(1,073)
Net earnings from continuing operations	80,258	89,328
Net earnings (loss) from discontinued operations (note 21)	6,395	(547)
Net earnings	\$ 86,653	\$ 88,781
Basic net earnings (loss) per unit (note 15):		
Continuing operations	\$ 0.84	\$ 1.01
Discontinued operations	0.07	(0.01)
	\$ 0.91	\$ 1.00
Diluted net earnings (loss) per unit (note 15):		
Continuing operations	\$ 0.84	\$ 1.01
Discontinued operations	0.06	(0.01)
	\$ 0.90	\$ 1.00

See accompanying notes to consolidated financial statements.

Consolidated Statements of Unitholders' Equity

<i>(In thousands of dollars)</i>	Value of units	Accumulated net earnings	Accumulated distributions	Cumulative foreign currency translation adjustment	Total
Unitholders' equity, December 31, 2003	\$ 970,521	\$ 396,817	\$ (387,765)	\$ (11,408)	\$ 968,165
Unit-based compensation relating to 2002 and 2003	621	(621)	-	-	-
Proceeds from issuance of units	161,740	-	-	-	161,740
Issued to subsidiary (note 9)	(119,823)	-	-	-	(119,823)
Issue costs	(172)	-	-	-	(172)
Net earnings	-	88,781	-	-	88,781
Distributions to unitholders	-	-	(111,251)	-	(111,251)
Unit-based compensation	398	-	-	-	398
Foreign currency translation adjustment	-	-	-	(10,693)	(10,693)
Unitholders' equity, December 31, 2004, as previously reported	1,013,285	484,977	(499,016)	(22,101)	977,145
Variable interest entities adjustment to prior periods (note 2)	-	(1,165)	-	-	(1,165)
Unitholders' equity, December 31, 2004, as restated	1,013,285	483,812	(499,016)	(22,101)	975,980
Proceeds from issuance of units (note 10(a))	273,076	-	-	-	273,076
Issue costs	(11,072)	-	-	-	(11,072)
Net earnings	-	86,653	-	-	86,653
Distributions to unitholders	-	-	(126,108)	-	(126,108)
Unit-based compensation	175	-	-	-	175
Foreign currency translation adjustment	-	-	-	(7,563)	(7,563)
Unitholders' equity, December 31, 2005	\$ 1,275,464	\$ 570,465	\$ (625,124)	\$ (29,664)	\$ 1,191,141

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands of dollars)

Years ended	December 31, 2005	December 31, 2004
Cash provided by (used in):		
Operations:		
Net earnings	\$ 86,653	\$ 88,781
Items not affecting cash:		
Depreciation of income properties (note 13)	70,192	57,181
Amortization of deferred expenses and intangible costs (note 14)	22,626	9,010
Loss (gain) on sale of income properties and land under development (note 21)	(6,116)	1,076
Unit-based compensation	175	398
Net earnings attributable to non-controlling interest (note 9)	6,333	1,076
Change in other non-cash operating items (note 16)	(73,487)	(25,484)
	106,376	132,038
Financing:		
Bank indebtedness	(28,781)	33,257
Mortgages payable:		
New mortgages payable	257,786	405,275
Principal repayments	(92,262)	(79,130)
Proceeds from issuance of units, net	262,004	63,700
Distributions to unitholders	(126,108)	(111,251)
Distributions to non-controlling interest (note 9)	(9,097)	(1,447)
	263,542	310,404
Investments:		
Income properties:		
Land under development	(1,583)	–
Proceeds on disposition of income properties and land under development	17,022	19,258
Acquisitions and capital expenditures	(406,303)	(450,210)
Mortgages receivable	23,624	(24,400)
	(367,240)	(455,352)
Increase (decrease) in cash and cash equivalents	2,678	(12,910)
Cash and cash equivalents, beginning of year	6,631	19,541
Cash and cash equivalents, end of year	\$ 9,309	\$ 6,631
Supplemental cash flow information:		
Interest paid	\$ 150,684	\$ 120,215
Supplemental disclosure of non-cash financing and investing activities:		
Acquisitions of income properties through assumption of mortgages payable	201,853	139,685
Acquisitions of income properties through repayment of mortgages receivable	15,328	61,376
Acquisition of income properties through issuance of Class B units of H&R Portfolio Limited Partnership	–	97,868
Mortgages payable assumed by purchaser on disposition of income properties	2,133	–
Mortgages receivable granted to purchaser on disposition of income properties and land under development	23,940	–

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2005 and 2004

H&R Real Estate Investment Trust (the "Trust") is an unincorporated open-ended trust (note 10) with each unitholder participating pro rata in distributions of income and, in the event of termination of the Trust, participating pro rata in the net assets remaining after satisfaction of all liabilities.

1. Significant Accounting Policies:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect the following policies:

(a) Principles of Consolidation:

The consolidated financial statements include the accounts of all entities in which the Trust holds a controlling interest and consolidates certain variable interest entities that are subject to control on a basis other than through ownership of a majority interest (note 2). The Trust consolidates its interest in joint ventures on a proportionate basis, eliminating its proportionate share of transactions with the joint venture. All material transactions and balances have been eliminated.

(b) Income Properties:

Income properties are recorded at cost less accumulated depreciation. If the sum of the estimated undiscounted future cash flows from operations and expected residual value is less than the carrying value of a particular asset, an impairment would be recognized whereby the asset would be written down to fair value. The buildings are depreciated on a straight-line basis over a period not to exceed 40 years. Paving and equipment are depreciated on a straight-line basis over 10 years. Intangibles resulting from in-place leases are amortized over the related lease terms.

Upon acquisition of properties, the Trust allocates the purchase price to the fair value of assets and liabilities including land, building and intangibles such as above- and below-market leases and in-place operating leases.

(c) Deferred Expenses:

Leasing costs, such as commissions and other tenant inducements, are deferred and amortized on a straight-line basis over the terms of the related leases. Mortgage financing costs are deferred and amortized over the terms of the related debt. Maintenance and repair costs are expensed against operations, while deferred maintenance costs, which are major items of repair or replacement, are amortized on a straight-line basis over the expected recovery from the tenants. The unamortized balance of all these costs is included in deferred expenses.

(d) Revenue Recognition:

The Trust retains substantially all of the benefits and risks of ownership of its income properties and, therefore, accounts for its leases with tenants as operating leases. Rentals from income properties include all amounts from tenants including recovery of operating costs.

Rental revenue from all leases is recognized on the straight-line method over the term of the related lease. The difference between the rental revenue recognized and the amounts contractually due under the lease agreements is recorded in accrued rent receivable.

(e) Co-ownerships:

The Trust carries out a portion of its activities through co-ownership agreements and records its proportionate share of assets, liabilities, revenue, expenses and cash flows of all co-ownerships in which it participates.

(f) Income Taxes:

Pursuant to the terms of the Declaration of Trust, the trustees intend to distribute or designate all taxable income to unitholders of the Trust and to deduct such distributions and designations for Canadian income tax purposes. Therefore, no provision for income taxes is required on income earned by the Trust, its subsidiary trust and flow through entities.

The Trust's corporate subsidiaries are subject to tax on their taxable income. Income taxes are accounted for using the asset and liability method, whereby future income tax assets and liabilities are determined based on differences between the carrying amount of the balance sheet items and their corresponding tax values. Income taxes are computed using substantively enacted corporate income tax rates for the years in which tax and accounting basis differences are expected to reverse.

(g) Unit Option Plan:

The Trust has a unit option plan available for officers, employees and certain trustees as disclosed in note 10(b). Any consideration paid by optionholders on exercise of unit options is credited to unitholders' equity. All options granted under the option plan are fair valued and expensed over the vesting period of three years.

(h) Cash and Cash Equivalents:

Included in cash and cash equivalents are short-term investments which have maturities of three months or less from the date of acquisition.

(i) Use of Estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of the assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the year. Actual results could differ from those estimates.

(j) Foreign Currency Translation:

The Trust accounts for its investments in the United States (“foreign operations”) as self-sustaining operations. Assets and liabilities of foreign operations are translated into Canadian dollars at the exchange rate in effect at the balance sheet date and revenue and expenses are translated at the average exchange rate for the year. The foreign currency translation adjustment is recorded as a separate component of unitholders’ equity until there is a reduction in the Trust’s net investment in the foreign operations.

The U.S. denominated bank indebtedness is designated as a hedge of its investment in self-sustaining operations. Accordingly, the cumulative unrealized gains or losses arising from the translation of this obligation are recorded as a foreign currency translation adjustment.

(k) Derivative Financial Instruments:

Derivative financial instruments are utilized by the Trust in its management of its foreign currency and interest rate exposures. The Trust formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Trust also formally assesses, both at the hedge’s inception and on an ongoing basis, whether hedging relationships will be highly effective. Gains or losses on hedges of existing assets and liabilities are deferred. Unrealized gains or losses on hedged commitments or anticipated transactions are not recorded in the consolidated financial statements until the transaction occurs.

The Trust has entered into foreign exchange contracts which hedge the currency risk attributable to forecasted U.S. denominated interest payments on U.S. denominated debt from its wholly owned subsidiary. The foreign exchange translation gains and losses are recognized as an adjustment to income when this interest is recorded.

The Trust, in certain cases, enters into bond forward contracts to lock in interest rates on specific anticipated mortgages. For contracts qualifying as hedges, the gain or loss on settlement of the contract is recognized as an adjustment to interest expense over the term of the related mortgage.

The Trust has entered into electricity contracts to hedge the electricity price on notional quantity usage of electricity. The gains and losses are recognized as an adjustment to income when the electricity expense is recorded.

In the event a designated hedged item is sold, extinguished, or it is no longer probable that the anticipated transaction will occur, or matures prior to termination of the related derivative instrument, any realized or unrealized gain or loss on such derivative instrument is recognized in income.

(l) Land Under Development:

Land under development is stated at cost. If it is determined that the carrying amount exceeds the undiscounted estimated future net cash flows expected to be received from the ongoing use and residual value of the land, after taking into account estimated costs to complete the development, it is reduced to its estimated fair value.

Cost includes initial acquisition costs, other direct costs and realty taxes, interest, and operating revenue and expenses during the period of development.

2. Change in Accounting Policy:

Effective January 1, 2005, the Trust is required, pursuant to Accounting Guideline 15, Consolidation of Variable Interest Entities (“AcG-15”) issued by The Canadian Institute of Chartered Accountants (“CICA”), to consolidate certain variable interest entities (“VIEs”) that are subject to control on a basis other than through ownership of a majority of voting interest.

AcG-15 defines a VIE as an entity that either does not have sufficient equity at risk to finance its activities without subordinated financial support or where the holders of the equity at risk lack the characteristics of a controlling financial interest. AcG-15 requires the primary beneficiary to consolidate VIEs and considers an entity to be the primary beneficiary of a VIE if it holds variable interests that expose it to a majority of the VIE’s expected losses or entitles it to receive a majority of the VIE’s expected residual returns or both.

Effective January 1, 2005, the Trust implemented AcG-15 retroactively without restatement of prior periods and, as a result, the Trust consolidates all VIEs for which it is the primary beneficiary.

Upon implementation of AcG-15, the Trust determined that it was required to consolidate two entities for development projects, for which the Trust had provided mezzanine financing, and which the Trust has an option to purchase upon completion.

Details of the amounts recorded upon implementation and their effect on the relevant balance sheet captions at January 1, 2005 are summarized below:

	Before AcG-15 impact	Impact of the implementation of AcG-15	After AcG-15 impact
Assets			
Mortgages receivable	\$ 54,768	\$ (15,771)	\$ 38,997
Land under development	–	20,946	20,946
Liabilities and Unitholders' Equity			
Bank indebtedness	89,538	6,340	95,878
Unitholders' equity	977,145	(1,165)	975,980

3. Income Properties:

	2005		2004	
	Cost	Accumulated depreciation and amortization	Net book value	Net book value
Land	\$ 703,952	\$ –	\$ 703,952	\$ 608,053
Buildings	2,756,000	164,425	2,591,575	2,315,275
Paving and equipment	94,392	19,039	75,353	34,112
	3,554,344	183,464	3,370,880	2,957,440
Income properties held for sale (note 21)	7,423	61	7,362	15,388
Intangible assets on acquisitions	300,297	23,664	276,633	185,569
Intangible liabilities on acquisitions	(19,286)	(1,899)	(17,387)	(13,352)
	\$ 3,842,778	\$ 205,290	\$ 3,637,488	\$ 3,145,045

Included in intangible assets on acquisitions are intangible assets relating to the property management contract.

4. Deferred Expenses:

	2005		2004	
	Cost	Accumulated amortization	Net book value	Net book value
Deferred leasing	\$ 56,003	\$ 12,616	\$ 43,387	\$ 23,580
Deferred financing	19,889	4,088	15,801	13,969
Deferred maintenance	13,958	2,794	11,164	7,570
	\$ 89,850	\$ 19,498	\$ 70,352	\$ 45,119

5. Mortgages Receivable:

The mortgages receivable are secured by real property and bear interest at a weighted average rate of 5.2% (2004 – 8.3%) per annum. They are repayable between 2006 and 2009.

6. Cash and Cash Equivalents:

Included in cash and cash equivalents at December 31, 2005 is approximately \$4,282 of restricted cash (2004 – \$3,500).

7. Mortgages Payable:

The mortgages payable are secured by income properties and letters of credit in certain cases, bear fixed interest with a weighted average rate of 6.6% (2004 – 6.9%) per annum and mature between 2006 and 2035. Included in the mortgages payable at December 31, 2005 are mortgages denominated in U.S. dollars of U.S. \$651,678 (2004 – U.S. \$428,223). The Canadian equivalents of these amounts are \$755,946 and \$513,868, respectively.

Future principal mortgage payments are as follows:

Years ending December 31:	
2006	\$ 92,498
2007	118,484
2008	148,420
2009	112,818
2010	96,327
Thereafter	1,814,868
	2,383,415
Mortgage premiums	13,479
	\$ 2,396,894

The mortgage premiums represent the difference between the actual mortgages assumed on property acquisitions and the fair value of the mortgages at the date of purchase, less accumulated amortization of \$1,771 (2004 – \$229).

8. Bank Indebtedness:

The bank indebtedness of the Trust is secured by fixed charges over certain income properties, is due on demand and is subject to review each year on July 31. The total facility is \$180,000. The amount available at December 31, 2005, after taking into account the bank indebtedness drawn of \$67,097 and the outstanding letters of credit and other items is \$93,858. The amount can be drawn in Canadian or U.S. dollars.

The Canadian dollar bank indebtedness bears interest at rates approximating the prime rate of a Canadian chartered bank. At December 31, 2005, the Canadian prime interest rate was 5.00% (2004 – 4.25%) per annum.

Included in bank indebtedness at December 31, 2005 is U.S. \$26,366 (2004 – U.S. \$33,173). The Canadian equivalents of these amounts are \$30,584 and \$39,808, respectively. The United States dollar bank indebtedness bears interest at LIBOR rates.

9. Non-controlling Interest:

Non-controlling interest represents the amount of equity related to the Class B units of a subsidiary, H&R Portfolio Limited Partnership (“HRLP”). This non-controlling interest has been accounted for in accordance with EIC-151, Exchangeable Securities Issued by Subsidiaries of Income Trusts. The accounts of HRLP are consolidated in these consolidated financial statements. Class B units of HRLP are only exchangeable on a one-for-one basis, at the option of the holder, into Trust units which have already been issued to HRLP.

Holders of the Class B units of HRLP are entitled to receive distributions on a per unit amount equal to a per Trust unit amount provided to holders of Trust units.

The details of the non-controlling interest are as follows:

Issuance of Class B units of HRLP on November 1, 2004 (note 10(a))	\$ 119,823
Non-controlling interest from continuing operations	1,073
Non-controlling interest from discontinued operations (note 21)	3
Distributions on Class B units of HRLP	(1,447)
December 31, 2004	119,452
Non-controlling interest from continuing operations	5,866
Non-controlling interest from discontinued operations (note 21)	467
Distributions on Class B units of HRLP	(9,097)
December 31, 2005	\$ 116,688

10. Unitholders' Equity:

The Trust completed its conversion into an “open-ended” mutual fund trust under the provisions of the Income Tax Act (Canada) effective July 21, 2005. The beneficial interests in the Trust are represented by a single class of units, which are unlimited in number. Each unit carries a single vote at any meeting of unitholders and carries the right to participate pro rata in any distributions. The unitholders have the right to require the Trust to redeem their units on demand. Upon the tender of their units for redemption by the Trust, all of the unitholders' rights to and under such units are surrendered and the unitholder is entitled

to receive a price per unit as determined by a market formula. The redemption price payable by the Trust will be satisfied by way of a cash payment to the unitholder or, in certain circumstances, including where such payment would cause the Trust's monthly cash redemption obligations to exceed \$50, an *in specie* distribution of notes of H&R Portfolio LP Trust (a subsidiary of the Trust).

(a) The Following Units are Issued and Outstanding:

December 31, 2003	86,198,168
Issued on January 15, 2004 (at a price of \$13.52 per unit)	1,849,605
Issued on November 1, 2004 (at a price of \$17.18 per unit) to a subsidiary (note 9)	6,974,555
Issued under the distribution reinvestment plan and direct unit purchase plan	410,894
Options exercised	873,100
Subtotal	96,306,322
Units held by a subsidiary (note 9)	(6,974,555)
December 31, 2004	89,331,767
December 31, 2004	96,306,322
Issued on March 16, 2005 (at a price of \$19.10 per unit)	5,250,000
Issued on October 31, 2005 (at a price of \$19.55 per unit)	7,675,000
Issued under the distribution reinvestment plan and direct unit purchase plan	884,357
Options exercised	508,637
Subtotal	110,624,316
Units held by a subsidiary (note 9)	(6,974,555)
December 31, 2005	103,649,761

(b) Unit Option Plan:

A maximum of 5,800,000 units were authorized to be issued to the Trust's officers, employees and certain trustees. All such options were issued prior to December 31, 2003. The exercise price of each option approximated the market price of the Trust's units on the date of grant. The options vested at 33.33% per year from the grant date, being fully vested after 3 years, and expire 10 years after the date of the grant.

A summary of the status of the plan as at December 31, 2005 and 2004 and the changes during the years ended on those dates are as follows:

	2005		2004	
	Units	Weighted average exercise price	Units	Weighted average exercise price
Outstanding, beginning of year	2,418,668	\$ 12.66	3,291,768	\$ 12.40
Exercised	(508,637)	12.02	(873,100)	11.68
Outstanding, end of year	1,910,031	12.83	2,418,668	12.66
Options exercisable at December 31	1,753,976	\$ 12.78	1,848,219	\$ 12.48

The options outstanding at December 31, 2005 are exercisable at varying prices ranging from \$12.01 to \$13.36 (2004 – \$11.22 to \$13.36) with a weighted average remaining life of 6.1 years (2004 – 6.9 years). The vested options are exercisable at varying prices ranging from \$12.01 to \$13.36 (2004 – \$11.22 to \$13.36) with a weighted average remaining life of 6.1 years (2004 – 6.7 years).

(c) Unit-based Compensation:

During the year ended December 31, 2005, no options were granted (2004 – nil). The fair value of the unit options used to compute compensation expense is the estimated fair value of each option grant on the grant date. This was calculated for options granted during 2003 and 2002 using the Black-Scholes option pricing model with the following weighted average assumptions: expected distribution yield for 2003 is 9.0% (2002 – 8.6%); expected volatility for 2003 is 12.5% (2002 – 10.2%); risk free interest rate for 2003 is 5.0% (2002 – 5.4%); and expected option life in years for 2003 is 10 (2002 – 10).

(d) Unitholders' Rights Plan:

The Trust has adopted a Unitholders' Rights Plan ("Rights Plan") effective May 20, 2003 to ensure that any takeover bid made for the units of the Trust would be made to all unitholders, treat all unitholders equally, and provide the Board of Trustees with sufficient time to consider any such offer and encourage competing bids to emerge. The Rights Plan grants unitholders the right to acquire, under certain circumstances, additional units at a 50% discount from its then current market price. The Trust, with the consent of its unitholders or rights holders, may redeem each right at a nominal price. The Rights Plan will expire at the annual meeting of unitholders in 2006, unless terminated earlier.

(e) Distribution Reinvestment Plan and Direct Unit Purchase Plan:

The Trust has a distribution reinvestment plan and direct purchase plan for its unitholders which allows participants to reinvest their monthly cash distributions in additional Trust units at an effective discount of 3% and to purchase additional Trust units at an undiscounted price.

(f) Distributions:

The Trust is required to distribute to unitholders not less than 80% of the Distributable Cash as defined in the Declaration of Trust.

11. Rentals from Income Properties:

	2005	2004
Rentals from income properties	\$ 464,576	\$ 380,130
Straight-lining of contractual rent increases	25,744	22,352
Rent amortization of above- and below-market rents	(4,068)	(64)
	\$ 486,252	\$ 402,418

12. Mortgage and Other Interest Expense:

	2005	2004
Mortgage interest	\$ 147,131	\$ 118,863
Amortization of mortgage premium	(1,719)	(229)
Bank interest and charges	3,988	3,003
	\$ 149,400	\$ 121,637

13. Depreciation of Income Properties:

	2005	2004
Depreciation	\$ 70,192	\$ 57,181
Depreciation included in discontinued operations (note 21)	(285)	(398)
	\$ 69,907	\$ 56,783

14. Amortization of Deferred Expenses and Intangible Costs:

	2005	2004
Amortization of deferred leasing expenses	\$ 4,185	\$ 3,658
Amortization of deferred financing expenses	1,510	1,029
Amortization of deferred maintenance costs	1,750	914
Amortization of intangible assets on acquisitions of properties	15,181	3,409
	22,626	9,010
Amortization included in discontinued operations (note 21)	(10)	(117)
	\$ 22,616	\$ 8,893

15. Net Earnings per Unit:

	2005	2004
Net earnings:		
Basic net earnings	\$ 86,653	\$ 88,781
Add net earnings attributable to non-controlling interest (note 9)	6,333	1,076
Diluted net earnings	\$ 92,986	\$ 89,857
The weighted average number of units outstanding was as follows:		
Basic units	95,429,798	88,444,993
Effect of dilutive securities:		
Unit option plan	650,720	606,722
Non-controlling interest conversion to units (notes 9 and 10(a))	6,974,555	1,146,502
Diluted units	103,055,073	90,198,217
Net earnings per unit:		
Basic	\$ 0.91	\$ 1.00
Diluted	0.90	1.00

16. Change in Other Non-cash Operating Items:

	2005	2004
Deferred expenses	\$ (33,189)	\$ (22,544)
Accrued rent receivable	(25,577)	(22,376)
Prepaid expenses and sundry assets	(8,478)	(642)
Accounts receivable	239	815
Accounts payable and accrued liabilities	(6,482)	19,263
	\$ (73,487)	\$ (25,484)

17. Risk Management and Fair Values of Financial Assets and Liabilities:**(a) Risk Management:**

The Trust is exposed to interest rate risk on its borrowings. It minimizes this risk by restricting total debt to 65% of aggregate assets and by attaining long-term fixed rate debt to replace short-term floating rate borrowings. In addition, the weighted average term to maturity of long-term debt is relative to the remaining average lease terms.

The Trust is exposed to credit risk as an owner of real estate in that tenants may become unable to pay the contracted rents. Management mitigates this risk by carrying out appropriate credit checks and related due diligence on the significant tenants. Management has diversified the Trust's holdings so that it owns several categories of properties (office, industrial and retail) and acquires properties throughout Canada and the United States. In addition, management reviews exposures to tenant or related groups of tenants. Bell Canada is the only tenant that accounts for more than 10% of the Trust's rentals from income properties.

The Trust is also exposed to credit risk as a lender on the security of real estate in the event that a borrower is unable to make the contracted payments. Such risk is mitigated through credit checks and related due diligence of the borrowers and through careful evaluation of the worth of the underlying assets.

The Trust is exposed to foreign exchange fluctuations as a result of ownership of assets in the United States. In order to mitigate the risk of significant fluctuations, a hedging program has been implemented to protect income earned in US dollars.

(b) Fair Values:

The fair values of the Trust's mortgages receivable, accounts receivable, cash and cash equivalents, bank indebtedness and accounts payable and accrued liabilities approximate their carrying amounts due to the relatively short periods to maturity of the instruments.

The fair value of the mortgages payable has been determined by discounting the cash flows of these financial obligations using year-end market rates for debt of similar terms and credit risks. Based on these assumptions, the fair value of mortgages payable at December 31, 2005 has been estimated at \$2,583,495 (2004 – \$2,133,911) compared with the carrying value of \$2,396,894 (2004 – \$2,053,168).

At December 31, 2005, the Trust has foreign exchange forward contracts to sell U.S. dollars for Canadian dollars at a stipulated rate. Additionally, the Trust has an electricity contract to swap floating for fixed price rates as a cash flow hedge of price volatility of the Trust's electricity costs in Ontario, Canada. As at December 31, 2005, the foreign exchange forward contracts total \$10,547 for 2006 and \$3,523 for 2007. The fair value of these foreign exchange forward contracts at December 31, 2005 have been estimated

at \$241 (2004 – \$225) as quoted by the Trust's banker, taking into account current foreign exchange rates. The electricity swap contract hedges a monthly notional amount of approximately 4,000 MWh until June 2008. The fair value of this contract at December 31, 2005 has been estimated at \$2,242 (2004 – (\$65)).

As at December 31, 2005, the Trust has bond forward contracts for notional amounts totalling \$160,000 to hedge against the interest payments on mortgages anticipated to be entered into in January 2006 for the acquisition of two properties as described in note 26(a). The fair value of these contracts at December 31, 2005 is a liability of \$2,867.

18. Co-ownership Activities:

These financial statements include the Trust's proportionate share of assets, liabilities, revenue, expenses and cash flows of the co-ownerships. The Trust's proportionate share of these co-ownerships range between 20.0% and 98.5%, summarized as follows:

	2005	2004
Assets	\$ 137,196	\$ 140,511
Liabilities	63,587	66,872
Revenue	26,200	59,266
Expenses	17,891	51,336
Operating income from properties	8,309	7,860
Cash flows provided by operations	6,301	23,790
Cash flows used in financing	(1,649)	(6,185)
Cash flows provided by (used in) investing	750	(2,583)

Under the terms of the co-ownership agreements, the Trust is only responsible for its proportionate share of the obligations of the co-ownerships, except as disclosed under note 22.

19. Related Party Transactions:

(a) The Trust has entered into an agreement with H&R Property Management Ltd. ("Property Manager"), a company owned by family members of the Chief Executive Officer, to provide property management services including leasing services concerning the properties owned by the Trust for a fee of approximately 3% of gross revenue. In addition, the Property Manager provides support services in connection with the acquisition and development activities of the Trust for a fee of 1% of total acquisition costs as defined in the agreement. This fee payment is limited to 1% of gross revenue for any particular year with the balance available for carry forward subject to certain conditions. The current agreement is for four years expiring December 31, 2009 with two automatic five-year extensions. During the year ended December 31, 2005, the Trust accrued fees pursuant to this agreement of \$17,351 (2004 – \$15,849), of which \$6,135 (2004 – \$5,904) was capitalized to the cost of the income properties acquired and \$2,099 (2004 – \$1,913) was capitalized to deferred expenses. The Trust has also reimbursed the Property Manager for certain direct property operating costs.

For the year ended December 31, 2005, a further amount of \$1,300 (2004 – \$2,200) has been allocated to the Property Manager in accordance with the annual incentive bonus pool and has been expensed in the consolidated statements of earnings.

Pursuant to the above agreements, as at December 31, 2005, \$2,073 (2004 – \$2,135) was payable to the Property Manager.

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

In March 2006, the Trust and the Property Manager agreed to further amend the fees for property management services and support services, as more fully described below under note 26.

(b) On November 1, 2004, the Trust, through its subsidiary, HRLP, completed the acquisition of substantially all of the 30% interest of 22 properties in which the Trust acquired an initial 70% undivided interest as part of its 1996 initial public offering (note 23(a)).

20. Segment Disclosures:

Segmented information on identifiable assets by geographic region and property operating income is as follows:

Geographic information:

Items are attributed to countries based on the location of the properties.

Income properties:

	2005	2004
Canada	\$ 2,619,452	\$ 2,466,923
United States	1,018,036	678,122
	\$ 3,637,488	\$ 3,145,045

Property operating income for the year ended December 31, 2005:

	Canada	United States	Total
Operating revenue	\$ 420,903	\$ 67,266	\$ 488,169
Property operating costs	(149,766)	(3,490)	(153,256)
Mortgage and other interest	(112,532)	(36,868)	(149,400)
Depreciation of income properties	(52,136)	(17,771)	(69,907)
Amortization of deferred expenses and intangible costs	(17,932)	(4,684)	(22,616)
Property operating income	\$ 88,537	\$ 4,453	\$ 92,990

Property operating income for the year ended December 31, 2004:

	Canada	United States	Total
Operating revenue	\$ 364,094	\$ 46,428	\$ 410,522
Property operating costs	(124,750)	(2,262)	(127,012)
Mortgage and other interest	(97,460)	(24,177)	(121,637)
Depreciation of income properties	(44,663)	(12,120)	(56,783)
Amortization of deferred expenses and intangible costs	(7,208)	(1,685)	(8,893)
Property operating income	\$ 90,013	\$ 6,184	\$ 96,197

21. Discontinued Operations:

During the year ended December 31, 2005, three industrial buildings and land under development were sold for consideration of \$43,095, settled by cash of \$17,022, vendor take-back mortgages of \$23,940, and vendor assumption of Trust's mortgage payable of \$2,133. In addition, one industrial building is currently listed for sale. During 2004, there were two properties sold. The results of operations from these properties have been separately disclosed below:

	2005	2004
Property operating income before depreciation and amortization	\$ 1,041	\$ 1,047
Depreciation of income properties	(285)	(398)
Amortization of deferred expenses and intangible costs	(10)	(117)
Property operating income	746	532
Gain (loss) on sale of income properties and land under development	6,116	(1,076)
Earnings (loss) from discontinued operations before non-controlling interest	6,862	(544)
Non-controlling interest (note 9)	(467)	(3)
Net earnings (loss) from discontinued operations	\$ 6,395	\$ (547)

22. Commitments and Contingencies:

(a) In the normal course of operations, the Trust has issued letters of credit in connection with financings, operations and acquisitions. As at December 31, 2005, the Trust has outstanding letters of credit totalling \$17,295 (2004 – \$23,244), including \$16,435 (2004 – \$16,326) which has been pledged as security for certain mortgages payable. These letters of credit are secured in the same means as the bank indebtedness (note 8).

At December 31, 2005, the Trust had issued guarantees amounting to \$50,022 (2004 – \$51,457) which expire between 2011 and 2016 and no amount has been provided for in the consolidated financial statements for these items. These amounts arise out of two properties where the Trust has guaranteed a co-owner's share of the mortgage liability. The Trust has recourse to the co-owner's share of the assets in the event the guarantees are called upon.

(b) As of December 31, 2005, the Trust had entered into agreements to acquire properties for purchase prices aggregating \$455,711, including the transactions described in note 26.

(c) The Trust is involved in litigation and claims in relation to the income properties that arise from time to time in the normal course of business. In the opinion of management, any liability that may arise from such contingencies would not have a significant adverse effect on the consolidated financial statements.

23. Acquisitions:**(a) Related Party Acquisitions:**

On November 1, 2004, the Trust, through its subsidiary HRLP, completed the acquisition of substantially all of the 30% interest of 22 properties as disclosed in note 19(b). The participating vendors exchanged, on a tax deferred basis, their remaining interest in these properties for an aggregate of 5,696,610 Class B units of HRLP which are exchangeable on a one-for-one basis at any time for Trust units held by HRLP, and the assumption by HRLP of the proportionate share of the mortgage liabilities on the particular properties. As part of the acquisition consideration, the fee arrangement with the Property Manager has been amended. The amendments for the fee arrangement comprise: (i) an aggregate reduction in the payments owing to it under the 3% management fee and the bonus plan by an amount of \$2,500 per annum over the remaining term of the property management agreement (commencing January 1, 2005), and (ii) a change to the basis for calculating the support services fee payable by the Trust from 1% of the Trust's total annual revenue, to 1% of the value of the Trust's property acquisition and project development costs, not to exceed 1% of total revenue (effective January 1, 2004). At closing, the Trust issued 5,696,610 Trust units to HRLP. The acquisitions have been recorded by the purchase method, with the results of operations included in these consolidated financial statements from the date of acquisition.

The following table summarizes the acquired net assets at fair value:

Assets		
Land		\$ 19,526
Building		78,105
Paving and equipment		731
Intangible above market leases		16,287
Intangible acquired in-place lease costs		21,876
Intangible asset relating to property management contract		21,400
		157,925
Liabilities		
Mortgages payable		59,106
Intangible below market leases		951
		60,057
Net assets acquired and settled by issuance of 5,696,610 Class B units of HRLP, recorded at the exchange amount		\$ 97,868

The vendors also subscribed for an additional 1,277,945 Class B units of HRLP for an aggregate price of approximately \$21,955 which was settled for cash. This increased their total Class B units to 6,974,555 (note 10(a)).

(b) Other Acquisitions:

During the year ended December 31, 2005, the Trust acquired a total of 34 properties (2004 – 40). These acquisitions have been recorded by the purchase method with the results of operations included in these consolidated financial statements from the date of acquisition. The following table summarizes the acquired net assets at fair value:

	2005	2004
Assets		
Land	\$ 108,689	\$ 90,507
Building	363,455	362,031
Paving and equipment	36,033	1,378
Intangible above market leases	28,205	21,828
Intangible acquired in-place lease costs	82,515	102,953
Customer relationship value	6,151	–
	625,048	578,697
Liabilities		
Mortgages payable	201,853	80,579
Intangible below market leases	6,418	9,962
	208,271	90,541
	\$ 416,777	\$ 488,156
Settled by:		
Cash	\$ 401,449	\$ 426,780
Mortgages receivable	15,328	61,376
	\$ 416,777	\$ 488,156

24. Income Taxes:

The Trust is taxed as a Mutual Fund Trust for Canadian income tax purposes.

In respect of assets and liabilities of the Trust, where income is taxed directly in the hands of the unitholders, the net book value for accounting purposes of those net assets exceeds their tax basis by an amount of approximately \$638,354 (2004 – \$591,247).

The Trust has certain subsidiaries in the United States which are subject to tax on their taxable income at a rate of approximately 38%. At December 31, 2005, these subsidiaries had accumulated net operating losses available for carryforward for income tax purposes of approximately \$25,069. These losses expire between 2018 and 2025. The net future tax assets of these corporate subsidiaries of \$7,605 consist of net operating losses and tax and book basis differences relating to United States income properties, against which a valuation allowance of \$7,605 has been recorded.

25. Comparative Figures:

Certain 2004 comparative figures have been reclassified to conform with the financial statement presentation adopted in 2005.

26. Subsequent Events:

(a) In January 2006, the Trust purchased two distribution facilities located in Brampton, Ontario and Calgary, Alberta for cash consideration of \$229,050. The Trust obtained two mortgages totalling \$180,113 on these properties.

(b) In February 2006, the Trust purchased a portfolio of four industrial properties in the United States for a total cash consideration of \$30,300.

(c) In March 2006, the Trust and the Property Manager agreed to further amend the Omnibus Property Management Agreement so that effective January 1, 2006 and for the remaining terms of the agreement, the fees payable by the Trust to the Property Manager (i) for property management services is reduced from 3% to 2% of gross rental revenue, and (ii) for support services is reduced from 1% to two-thirds of 1% of the value of real property acquisitions and project development costs, but without the 1% gross revenue limit or the carryforward mechanism. The currently accrued support services fees in the amount of \$3.1 million will be paid out to the Property Manager.

(d) On April 28, 2006, the Trust completed a public offering, issuing 5,985,000 units for gross proceeds of approximately \$125,100.

(e) On May 1, 2006, the Trust acquired a 100% undivided interest in a office complex located in Burnaby, British Columbia which has been leased for a 20 year term to Telus Communications Inc. for cash consideration of approximately \$151,000. A 20 year non-recourse mortgage for \$115,500 was secured at the time of closing.

Corporate Information

Trustees and Officers

Board of Trustees

Sandor Hofstedter
Honourary Chairman
and one of the founders
of H&R Developments

Thomas J. Hofstedter¹
President and
Chief Executive Officer
H&R Real Estate
Investment Trust

Robert Dickson²
Managing Director
MDC Partners

Edward Gilbert^{1,2,3}
Chief Operating Officer
Firm Capital Mortgage
Investment Fund

**The Honourable
Robert P. Kaplan, P.C., Q.C.**
Business Consultant
Member of Parliament until 1993

Laurence A. Lebovic^{1,3}
Chief Executive Officer
Runnymede Development
Corporation Ltd.

Ronald C. Rutman^{2,3}
Partner
Zeifman & Company,
Chartered Accountants

Officers

Thomas J. Hofstedter
President and
Chief Executive Officer

Eric Cohen
Chief Financial Officer

Nathan Uhr
Vice-President,
Acquisitions

Unitholder Information

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Telephone: 416 635 7520
Fax: 416 398 0040
E-mail: info@hr-reit.com
Website: www.hr-reit.com

Registrar and Transfer Agent
CIBC Mellon Trust Company
P.O. Box 7010
Adelaide Street Postal Station
Toronto, Ontario, Canada M5C 2W9
Telephone: 416 643 5500 or
1 800 387 0825
Fax: 416 643 5501
E-mail: inquiries@cibcmellon.com
Website: www.cibcmellon.com

Auditors
KPMG LLP

Legal Counsel
Fraser Milner Casgrain

Investor Information
Analysts, Unitholders, and others
seeking financial data should
contact: Eric Cohen, Chief Financial
Officer (416) 635-7520

Taxability of Distributions
64% of the distributions made by the
REIT to unitholders during 2005
were tax deferred. Management
estimates that between 55% and 65%
of the distributions to be made by the
REIT in 2006 will be tax deferred.

Plan Eligibility
RRSP RRIF DPSP

Stock Exchange Listing
Units of H&R REIT are listed on
the Toronto Stock Exchange under
the trading symbol "HR.UN".

Annual Meeting of Unitholders
June 23, 2006
3:00 p.m.
Le Royal Meridien
King Edward Hotel
37 King Street East
Toronto, ON
MJC 3E9

¹ Investment Committee

² Audit Committee

³ Compensation and Governance Committee

Unitholder Distribution Reinvestment Plan and Direct Unit Purchase Plan

Since January 1, 2000, H&R REIT has offered registered holders of its units resident in Canada the opportunity to participate in its Unitholder Distribution Reinvestment Plan (the “DRIP”) and Direct Unit Purchase Plan.

The DRIP allows participants to have their monthly cash contributions reinvested in additional units of H&R REIT at the weighted average price of the units on the TSE for the five trading days (the “Average Market Price”) immediately preceding the cash distribution date. In addition, participants will be entitled to receive an additional distribution equal to 3% of each cash distribution reinvested pursuant to the DRIP which will be reinvested in additional units.

The Direct Unit Purchase Plan allows participants to purchase additional units on a monthly basis at the Average Market Price subject to a minimum purchase of \$250 per month (up to a maximum of \$13,500 per year) for each participant.

For more information on the DRIP and/or the Direct Unit Purchase Plan, please contact us by email through the “Contact Us” webpage of our website or contact the plan agent: CIBC Mellon Trust Company, P.O. Box 7010, Adelaide Street Postal Station, Toronto, Ontario M5C 2W9, Tel: 416 643 5500 (or for callers outside of the 416 area code: 1 800 387 0825), Fax: 416 643 5501, Email: inquiries@cibcmellon.com.

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