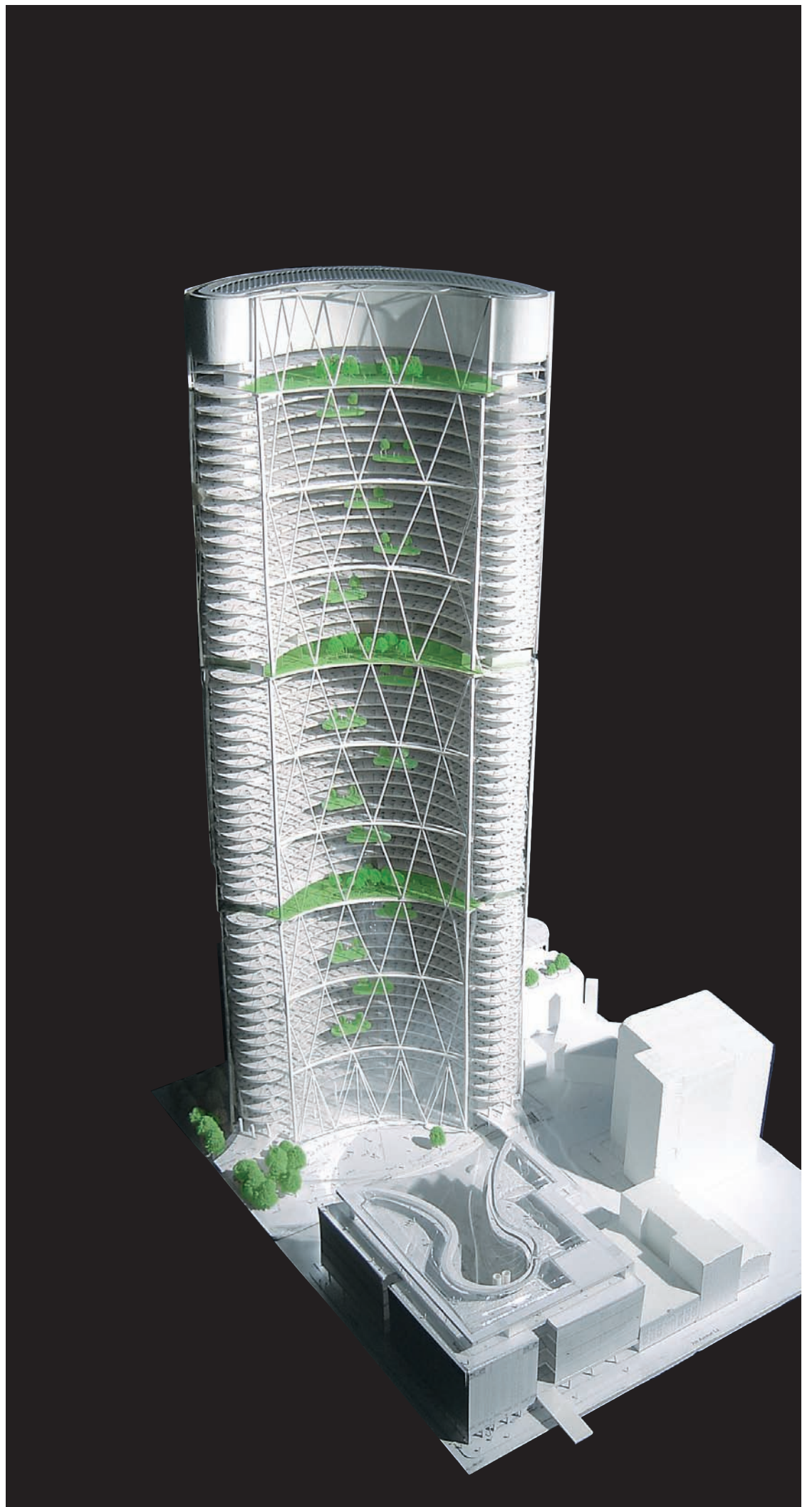


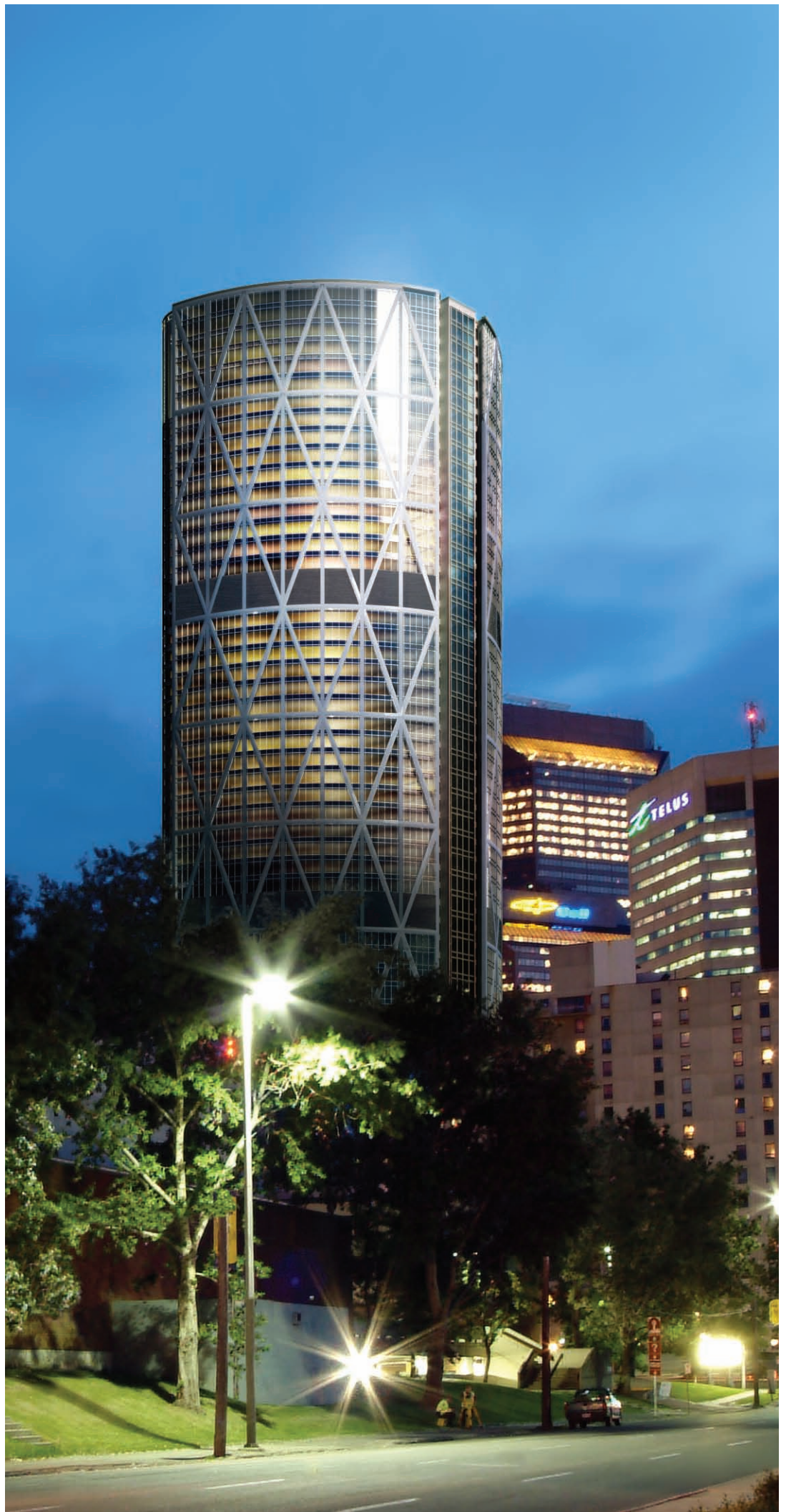
STABILITY
AND GROWTH
THROUGH
DISCIPLINE



2006 ANNUAL REPORT



On the front cover is an architectural rendering of The Bow – Encana Corporation's new 1.9 million square foot head office in downtown Calgary; H&R is developing the \$1.3-billion mixed-use complex for expected completion in 2011.



Architectural rendering of the view from one of The Bow's three "sky gardens"; the 59-storey, Class AAA office tower will be the tallest building in western Canada, and involves the single largest lease in Canadian history.



H&R will have a cluster of three prominent office towers comprising 3.5 million square feet to offer space to prospective tenants in Calgary, one of Canada's fastest growing metropolitan areas.

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	41 Consolidated Statements of Unitholders' Equity	42 Consolidated Statements of Cash Flows	43 Notes to Consolidated Financial Statements	
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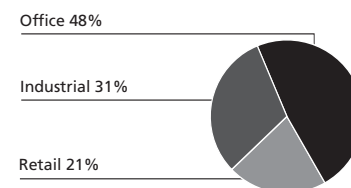


Architectural rendering of Phase III (in the foreground) of H&R's Bell Mobility Complex in Mississauga, Ontario; the \$120-million expansion of 325,000 square feet will bring the total leasable area of the property to 1.1-million square feet upon completion.

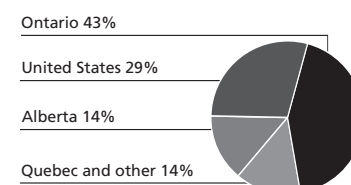
Profile Incorporated in 1996, H&R Real Estate Investment Trust owns, manages and acquires income-producing properties, and provides mezzanine financing for development projects that are substantially pre-leased. A significant portion of H&R's cash is distributed to unitholders each month and much of 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.

Operating Income by Type of Asset



Book Value by Geographic Region



Stable Growth and Returns from a Disciplined Strategy

H&R's success has been founded on a long-held commitment to provide stability, growth and attractive returns through discipline. Stable growth and returns are manifested by steady increases in distributions and unit price appreciation, while the discipline is reflected in risk mitigation achieved through long-term leasing and financing coupled with conservative management of assets and liabilities.

2006 Highlights

- Increased total distributions per unit by 2.3%
- Maintained portfolio occupancy rate at 99% for the ninth consecutive year
- Distributable income rose 16% primarily through acquisitions
- Year-end unit price up 16% from a year earlier
- Maintained long terms to maturities for leasing (12.6 years) and financing (11.1 years)
- Generated average 9% levered return on investment of nearly \$1 billion in acquisitions
- Raised \$275 million through two financings to maintain sound capital structure

	2006	2005	2004
Rental income (million)	\$ 556	\$ 478	\$ 403
Net earnings (million)	\$ 86	\$ 87	\$ 89
Net earnings per unit (basic)	\$ 0.79	\$ 0.91	\$ 1.00
Distributable income* (million)	\$ 174	\$ 150	\$ 129
Distributable income per unit (basic)*	\$ 1.49	\$ 1.46	\$ 1.44
Distributions to unitholders (million)	\$ 155	\$ 135	\$ 113
Distributions per unit	\$ 1.33	\$ 1.30	\$ 1.24
Assets (billion)	\$ 4.8	\$ 3.8	\$ 3.3
Unitholders' equity (billion)	\$ 1.4	\$ 1.2	\$ 1.0

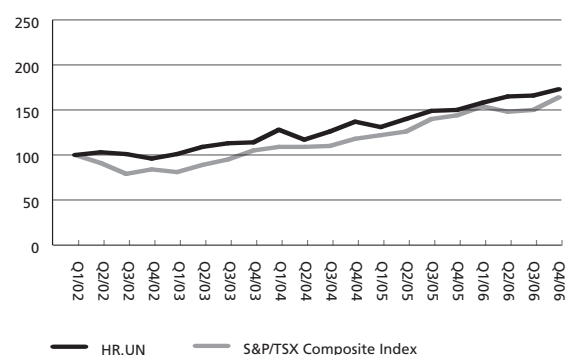
* Distributable income is a non-GAAP measure described in the MD&A

10-year Performance

(since first full year of operation in 1997)

- Compound average annual growth rate of 31% in distributable income, 8% in annual distributions per unit, and 9% in year-end unit price.
- Average annual return on investment to unitholders of 18%, including distributions and unit price appreciation

HR.UN versus S&P/TSX Composite Index

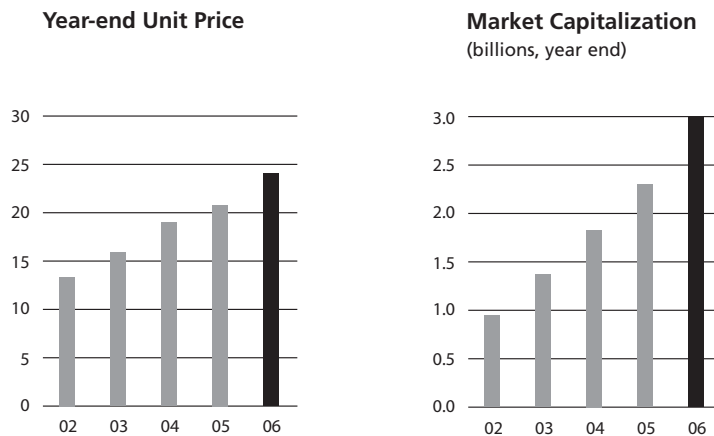


President's Message to Unitholders

IN 2006, H&R REAL ESTATE INVESTMENT TRUST
EXTENDED ITS TRACK RECORD WITH ANOTHER YEAR OF
DELIVERING SOLID, STEADY GAINS TO UNITHOLDERS.

Behind this success is our unwavering commitment to provide unitholders with stability, growth and attractive returns through a disciplined strategy. Our strategy is to acquire and develop a geographically diversified portfolio of prime commercial properties that produces a strong, predictable income stream virtually unaffected by regional or cyclical market factors.

Last year, we completed nearly \$1 billion in acquisitions, producing a weighted average 9% levered return on our equity, and attained a number of important milestones. Total distributable income exceeded \$170 million, and by year end achieved total assets of \$4.8 billion, a unit price of \$24 and a market capitalization of \$3 billion. H&R is one of the largest and fastest-growing REITs in Canada. In 2007, unitholders can anticipate continued growth as H&R's distributable income rises through accretive acquisitions and through contractual rental increases in existing leases.

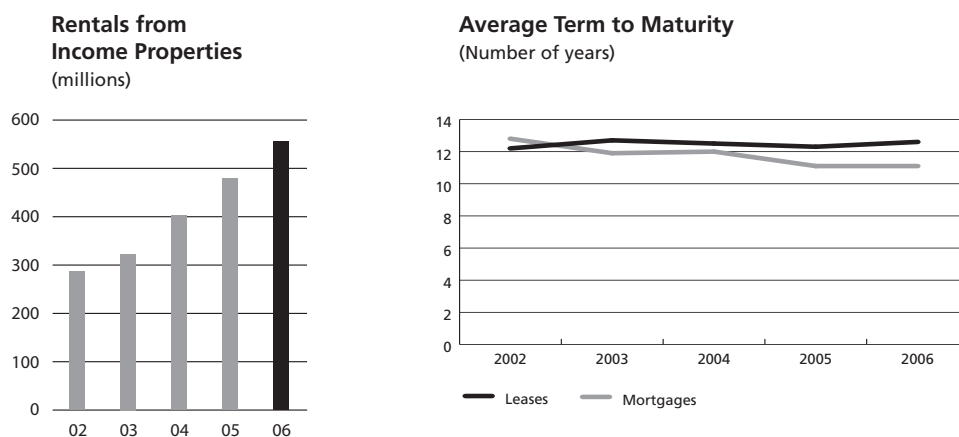


Reliable and Growing Income

Most of today's investors seek predictable and steadily growing income. With H&R REIT, distributions to our unitholders depend on factors such as the quality and diversification of our tenants, our property occupancy rates, and changes in rental rates at lease expiry.

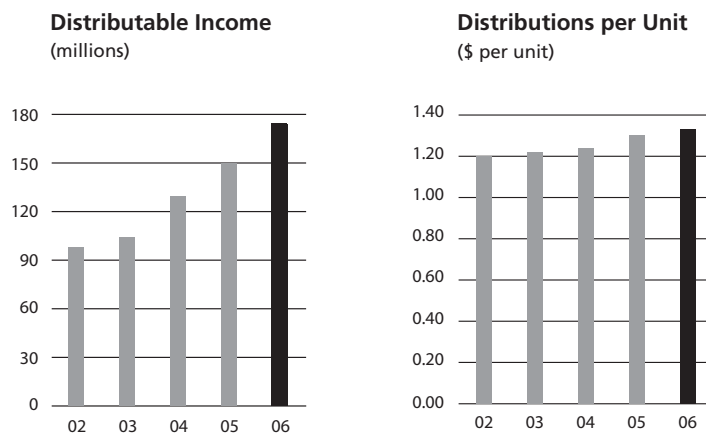
The main cornerstone of our strategy is to lease office, industrial and retail properties to highly creditworthy tenants, primarily on a long-term basis. This stabilizes and enhances occupancy and rental rates over the long run. In fact, our current overall average term to maturity for leases is over 12 years – probably the longest portfolio average in North America.

As a result, our portfolio was over 99% occupied last year, as it was the preceding eight years. And a relatively small proportion of the leases come up for renewal in any given year – only 12% of gross leasable area matures during the next 5 years. This minimizes our exposure to the potential downside risk related to economic cycles and real estate market conditions. And importantly, the majority of our long-term leases have built-in contractual rental escalations that regularly and predictably increase rental income.



Long-term financing is also key to delivering reliable and growing income. To help lock in our annual cash flow, we aim to match the long-term lease at each property with long-term, fixed-rate debt. The average term to maturity of our mortgages in place is over 11 years. Over 97% of the debt on our balance sheet at year-end 2006 was fixed-rate financing, with a weighted average interest rate of 6.4%, and over 55% of it was non-recourse to the REIT.

With strong real estate sector fundamentals and an active acquisition program, we were able to increase both rental revenue and distributable income by 16% last year. This allowed us to increase distributions per unit to H&R unitholders by 2.3% in January 2006 followed by a further 2.7% in January 2007.



Continuous Growth

Another major cornerstone of our long-term strategy is the quality and size of the REIT's portfolio. We continuously strengthen and expand the portfolio in two ways – through the acquisition of existing properties and through new development projects.

On the acquisition front, we had another busy year in 2006. We invested nearly \$1 billion in 68 properties across North America with 6.9 million square feet of rentable area, which produced a weighted average levered return of 9.3%.

These accretive acquisitions were financed by a combination of long-term mortgages, equity issues and cash flow from operations. Last year, we raised \$275 million from two bought-deal public offerings: 6 million units at \$20.90 for gross proceeds of \$125 million in April, and 6.5 million units at \$23.15 for gross proceeds of \$150 million in November.

Among the most sizeable acquisitions completed by H&R in 2006:

Property	Location	Rentable area (square feet)	Purchase price (millions)	Lease term (years)
2 Canadian Tire distribution centres	Brampton, ON and Calgary, AB	2.1 million	\$ 229	21
7 industrial properties	US and Canada	732,000	\$ 48	16
Telus office property	Burnaby, BC	686,000	\$ 151	20
8 Boscov department stores	United States	1 million	\$ 109	20
33 retail properties	Mostly Ontario	1.5 million	\$ 242	13
8 Marsh supermarkets	United States	489,000	\$ 88	20

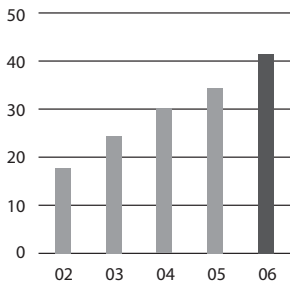
We recently announced that we have entered into agreements for the development of the “The Bow” – EnCana Corporation’s future head office of approximately 1.9 million square feet rising 59 storeys – to be completed in the heart of downtown Calgary, along with 120,000 square feet of first-class retail store premises, a cultural arts facility spanning up to 100,000 square feet, and 1,400 underground parking spaces. This extraordinary project, estimated to cost \$1.3 billion, is scheduled to begin construction this spring and to be fully occupied in 2011. The Bow will be the largest mixed-use complex in Western Canada and the premier trophy property in H&R’s portfolio. In keeping with our stated strategy, we secured a long-term lease of 25 years with an investment grade tenant and contractual rental increases of 1.5% per annum.

This landmark property will also significantly increase H&R’s office market presence in one of the fastest-growing metropolitan areas in the country. Upon completion of The Bow, H&R will own a cluster of three Class AAA office towers – The Bow, the Telus Tower, and the TransCanada Tower. H&R’s interest in these three properties will comprise an aggregate of 3.2 million square feet of prime rentable office space in Calgary’s downtown core. The city’s office market is the strongest in North America with a Class A vacancy rate approaching zero percent.

In addition, we will provide approximately \$120 million of mezzanine financing for the construction of the 325,000 square foot Phase III of the Bell Mobility office complex in Mississauga, Ontario. We provided the mezzanine financing and subsequently exercised our option to buy the first phase of 525,000 square feet in 2002 and the second phase of 249,000 square feet in 2004. As was the case for the first two phases, Phase III will have a 20-year lease with rental escalations every five years.

Through our many investments, we have built a portfolio with critical mass that is broadly diversified by type of property and geographic region. This not only gives us economies of scale, but also spreads out risk and provides for a more dependable income stream. Our portfolio is relatively new, with an average age of 13 years, resulting in modest capital expenditures over the next few years.

Leasable Area
(square feet, millions)



Diversification of Rental Area

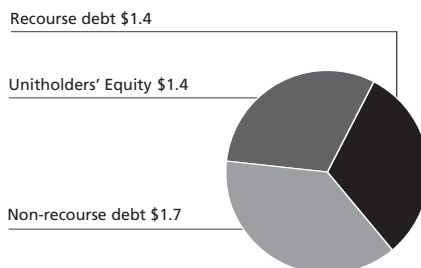
	Ontario	United States	Alberta	Quebec & other	Total
Office	12%	1%	3%	3%	19%
Industrial	24%	18%	6%	8%	56%
Retail	6%	13%	1%	5%	25%
Total	42%	32%	10%	16%	100%

Rising Unitholder Value

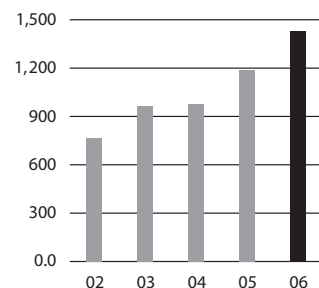
The strength of financial performance and future prospects are evident in the marketplace as investors buy more H&R units. Over the course of last year, the trading volume of the REIT’s units increased 18%. This was also due to the addition of H&R to the S&P/TSX Composite Index in December 2005, which significantly broadened our investor base.

By year-end 2006, the market price of H&R units had risen nearly 16% to just over \$24 per unit, giving unitholders an annual return on their investment of 22% once distributions are factored in. This strong performance topped our compound average return of 19% since inception.

Capital Structure
(\$ billions)



Unitholders' Equity
(millions)



We also increased value on our balance sheet. Unitholders' equity rose 20% to \$1.4 billion at the end of 2006, and we closed the year with debt to gross book value of 62%, thereby maintaining our conservative financing strategy.

Encouraging Outlook

Looking to the future, we see a number of favourable market fundamentals supporting both high occupancy and rental rate increases. These include solid employment and economic growth rates, stable inflation and interest rates, and a continuing balance between demand and supply of commercial space.

Our experienced management team will press on with creating unitholder value by adhering strictly to our proven strategy. We will continue to generate predictable cash flow, and reinvest it in core business assets to produce steady distributions and capital gains for the future. No doubt, we will be challenged by higher commercial property prices as massive amounts of capital flow readily across the globe. But we will continue to thrive and prosper by acting prudently, and maintaining our proven operating strategy.

In closing, I wish to express the appreciation of our entire Board of Trustees to Eric Cohen, who retired last year after nearly two decades of highly dedicated and valuable service to H&R. He has passed the baton to Larry Froom, who brings 10 years of experience in finance at H&R to the role of Chief Financial Officer. We also extend our gratitude to all the tenants, employees and other business partners who contributed to H&R REIT's success in 2006 and look forward to delivering additional stability and growth to all stakeholders this year and beyond.



Tom Hofstedter

March 15, 2007

Management's Discussion and Analysis

For the year ended December 31, 2006

SECTION I

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, 2006 should be read in conjunction with the Trust's consolidated financial statements and the notes thereto for the years ended December 31, 2006 and 2005. 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 period.

Certain information in this MD&A contains forward-looking statements within 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 February 28, 2007 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, 2006 and 2005 is unaudited.

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) ("the Tax Act") 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 units of the Trust trade on the Toronto Stock Exchange under the symbol HR.UN.

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, 2006 is outlined in the charts below:

	Ontario properties	United States properties	Alberta properties	Quebec properties	Other properties	Total properties
Office	23	2	4	1	4	34
Industrial	57	17	18	9	14	115
Retail	42	83	6	7	5	143
Total	122	102	28	17	23	292

<i>(in thousands of square feet)</i>	Ontario sq. ft.	United States sq. ft.	Alberta sq. ft.	Quebec sq. ft.	Other sq. ft.	Total sq. ft.
Office	5,002	258	1,406	452	884	8,002
Industrial	10,030	7,392	2,662	2,435	735	23,254
Retail	2,371	5,521	571	898	772	10,133
Total	17,403	13,171	4,639	3,785	2,391	41,389

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, 2006, the Trust had invested \$2.9 million as mezzanine financing and \$27.3 million as land under development (as part of a joint venture in which the Trust owns an 80% interest). The Trust had also taken back a mortgage receivable of \$16.1 million on the sale of a project in December 2005 when the Trust relinquished its option to purchase the 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 12.6 years at December 31, 2006 (2005 – 12.3 years) closely matches the average term to maturity of our mortgages of 11.1 years at December 31, 2006 (2005 – 11.1 years). These statistics are evidence that our objective of providing long-term stable income continues to be met.

The following chart outlines our lease expiries over the next five years highlighting the fact that leases representing only 12.1% of our total square feet 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
2007	0.2	17.77	1.0	5.18	0.1	14.92	1.3	7.87
2008	0.6	14.92	2.7	3.95	0.2	23.36	3.5	6.94
2009	0.9	19.80	2.3	5.24	0.4	8.01	3.6	9.19
2010	0.6	20.00	1.0	6.47	0.3	26.27	1.9	13.87
2011	0.7	17.21	0.9	8.32	0.2	12.74	1.8	12.27
Total	3.0	18.12	7.9	5.30	1.2	16.50	12.1	9.59

The occupancy levels and the average rent per square foot in the portfolio are as follows:

	Year ended December 31		Office		Industrial		Retail		Weighted average total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
Occupancy – all assets	2006		98.6%		99.9%		99.7%		99.6%	
	2005		98.2%		99.5%		99.9%		99.3%	
Occupancy – same asset	2006		98.4%		99.9%		99.9%		99.5%	
	2005		98.4%		99.9%		99.9%		99.5%	
Average rent per square foot	2006		\$ 18.61		\$ 5.17		\$ 11.69		\$ 9.35	
	2005		\$ 17.75		\$ 5.22		\$ 13.16		\$ 9.62	

“Same-asset” refers to those properties owned by the Trust for the entire 24 months ended December 31, 2006 and excludes any asset classified as discontinued operations.

The Trust's property operating income by asset class (before interest, depreciation and amortization) is as follows:

	Three months ended December 31		Year ended December 31	
	2006	2005	2006	2005
Office	45.9%	51.3%	47.4%	51.6%
Industrial	31.4%	28.6%	31.4%	28.6%
Retail	22.7%	20.1%	21.2%	19.8%
	100.0%	100.0%	100.0%	100.0%

Property operating income is not a measure recognized under Canadian Generally Accepted Accounting Principles ("GAAP") and does not have a standardized meaning prescribed by GAAP. Property operating income as defined by the Trust is calculated as operating revenue less property operating costs. H&R's method of calculating property operating income may differ from other issuers' methods and accordingly may not be comparable to other issuers.

SECTION II

Selected Annual Information

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

	Year ended December 31, 2006	Year ended December 31, 2005 ⁽¹⁾	Year ended December 31, 2004 ⁽¹⁾
<i>(in thousands of dollars except per unit amounts)</i>			
Rentals from income properties	\$ 555,767	\$ 478,052	\$ 403,087
Mortgage interest and other income	1,793	1,916	7,261
Net property operating income	94,685	91,041	95,571
Net earnings from continuing operations	77,787	78,360	88,544
Net earnings per unit from continuing operations			
(basic)	0.71	0.82	1.00
(diluted) ⁽²⁾	0.70	0.81	1.00
Net earnings	\$ 86,437	\$ 86,653	\$ 88,781
Net earnings per unit			
(basic)	0.79	0.91	1.00
(diluted) ⁽²⁾	0.78	0.90	1.00
Total assets	4,779,040	3,844,335	3,314,265
Mortgages payable	3,036,365	2,396,894	2,053,168
Distributable income per unit ⁽³⁾	\$ 1.49	\$ 1.46	\$ 1.44
Cash distributions per unit	\$ 1.33	\$ 1.30	\$ 1.24

Notes:

- (1) Certain items have been reclassified to conform with the presentation adopted in the current year.
- (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 where dilutive and non-controlling interest conversion to units.
- (3) Distributable Income ("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 issuers' methods and accordingly, DI may not be comparable to measures used by other issuers.

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 net property operating income have increased reflecting the greater number of income properties owned by the Trust. In addition, mortgages payable have also increased due to property acquisitions and in order 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.

Results of Operations

<i>(in thousands of dollars except per unit amounts)</i>	Three months ended December 31			Year ended December 31		
	2006 <i>(unaudited)</i>	2005 <i>(unaudited)</i>	Change %	2006	2005	Change %
Operating revenue:						
Rentals from income properties	\$ 150,634	\$ 124,251	21	\$ 555,767	\$ 478,052	16
Mortgage interest and other income	498	197	153	1,793	1,916	(6)
	\$ 151,132	\$ 124,448	21	\$ 557,560	\$ 479,968	16
Operating expenses:						
Property operating costs	50,335	38,925	29	174,478	153,652	14
Mortgage and other interest expense	45,758	39,041	17	174,983	147,254	19
Depreciation of income properties	22,758	19,304	18	83,898	68,300	23
Amortization of deferred expenses and intangible costs	8,222	6,139	34	29,516	19,721	50
	127,073	103,409	23	462,875	388,927	19
Net property operating income	\$ 24,059	\$ 21,039	14	\$ 94,685	\$ 91,041	4
Trust expenses	1,970	918	115	9,101	6,866	33
Net earnings before income taxes, non-controlling interest and discontinued operations	22,089	20,121	10	85,584	84,175	2
Income taxes	897	10	8,870	2,837	88	3,124
Net earnings before non-controlling interest and discontinued operations	21,192	20,111	5	82,747	84,087	(2)
Non-controlling interest	(1,213)	(1,289)	(6)	(4,960)	(5,727)	(13)
Net earnings from continuing operations	19,979	18,822	6	77,787	78,360	(1)
Net earnings from discontinued operations	585	4,660	(87)	8,650	8,293	4
Net earnings	\$ 20,564	\$ 23,482	(12)	\$ 86,437	\$ 86,653	–
Basic net earnings per unit						
Continuing operations	\$ 0.17	\$ 0.18	(6)	\$ 0.71	\$ 0.82	(13)
Discontinued operations	0.01	0.05	(80)	0.08	0.09	(11)
	\$ 0.18	\$ 0.23	(22)	\$ 0.79	\$ 0.91	(13)
Diluted net earnings per unit						
Continuing operations	\$ 0.17	\$ 0.18	(6)	\$ 0.70	\$ 0.81	(14)
Discontinued operations	0.01	0.05	(80)	0.08	0.09	(11)
	\$ 0.18	\$ 0.23	(22)	\$ 0.78	\$ 0.90	(13)

Most of the above changes are due mainly to the impact of the asset acquisition program of the Trust as discussed in more detail below. There were no changes to significant accounting policies for the year ended December 31, 2006 that impacted net earnings.

Rentals from Income Properties and Property Operating Costs

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. Rentals from properties sold or where an asset meets the definition of being held for sale during the year ended December 31, 2006 and December 31, 2005 have been recorded under net earnings from discontinued operations.

Rentals from Income Properties

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change	2006	2005	Change
Same-asset – current rentals	\$ 113,709	\$ 106,948	\$ 6,761	\$ 438,303	\$ 431,583	\$ 6,720
Same-asset – straight-lining of contractual rent increases	4,252	6,580	(2,328)	18,914	23,414	(4,500)
Acquisitions – current rentals and straight-lining of contractual rent increases	32,673	10,723	21,950	98,550	23,055	75,495
Total rentals	\$ 150,634	\$ 124,251	\$ 26,383	\$ 555,767	\$ 478,052	\$ 77,715

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 (see "Related Party Transactions") among other items. For Q4 2006, building operating costs, realty taxes, utilities and property management fees represented 23.0%, 51.6%, 11.1%, and 5.5% respectively of total property operating costs (Q4 2005 – 21.4%, 50.3%, 12.4% and 5.9%). For the year ended December 31, 2006, these costs represented 18.1%, 56.0%, 11.8% and 4.9% on the same basis (2005 – 18.4%, 53.4%, 12.3% and 5.7%).

Property Operating Costs

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change	2006	2005	Change
Same-asset property operating costs	\$ 42,603	\$ 37,968	\$ 4,635	\$ 153,077	\$ 150,284	\$ 2,793
Acquisitions	7,732	957	6,775	21,401	3,368	18,033
Total property operating costs	\$ 50,335	\$ 38,925	\$ 11,410	\$ 174,478	\$ 153,652	\$ 20,826

As highlighted above, the overall increase in rentals and property operating costs is mainly the result of the Trust's ongoing strategy of adding to its properties either through acquisitions or mezzanine financing programs. A total of 102 properties were added and six were disposed of between January 1, 2005 and December 31, 2006.

Property Operating Income

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change	2006	2005	Change
Canada						
Same-asset total rentals	\$ 103,429	\$ 98,099	\$ 5,330	\$ 398,199	\$ 392,630	\$ 5,569
Same-asset property operating costs	40,126	35,090	5,036	143,771	140,406	3,365
Same-asset property operating income	\$ 63,303	\$ 63,009	\$ 294	\$ 254,428	\$ 252,224	\$ 2,204

Property Operating Income (continued)

United States <i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change	2006	2005	Change
Same-asset total rentals	\$ 14,532	\$ 15,429	\$ (897)	\$ 59,018	\$ 62,367	\$ (3,349)
Same-asset property operating costs	2,477	2,878	(401)	9,306	9,878	(572)
Same-asset property operating income	\$ 12,055	\$ 12,551	\$ (496)	\$ 49,712	\$ 52,489	\$ (2,777)
Total same-asset property operating income	\$ 75,358	\$ 75,561	\$ (202)	\$ 304,140	\$ 304,713	\$ (573)

Rentals from Income Properties

The increases in the same-asset current rentals of \$6.8 million for Q4 2006 over Q4 2005 and \$6.7 million for the year ended December 31, 2006 over the year ended December 31, 2005 are primarily due to:

1. An increase of \$2.3 million for the three months ended December 31, 2006 over the corresponding 2005 period is due to contractual rent increases. For the year ended December 31, 2006, the increase in contractual rental increases amounted to \$4.5 million over the 2005 year. This can be seen from the decline in the same-asset straight lining of contractual rent increases over the prior periods as there is a direct inverse relationship between same-asset current rentals and same-asset straight lining of contractual rent increases. A major portion of these increases was due to rental escalations on two significant leases. Firstly, effective May 1, 2006, rentals on the TransCanada PipeLines office tower lease in Calgary, AB increased by 12% per annum (with similar escalations occurring on each of the next two 5-year anniversaries of this date) and secondly, also effective May 1, 2006, rentals on approximately 80% of the Telus office tower space in Calgary, AB increased by 13% per annum.
2. The property operating cost recoveries and realty tax recoveries comprise a significant portion of total rental income. Accordingly, that portion of rentals will fluctuate from period to period as property operating costs fluctuate from period to period in the normal course of business. Canadian same-asset property operating costs increased by \$5.0 million from \$35.1 million in the fourth quarter of 2005 to \$40.1 million in the fourth quarter of 2006 and by \$3.4 million from \$140.4 million for the year ended December 31, 2005 to \$143.8 million for the year ended December 31, 2006. These increases in property operating costs would in turn lead to an equivalent increase in rentals as most of our leases are triple net leases and our portfolio is almost fully occupied.
3. An increase in rentals caused the same-asset property operating income for our Canadian portfolio to increase by \$0.3 million from \$63.0 million in the fourth quarter of 2005 to \$63.3 million in the fourth quarter of 2006 and to increase by \$2.2 million from \$252.2 million for the year ended December 31, 2005 to \$254.4 million for the year ended December 31, 2006.
4. Offsetting the above three rental increases is the decrease in the United States same-asset total rentals due to the strengthening of the Canadian dollar. Using the same exchange rate as the prior year would have increased the current U.S. same-asset total rentals by \$1.1 million for the three months ended December 31, 2006 from the current \$14.5 million to \$15.6 million and would have increased by \$4.2 million for the year ended December 31, 2006 from the current \$59.0 million to \$63.2 million.

Mortgage Interest and Other Income

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change %	2006	2005	Change %
Mortgage interest and other income before accounting for variable interest entities	\$ 603	\$ 545	11	\$ 2,192	\$ 3,424	(36)
Accounting for elimination of variable interest entities	(105)	(348)	(70)	(399)	(1,508)	(74)
Mortgage interest and other income	\$ 498	\$ 197	153	\$ 1,793	\$ 1,916	(6)

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 with the objective of obtaining better returns.

Interest income remained relatively constant when comparing Q4 2006 and 2005 before the adjustment for variable interest entities. For the 2006 year as compared to the 2005 year, mortgage interest income decreased primarily due to the repayment in July 2005 of a mortgage receivable of \$31.1 million. Offsetting part of this decrease was an advance of \$16.0 million as a mortgage receivable in December 2005 following the sale of the Front and John project in Toronto, ON.

Mortgage and Other Interest Expense

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change %	2006	2005	Change %
Mortgage and other interest expense before accounting for variable interest entities	\$ 45,811	\$ 39,268	17	\$ 175,199	\$ 148,313	18
Accounting for variable interest entities	(53)	(227)	(77)	(216)	(1,059)	(80)
Mortgage and other interest	\$ 45,758	\$ 39,041	17	\$ 174,983	\$ 147,254	19

The increase in mortgage and other interest expense is due to the increased level of debt obtained to help finance acquisitions during 2006 and 2005.

As at December 31, 2006 and 2005, H&R's weighted average cost of mortgage debt was 6.4% and 6.6%, respectively.

Depreciation of Income Properties

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change %	2006	2005	Change %
Depreciation of income properties	\$ 22,758	\$ 19,304	18	\$ 83,898	\$ 68,300	23

Depreciation of income properties is charged to income on a straight-line basis over the estimated useful life of the property. All of the increase is due to the continued acquisition of properties during 2006 and 2005. Depreciation will continue to increase as more income properties are purchased.

Amortization of Deferred Expenses and Intangible Costs

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change	2006	2005	Change
Amortization of deferred leasing expenses	\$ 1,116	\$ 809	\$ 307	\$ 4,213	\$ 2,918	\$ 1,295
Amortization of deferred financing expenses	495	417	78	1,869	1,490	379
Amortization of deferred costs	602	573	29	2,461	1,647	814
Amortization of intangible assets on acquisitions	6,009	4,340	1,669	20,973	13,666	7,307
Total amortization	\$ 8,222	\$ 6,139	\$ 2,083	\$ 29,516	\$ 19,721	\$ 9,795

Approximately 80% and 75% of the respective increases in total amortization for both the three months and the year ended December 31, 2006 is due to the increase in amortization of intangible assets on acquisition of properties. 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 operating leases and customer 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. The increase in this expense is reflective of the large increase in income properties over the

previous 24 months. The continued acquisition of properties will result in an increase of this expense in each quarter.

Trust Expenses

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change %	2006	2005	Change %
Trust expenses	\$ 1,970	\$ 918	115	\$ 9,101	\$ 6,866	33

Trust expenses are primarily comprised of salaries, professional fees and trustee fees. The overall increase was mainly as a result of an increase in salaries and professional fees. The increase in salaries was mostly due to an increase of \$1.2 million in the annual incentive bonus pool payable to the Property Manager. The increase in professional fees was due to additional services required due to higher audit and consulting costs associated with compliance with additional regulation requirements. Professional fees are expected to stabilize at the current level over the next few quarters.

For the three months ended December 31, 2006, salaries, professional fees and trustee fees represented approximately 59.6%, 31.5% and 4.3%, respectively, of overall trust expenses (Q4 2005 – 13.6%, 43.9% and 10.4% respectively). Salaries in Q4 2005 were lower than usual due to a revised lower bonus estimate for the 2005 year of which the entire amount was recorded in the fourth quarter of 2005. For the year ended December 31, 2006, salaries, professional fees and trustee fees represented approximately 56.6%, 28.0% and 3.5% respectively of overall trust expenses (2005 – 53.0%, 23.4%, and 3.4% respectively).

For Q4 2006 total trust expenses amounted to 1.3% of rentals from income properties (Q4 2005 – 0.7%). These expenses increased slightly for the year ended December 31, 2006 as compared to 2005, with the percentages being 1.6% and 1.4% for the year ended December 31, 2006 and 2005 respectively.

Income Taxes

H&R is generally subject to tax in Canada under the Tax Act in respect to its taxable income each year, except to the extent such taxable income is paid or deemed to be payable to Unitholders and deducted by H&R for tax purposes.

Pursuant to H&R's Declaration of Trust, the Trustees intend to distribute or designate all taxable income directly earned by H&R to Unitholders of the Trust such that H&R will not be subject to income tax under Part 1 of the Tax Act.

A Unitholder is required to include, in computing income for tax purposes each year, the portion of the amount of net income and net taxable capital gains of H&R paid or payable to the Unitholder in the year. The Declaration of Trust generally requires H&R to claim the maximum amount of capital cost allowance available to it in computing its income for tax purposes. The amount distributed to Unitholders, since its inception as a REIT in 1996, has exceeded the income of H&R as calculated for income tax purposes. Distributions in excess of H&R's taxable income allocated to the Unitholder for the year will not be included in computing the taxable income of the Unitholder. However, the adjusted cost base of the units held by the Unitholder will be reduced by the amount of distributions not included in income.

Upon the disposition or deemed disposition by a Unitholder of a unit, a capital gain (or a capital loss) will generally be realized to the extent that the net proceeds of disposition of the unit exceed (or are exceeded by) the adjusted cost base of the unit. Currently, only 50% of a capital gain ("taxable capital gain") must be included in computing a Unitholder's income and 50% of a capital loss (an "allowable capital loss") may be deducted against taxable capital gains.

For the year ended December 31, 2006, current income taxes amounted to \$0.2 million (2005 – \$0.1 million). Substantially all the current income taxes are due to various U.S. State taxes.

The Trust accounts for future income tax costs or liabilities resulting from one of its partnerships, pursuant to the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3465. A future income tax liability as at December 31, 2006 of \$0.6 million (2005 – nil) has been recorded to reflect the future tax obligations of the Canadian subsidiaries resulting from tax and book basis differences of Canadian income properties.

Under United States tax law, H&R may be subject to tax on a portion of its United States source income. H&R intends to designate its directly held United States source income to Unitholders such that the Unitholders will be able to utilize any foreign tax credits paid by the Trust. For the year ended December 31, 2006, the Trust had \$20.4 million (2005 – \$13.6 million) of taxable United States source income which was subject to U.S. withholding tax of \$2.0 million (2005 – nil). Previously, these withholding taxes of \$1.4 million were classified as distributions. See the "Tax Risk" section for a discussion of draft legislation proposed by the Minister of Finance regarding the federal income taxation of publicly traded income trusts and certain other publicly traded flow-through entities.

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, net earnings attributable to the Class B unitholders of H&R Portfolio Limited Partnership ("HRLP"), a subsidiary partnership, have been segregated and deducted from the net earnings of the Trust. In March 2006, HRLP purchased a portfolio of three industrial properties for which further Class B units were issued as partial consideration. However, these Class B units issued in March 2006 were exchanged into Trust units during April 2006 and the non-controlling interest and net earnings related thereto were adjusted accordingly. For a further discussion regarding non-controlling interest, please refer to "Financial Conditions".

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 2006 is \$1.2 million (Q4 2005 – \$1.3 million) and for the years ended December 31, 2006 and 2005 is \$5.0 million and \$5.7 million respectively. See "Net earnings from discontinued operations" below for the non-controlling interest deducted from income from discontinued operations.

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 assumed to be issued and are included in the per unit calculations.

Net earnings from discontinued operations

When the Trust decides to dispose of an asset that no longer fits its investment strategy and re-deploy the proceeds in more attractive opportunities or when a tenant exercises an option under the terms of their lease to purchase a property or when the Trust initiates the sale of an asset, the net 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 from discontinued operations as summarized below:

<i>(in thousands of dollars)</i>	Three months ended December 31			Year ended December 31		
	2006	2005	Change %	2006	2005	Change %
Net property operating income	\$ 593	\$ 1,056	(44)	\$ 3,173	\$ 2,783	14
Gain on sale of income properties and land under development	20	3,939	(99)	6,028	6,116	(1)
Non-controlling interest	(28)	(335)	(92)	(551)	(606)	(9)
	\$ 585	\$ 4,660	(87)	\$ 8,650	\$ 8,293	4

During the three months ended December 31, 2006 the Trust initiated the sale of two industrial and two retail properties totalling 269,597 square feet. One of these properties is scheduled to close in Q1 2007, with another scheduled to close in Q2 2007. In Q2 2006, the Trust initiated the sale of a 55,900 square foot retail property in Edmonton, Alberta, which closed in Q1 2007. Assets which were sold during the previous two years are as follows:

2006 Dispositions

Property	Property type	Date disposed	Square footage	Gross proceeds (\$ millions)	Ownership interest disposed
380 Markland Ave, Markham, ON	Industrial	Jul 18, 06	81,222	7.4	100%
401/405 The West Mall, Toronto, ON	Office	Sep 1, 06	418,531	65.0	100%
16900 107 Avenue NW, Edmonton, AB	Industrial	Sep 27, 06	172,070	10.7	100%
Total			671,823	83.1	

2005 Dispositions

Property	Property type	Date disposed	Square footage	Gross proceeds (\$ millions)	Ownership interest disposed
3655 Weston Road, Toronto, ON	Industrial	Jul 28, 05	184,266	8.3	100%
1060 Tristar Drive, Mississauga, ON	Industrial	Nov 30, 05	65,284	3.8	100%
2841 Langstaff Road, Vaughan, ON	Industrial	Dec 12, 05	123,529	10.0	100%
Total			373,079	22.1	

In addition to the properties listed above, in December 2005, the Trust relinquished its option to purchase land under development at the Front and John site in Toronto.

Distributable Income

Management uses Distributable Income to reflect distributable cash which is defined in the Declaration of Trust, which is amended by the Trustees from time to time, 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 issuers' 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.

The Trust has also issued Trust units to mirror the Class B Units of HRLP 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 reflect the actual number of units issued.

Calculation of Distributable Income:

	Three months ended December 31		Year ended December 31	
<i>(in thousands of dollars except unit and per unit amounts)</i>	2006	2005	2006	2005
Net earnings	\$ 20,564	\$ 23,482	\$ 86,437	\$ 86,653
Add (deduct)				
Depreciation of income properties	\$ 22,758	\$ 19,769	\$ 84,520	\$ 70,192
Net variable interest entities adjustment	52	121	183	449
Straight-lining of contractual rent increases	(5,248)	(7,287)	(21,586)	(25,690)
Unit based compensation	—	—	—	175
Amortization of intangible assets on acquisition	6,009	4,594	21,217	15,181
Amortization of above-and-below market rent	279	1,128	3,015	4,041
Amortization of mortgage premium	(552)	(485)	(2,043)	(1,771)
Gain on sale of income properties and land under development	(20)	(3,939)	(6,028)	(6,116)
Option fee earned (included in gain on sale of income properties)	—	500	—	500
Future income taxes	250	—	550	—
Withholding taxes	654	—	2,038	—
Net income attributable to non-controlling interest	1,241	1,624	5,511	6,333
Distributable income	\$ 45,987	\$ 39,507	\$ 173,814	\$ 149,947
Distributions to unitholders	\$ 38,442	\$ 33,415	\$ 146,067	\$ 126,108
Distributions to non-controlling interest	\$ 2,326	\$ 2,274	\$ 9,307	\$ 9,097
Total distributions paid	\$ 40,768	\$ 35,689	\$ 155,374	\$ 135,205
Total distributions paid as a % of DI	88.7%	90.3%	89.4%	90.2%
Weighted average number of units (in thousands of units)	121,618	107,865	116,362	102,404
Diluted weighted average number of units (in thousands of units)	122,481	108,521	117,146	103,055
Basic (adjusted for conversion of non-controlling interest) DI per unit	\$ 0.378	\$ 0.366	\$ 1.494	\$ 1.464
Diluted DI per unit	\$ 0.375	\$ 0.364	\$ 1.484	\$ 1.455
Distributions paid per unit	\$ 0.334	\$ 0.326	\$ 1.334	\$ 1.304

The increase in basic DI per unit of \$0.012 for the quarter and \$0.030 for the year ended December 31, 2006 as compared to the respective prior periods is comprised mainly of the following items:

Impact on Distributable Income

	Change in Q4 2006 over Q4 2005 per unit	Change in 2006 over 2005 per unit
Contractual rent increases	\$ 0.019	\$ 0.039
Accretive acquisitions and increase in same-asset net income	0.009	0.043
	\$ 0.028	\$ 0.082
Increase of amortization in deferred leasing, financing, and costs	(0.003)	(0.021)
Increase in trust expenses	(0.009)	(0.019)
Exchange rate fluctuations (net of hedged amounts)	(0.004)	(0.012)
	\$ (0.016)	\$ (0.052)
Net increase in basic DI per unit	\$ 0.012	\$ 0.030

Distributions made for the respective three months ended December 31, 2006 and 2005 amounted to \$40.8 million and \$35.7 million and for the respective years ended December 31, 2006 and 2005 amounted to \$155.4 million and \$135.2 million. The percentage of cash distributions to DI outlined above decreased marginally quarter over quarter and for the year ended December 31, 2006 as compared to 2005.

The tax deferred portion of distributions is 48% for the 2006 fiscal year as compared to 64% for the year ended December 31, 2005. 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.

In accordance with CSA Staff Notice 52-306 (Revised) Non-GAAP Financial Measures, the Trust is required to reconcile distributable income to cash flows from operating activities.

	Three months ended December 31		Year ended December 31	
	2006	2005	2006	2005
<i>(in thousands of dollars)</i>				
Distributable income	\$ 45,987	\$ 39,507	\$ 173,814	\$ 149,947
Change in other non-cash operating items	(5,473)	(14,260)	(35,661)	(73,487)
Straight-lining of contractual rent increases	5,248	7,287	21,586	25,690
Net variable interest entities adjustment	(52)	(121)	(183)	(449)
Rent amortization of tenant inducements	400	359	1,546	891
Amortization of deferred leasing expenses	1,116	922	4,321	3,294
Amortization of deferred financing expenses	495	420	1,874	1,510
Amortization of deferred costs	602	506	2,480	1,750
Amortization of mortgage premium	552	485	2,043	1,771
Withholding taxes	(654)	-	(2,038)	-
Future income taxes	(250)	-	(550)	-
Option fee earned (included in gain on sale of income properties)	-	(500)	-	(500)
Cash flows from operations	\$ 47,971	\$ 34,605	\$ 169,232	\$ 110,417

The Trust's definition of DI does not adjust for the change in other non-cash operating items, which represent balance sheet changes only and therefore is subtracted from DI in order to reconcile to cash flows from operations.

Straight-lining of contractual rent increases is deducted in calculating DI because the Trust does not receive this cash in the current period. Therefore straight-lining of contractual rent increases must be added back to reconcile to cash flows from operations.

Even though these are non-cash items, the Trust deducts rent amortization of tenant inducements, amortization of deferred leasing expenses, amortization of deferred financing expenses and amortization of deferred costs to arrive at DI as it is the Trust's intention that DI should be calculated on a net effective rental basis. All of these items are deducted when determining a net effective rental stream or net effective interest rate but are required to be added back to reconcile to cash flows from operations.

Amortization of mortgage premium is deducted in calculating DI as this is a non-cash item. This item is included within cash flows from financing on the statement of cash flows and not included in the reconciliation to cash flows from operations.

Withholding taxes and future income taxes while added back to DI are deducted when reconciling back to cash flows from operations as these amounts are deducted in determining net income, which flows into cash flows from operations.

Option fee earned is added back for DI purposes as this was a fee that was earned upon the relinquishment of an option to purchase the development property located at Front and John in Toronto. Since this fee is included in the gain on sale amount, it must be deducted when reconciling back to cash flows from operations as the full amount of the gain on sale is already included in this number.

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 has been provided in the overview of the MD&A.

Segmented disclosure is provided in the financial statements by net property 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 net property operating income is as follows:

Net property operating income for the three months ended December 31, 2006

<i>(in thousands of dollars)</i>	Canada	United States	Total
Operating revenue	\$ 123,398	\$ 27,734	\$ 151,132
Property operating costs	(45,839)	(4,496)	(50,335)
Mortgage and other interest expense	(32,341)	(13,417)	(45,758)
Depreciation of income properties	(16,083)	(6,675)	(22,758)
Amortization of deferred expenses and intangible costs	(6,113)	(2,109)	(8,222)
Net property operating income	\$ 23,022	\$ 1,037	\$ 24,059

Net property operating income for the three months ended December 31, 2005

<i>(in thousands of dollars)</i>	Canada	United States	Total
Operating revenue	\$ 102,504	\$ 21,944	\$ 124,448
Property operating costs	(35,640)	(3,285)	(38,925)
Mortgage and other interest expense	(28,271)	(10,770)	(39,041)
Depreciation of income properties	(13,345)	(5,959)	(19,304)
Amortization of deferred expenses and intangible costs	(4,506)	(1,633)	(6,139)
Net property operating income	\$ 20,742	\$ 297	\$ 21,039

Net property operating income for the year ended December 31, 2006

<i>(in thousands of dollars)</i>	Canada	United States	Total
Operating revenue	\$ 457,633	\$ 99,927	\$ 557,560
Property operating costs	(159,671)	(14,807)	(174,478)
Mortgage and other interest expense	(126,507)	(48,476)	(174,983)
Depreciation of income properties	(59,861)	(24,037)	(83,898)
Amortization of deferred expenses and intangible costs	(21,729)	(7,787)	(29,516)
Net property operating income	\$ 89,865	\$ 4,820	\$ 94,685

Net property operating income for the year ended December 31, 2005

<i>(in thousands of dollars)</i>	Canada	United States	Total
Operating revenue	\$ 405,097	\$ 74,871	\$ 479,968
Property operating costs	(142,645)	(11,007)	(153,652)
Mortgage and other interest expense	(110,386)	(36,868)	(147,254)
Depreciation of income properties	(50,529)	(17,771)	(68,300)
Amortization of deferred expenses and intangible costs	(15,037)	(4,684)	(19,721)
Net property operating income	\$ 86,500	\$ 4,541	\$ 91,041

Operating revenue from income properties in the United States has increased significantly by \$5.8 million or 26% for the quarter ended December 31, 2006 compared to the same period in 2005 and by \$25.1 million or 33% for the year ended December 31, 2006 compared to the same 2005 period. This is due to the 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 \$300.8 million or 29% between the end of Q4 2005 and Q4 2006.

The United States comprises 29% of the Trust's income properties at December 31, 2006 (2005 – 28%). However, the United States only comprises 4% of the Trust's net property operating income for the three months ended December 31, 2006 (2005 – 1%) and comprises 5% of the Trust's net property operating income for the year ended December 31, 2006 (2005 – 5%).

Use of Proceeds from Financing

Financing	Disclosed Use of Proceeds	Actual Use of Proceeds
Public offering of \$125.1 million of units completed on April 28, 2006	To fund the acquisition of additional properties and mezzanine financing. 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	The entire net proceeds were used to pay down the Trust's bank indebtedness on April 28, 2006, 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 November 8, 2006, as described below.
Public offering of \$150.5 million of units completed on November 8, 2006	To fund the acquisition of additional properties and mezzanine financing. 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	The entire net proceeds were used on November 8, 2006 to pay down Trust's bank indebtedness. Subsequent to November 8, 2006, approximately \$130.7 million of excess cash was utilized (in addition to assumption of debt) to purchase 41 retail properties. The equity component of acquisitions after November 2006 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.

Financial Condition

Assets

Income properties

Acquisitions of income properties during the year ended December 31, 2006 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 \$125.1 million Trust unit issue completed on April 28, 2006, proceeds of a \$150.5 million Trust unit issue completed on November 8, 2006, cash received from the sale of income properties as well as from the Trust's bank acquisition line and mortgages secured or assumed at closing or shortly thereafter.

2006 Acquisitions:

Property	Number of properties	Property type	Date acquired	Cash square footage	Secured on consideration (\$ millions)	Mortgage assumed or ownership on closing (\$ millions)	Interest acquired
Canadian Tire Industrial Buildings, ON and AB	2	Industrial	Jan 31, 06	2,103,785	229.1	180.1	100%
Automotive Industry, Various States, U.S.	4	Industrial	Feb 17, 06	437,104	30.3	22.6*	100%
Automotive Industry, ON	3	Industrial	Mar 30, 06	294,757	17.4	14.9*	100%
Telus Tower – 3777 Kingsway St, Burnaby, BC	1	Office	May 1, 06	686,697	151.0	115.5*	100%
Boscov Department Stores, Various States, U.S.	6	Retail	May 22, 06	1,491,413	87.2	66.1*	55%
717 Clearview Pkwy, Metairie, LA	1	Retail	May 30, 06	59,581	14.0	11.1*	100%
Boscov Department Stores, PA	2	Retail	Jun 1, 06	363,753	21.9	16.5*	52%
7350 Middlebelt Rd, Westland, MI	1	Retail	Jun 19, 06	53,773	10.9	8.6*	100%
260 Jordan Rd, Tifton, GA	1	Industrial	Aug 8, 06	676,031	21.7	17.3*	100%
225 S. Canton Center Rd, Canton, MI	1	Retail	Sep 21, 06	65,279	14.3	11.4*	100%
Maxxam Industrial Buildings, AB	2	Industrial	Sep 27, 06	69,104	11.7	8.7	100%
Retail Portfolio, ON and QC	33	Retail	Nov 9, 06	1,500,969	241.8	148.8**	100%
Marsh Department Stores, IN	8	Retail	Nov 22, 06	489,426	88.1	65.4*	100%
6330 State Rd. 7, Coconut Creek, FL	1	Retail	Dec 8, 06	9,553	7.6	–	100%
205 West Ave., Tallmadge, OH	1	Retail	Dec 18, 06	70,046	11.3	9.0*	100%
180 Market Dr., Milton, ON	1	Industrial	Dec 21, 06	69,000	5.1	–	100%
Total	68			8,440,271	963.4	696.0	

* indicates non-recourse. Non-recourse mortgages are generally non-recourse to the Trust but have recourse to the specific property to which the mortgage applies.
 ** of this amount, \$36.2 million are non-recourse mortgages.

The dollar figures shown above for U.S. acquisitions are in Canadian dollars and are based on the exchange rates at the time of such acquisitions.

For the acquisitions in Q4 2006, the weighted average interest rate on the mortgages secured was 5.6% and the expected levered return on equity invested is approximately 8.6%. For the year ended December 31, 2006, the weighted average interest rate on the mortgages secured was 5.8% and the expected levered return on equity invested is approximately 9.3%.

After accounting for these transactions and for depreciation expensed, income properties increased by 24% to \$4.538 billion at December 31, 2006 (including income properties held for sale) from \$3.655 billion at December 31, 2005. The allocation of costs to income properties was done in accordance with the requirements of CICA EIC 140.

Capital expenditure and non-recoverable maintenance required on the Trust's portfolio had been relatively immaterial prior to 2004. However, the Trust is committed to continuously maintain and improve the quality of the assets in its portfolio through the implementation of its capital improvement 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 three years in terms of leasing demand and rental rates. The program should be largely completed by the end of 2008.

The total amount of expenditures that have been capitalized to deferred costs as part of our capital expenditure program for the year ended December 31, 2006 was \$5.6 million (2005 – \$5.4 million) against which future applicable recoveries from tenants will be applied. The total amount of expenditures that have been allocated to income properties during the year ended December 31, 2006 was \$1.5 million (2005 – \$7.2 million). In addition, during the year ended December 31, 2006, a further \$4.5 million of costs were capitalized to both income producing properties and deferred costs for 401/405 The West Mall, which were subsequently written off as part of the sale of the property. As a result, the total expenditure for 2006 amounted to \$11.6 million.

The portion of the above expenditure comprising deferred 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 costs. Those costs which relate to the redevelopment and upgrading of the quality and class of the asset have been capitalized to income properties.

Total expenditures in 2004 and 2005 amounted to \$8.6 million and \$12.6 million, respectively. Currently, the budget for 2007 is \$12 million and for 2008 is \$10 million, and thereafter this expenditure is expected to reduce to regular levels consistent with 2003 and prior years. H&R expects to fund its capital expenditure program in part by using the excess of distributable income over distributions paid, which for the year ended December 31, 2006, amounted to \$18.4 million.

Notwithstanding the above, the portfolio remains relatively new and should require minimal capital expenditure in the future. The average age of the total portfolio from the date built is 13.0 years at December 31, 2006 (2005 – 12.1 years) and the split between asset class by age of property is as follows:

<i>(years)</i>	December 31, 2006	December 31, 2005
Office	16.2	15.0
Industrial	13.1	12.6
Retail	10.5	7.4
Total	13.0	12.1

Debt related to certain Canadian properties is held by 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 the Trust.

Legal title to each of the United States 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"); a subsidiary of the Trust; 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 structure does not prevent distributions to the entity owners provided there are no conditions of default.

The composition 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, 2006	December 31, 2005
Office	\$ 1,582	\$ 1,478
Industrial	1,394	1,120
Retail	1,562	1,057
Total	\$ 4,538	\$ 3,655

Book value by Region

<i>(millions)</i>	December 31, 2006	December 31, 2005
Ontario	\$ 1,925	\$ 1,626
Alberta	613	521
Other	427	244
Quebec	242	234
Canada	\$ 3,207	\$ 2,625
United States	1,331	1,030
Total	\$ 4,538	\$ 3,655

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. Mezzanine financing is usually 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 both December 31, 2006 and December 31, 2005, there was one project for which the Trust had provided mezzanine financing.

At December 31, 2006, there was one property for which the Trust had provided regular mortgage vendor take-back financing totalling \$16.1 million with an interest rate of 5.3%. At December 31, 2005, there were two regular mortgage receivables outstanding totalling \$24.0 million with a weighted average interest rate of 5.2%.

Mortgages receivable (as analyzed before the variable interest entities adjustment described below) decreased from \$26.6 million at December 31, 2005 to \$19.0 million at December 31, 2006, a 29% decrease due primarily to the repayment of the Langstaff industrial project mortgage in February 2006.

Mortgages Receivable

<i>(in thousands of dollars)</i>	Option %	Type	December 31, 2006	December 31, 2005
Front and John, Toronto	0%	N/A	\$ 16,125	\$ 15,985
Langstaff Industrial project	0%	N/A	-	8,000
Bell Canada Complex (Phase III), Mississauga	100%	Office	2,864 ⁽¹⁾	2,648 ⁽¹⁾
			\$ 18,989	\$ 26,633
(1) Less: reallocated in accordance with variable interest entities accounting policy			2,864	2,648
			\$ 16,125	\$ 23,985

Deferred Expenses

<i>(in thousands of dollars)</i>	December 31, 2006	December 31, 2005
Deferred leasing	\$ 28,269	\$ 27,491
Deferred financing	18,028	15,801
Deferred costs	14,870	11,164
	\$ 61,167	\$ 54,456

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 improvements 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 \$0.8 million (after amortization) or 3% between December 31, 2005 and December 31, 2006 mainly as a result of lease renewals and lease extensions that occurred during the year ended December 31, 2006 at the following properties:

- 25 Sheppard Avenue, West, Toronto
- 160 Elgin Street, Ottawa
- 401/405 The West Mall, Toronto
- 2611-3rd Avenue, Calgary
- 411-1st Street, Calgary
- 26 Wellington Avenue, E., Toronto
- 2780–2800 Skymark Avenue, Mississauga

This increase would have been higher except that a net amount of \$2.6 million of deferred leasing expenses was written off as part of the sale of 401/405 The West Mall in September 2006.

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, 2005 and December 31, 2006 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 costs represent those costs incurred under the Trust's capital improvement program which are to be deferred and amortized over the expected recovery period from tenants. The properties where the Trust incurred the majority of these costs include:

- 310–330 Front Street, Toronto
- 100 Wynford Drive, Toronto
- 160 Elgin Street, Ottawa

Land under development

An investment of \$25.4 million was made in March 2006 (through a joint venture in which the Trust has an 80% interest) to purchase 72 acres of development land located on Airport Road in Mississauga, Ontario. The project is expected to provide a total of 1.6 million square feet of single tenant industrial distribution facilities over the next 3 years. The Trust has secured bank indebtedness of \$12.1 million to fund part of its investment. This investment increased by \$1.2 million in Q4 2006 to \$27.3 million at December 31, 2006.

CICA AcG-15 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, 2006 has been to reallocate one transaction from mortgages receivable to land under development in the amount of \$2.9 million (December 31, 2005 – \$2.6 million).

The above has given rise to a total consolidated asset in this category of \$30.2 million at December 31, 2006 (2005 – \$2.6 million).

Other assets

Tenant inducements represent those costs for which the Trust has given the tenant cash as an inducement to enter into a lease agreement. This amount is amortized over the life of the applicable lease and the amortization is deducted from rentals from income properties. Tenant inducements decreased by \$1.1 million from \$15.9 million at December 31, 2005 to \$14.8 million at December 31, 2006, mostly due to amortization expensed during the year.

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 37% or \$22.4 million from \$60.5 million at December 31, 2005 to \$82.9 million at December 31, 2006 with a corresponding adjustment to rentals from income properties.

Prepaid expenses and sundry assets decreased from \$18.1 million at December 31, 2005 to \$12.4 million at December 31, 2006, a decrease of 31%. The decrease is primarily a result of a change in the amount of purchase deposits outstanding arising during the normal course of business operations.

Accounts receivable increased by \$3.2 million between December 31, 2005 and December 31, 2006. The increase is due to fluctuations arising during the normal course of business operations mainly due to the fact that the property portfolio continues to increase in size each quarter.

Cash and cash equivalents increased to \$15.8 million at December 31, 2006 from \$9.3 million at December 31, 2005. Included in the balance at December 31, 2006 is \$8.2 million (2005 – \$4.3 million) related to funds being held in escrow until the expiry of certain non-recourse public mortgage bonds and other non-recourse U.S. mortgages. Of the \$15.8 million, approximately \$5.3 million (2005 – \$2.1 million) represents rents paid in advance which fluctuates monthly depending on the timing of receipt of such rental payments.

Liabilities

Prior to the Trust's annual meeting held on June 23, 2006, H&R's Declaration of Trust limited the indebtedness of the Trust to a maximum of 65% of the gross book value ("GBV") of the Trust, provided that within such limitation, debt that was recourse to the Trust (as defined in the Declaration of Trust) could not exceed 60% of the GBV of those assets to which the recourse debt pertained. This "recourse debt" restriction was eliminated at the Trust's annual meeting held on June 23, 2006 so that only the overall 65% debt limitation test remains. The Trust's allocation of debt, including bank indebtedness, is as follows:

	December 31, 2006	December 31, 2005
Total debt ⁽¹⁾ to GBV	62.0%	62.1%
Non-recourse debt as a percentage of total debt	55.3%	55.8%
Floating rate debt as a percentage of total debt	2.3%	2.7%

Includes guarantees in the amount of \$48.5 million (2005 – \$50.0 million). Excluding guarantees, total debt to GBV is 61.0% as at December 31, 2006 and 60.8% as at December 31, 2005. The Trust's calculation of what is included in the computation of total debt to GBV ratio is not necessarily consistent with the definition of guarantees under GAAP.

There were no material changes in the allocation of debt as outlined above. The maintenance 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.

Mortgages Payable

Mortgages payable (including mortgages payable on income properties held for sale) increased 27% from the December 31, 2005 figure of \$2.397 billion to \$3.036 billion at December 31, 2006. This increase is mainly a result of the transactions described in detail in "Income Properties" above, as well as two additional mortgages secured totalling \$49.4 million. Other changes to mortgages payable during the year include repayment in full of two mortgages that matured in July and December 2006. The total amount that was repaid was \$21.0 million. Upon the sale of two properties in September 2006, the Trust repaid mortgages payable totalling \$24.3 million. The dollar figures shown for U.S. transactions are based on the exchange rates at the time of such transactions.

The mortgages bear interest at the weighted average rate of 6.4% (2005 – 6.6%) and mature between 2007 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 (2005 – 11.1 years) to the remaining average lease term of 12.6 years (2005 – 12.3 years). Going forward, the Trust anticipates being able to refinance all its debt as it matures. For a further discussion of interest rate risk, please see "Risks and Uncertainties".

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:

Mortgages Payable

Years	Periodic amortized principal (\$000s)	Principal on maturity (\$000s)	Total principal (\$000s)	% of total principal	Weighted average interest rate on maturity
2007	\$ 82,788	\$ 37,371	\$ 120,159	4.0%	8.5%
2008	86,004	71,181	157,185	5.2%	9.1%
2009	89,768	37,705	127,473	4.2%	7.1%
2010	99,736	16,512	116,248	3.9%	7.3%
2011	96,127	67,766	163,893	5.4%	6.5%
Thereafter			2,338,217	77.3%	
Mortgage premiums ⁽¹⁾			13,190		
Total			\$ 3,036,365		

(1) 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.

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

<i>(in thousands of dollars)</i>	December 31, 2006	December 31, 2005
Canada	\$ 2,053,803	\$ 1,640,948
United States	982,562	755,946
Total	\$ 3,036,365	\$ 2,396,894

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 U.S. dollars (with U.S. dollar loans being limited to a maximum Canadian equivalent of \$100 million).

Bank indebtedness increased by \$3.9 million from \$67.1 million at December 31, 2005 to \$71.0 million at December 31, 2006. Included in the \$71.0 million balance is an amount of \$12.1 million (December 31, 2005 – \$0) relating to the development land joint venture previously described in which the Trust has an 80% interest. Excluding this amount, bank indebtedness decreased by \$8.2 million as compared to the December 31, 2005 balance. The change is primarily as a result of the sale of three income properties in Q3 2006, the April 28, 2006 public offering which raised gross proceeds of \$125.1 million, and the November 8, 2006 public offering which raised gross proceeds of \$150.5 million offset by equity required for acquisitions made during the year ended December 31, 2006. The Canadian dollar portion of the debt bears interest at rates approximating the prime rate of a Canadian chartered bank, while the U.S. portion of the debt (Canadian equivalent of \$9.5 million at December 31, 2006 compared to \$30.6 million at December 31, 2005) 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.

Intangible Liabilities

For all acquisitions subsequent to September 12, 2003, the acquisition cost is allocated to land, buildings and intangible costs. The portion of the purchase price that is allocated to "below-market-value rents" is recorded as a liability on the Trust's balance sheet and is amortized over the related lease. This amount has increased by a net \$51.0 million to \$68.4 million at December 31, 2006.

The change in this liability in the future will be dependant upon the leases that are in place in future acquisitions and the rent in place as compared to market rents at the time of purchase of the related asset.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities increased by \$4.3 million from \$55.1 million at December 31, 2005 to \$59.4 million at December 31, 2006. The increase is primarily due to rent received in advance of it being due as well as 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). There is also a general 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 properties each year.

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 HRLP, which was 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.

In connection with the purchase completed on March 30, 2006 of an industrial portfolio, 293,879 Trust units having a value of \$6.3 million were issued to HRLP to complete this transaction. As partial consideration for the purchase of these properties, HRLP issued 293,879 Class B units to the vendors. These units were also exchangeable on a one for one basis for Trust units and were in fact exchanged in April 2006 into 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 and can be exchanged 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 conversion will result in a transfer to unitholders' equity and the non-controlling interest will accordingly be reduced as was the case with the units issued for the industrial portfolio transaction.

Non-controlling interest decreased slightly when comparing the balance of \$112.9 million at December 31, 2006 to the \$116.7 million balance at December 31, 2005.

Equity**Unitholders' Equity**

Unitholders' equity increased by \$239.8 million between December 31, 2005 and December 31, 2006 primarily as a result of the completion by the Trust on April 28, 2006 of a public offering issuing 5,985,000 units for gross proceeds of approximately \$125.1 million as well as the completion by the Trust on November 8, 2006 of a public offering issuing 6,500,000 units for gross proceeds of approximately \$150.5 million. Unitholders' equity also increased due to 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 year offset partially by the excess of distributions paid over net earnings for the year.

Cumulative Foreign Exchange Adjustment

As at December 31, 2006, the Canadian dollar weakened in relation to the U.S. dollar when compared to the December 31, 2005 exchange rate hence the unrealized loss decreased to \$25.2 million from \$29.7 million, a decrease of \$4.5 million.

This cumulative adjustment reflects the net adjustment to the equity invested in U.S. properties, with the Trust's debt being held in U.S. dollars currently acting as a natural hedge against its total investment in U.S. dollars. This amount fluctuates continuously depending on the U.S. exchange rate at the end of the applicable accounting period, but is not a concern to management at this time as all the U.S. assets are long-term in nature and no short-term realization of loss is anticipated. This amount, (whether the adjustment is a gain or a loss), is taken into 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 U.S. income to minimize exposure to currency fluctuations, whereby the Trust has purchased forward contracts with a Canadian chartered bank to exchange U.S. dollar cash flows received into Canadian dollars at a set future price to protect the Trust against a material change in the Canadian/U.S. 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.

Liquidity and Capital Resources

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.

	Three months ended December 31		Year ended December 31	
<i>(in thousands of dollars except per unit amounts)</i>	2006	2005	2006	2005
Net earnings	\$ 20,564	\$ 23,482	\$ 86,437	\$ 86,653
Add (deduct)				
Depreciation of income properties	22,758	19,304	83,898	68,300
Amortization of deferred leasing expenses	1,116	809	4,213	2,918
Rent amortization of tenant inducements	400	359	1,546	891
Amortization of intangible assets on acquisitions	6,009	4,340	20,973	13,666
Future income taxes	250	–	550	–
Net earnings attributable to non-controlling interest	1,241	1,624	5,511	6,333
Gain on sale of income properties and land under development	(20)	(3,939)	(6,028)	(6,116)
Option fee earned (included in gain on sale of income properties)	–	500	–	500
Operating income from discontinued operations	(593)	(1,056)	(3,173)	(2,783)
Funds from operations – continuing operations	51,725	45,423	193,927	170,362
Funds from operations – discontinued operations	593	1,888	4,147	6,566
Funds from operations	\$ 52,318	\$ 47,311	\$ 198,074	\$ 176,928
Funds from operations per unit (basic – adjusted for conversion of non-controlling interest)	\$ 0.430	\$ 0.439	\$ 1.702	\$ 1.728
Funds from operations per unit (diluted)	\$ 0.427	\$ 0.436	\$ 1.691	\$ 1.717

In accordance with CSA Staff Notice 52-306 (Revised) Non-GAAP Financial Measures, the Trust is required to reconcile funds from operations to cash flows from operations.

<i>(in thousands of dollars)</i>	Three months ended December 31		Year ended December 31	
	2006	2005	2006	2005
Funds from operations	\$ 52,318	\$ 47,311	\$ 198,074	\$ 176,928
Funds from operations – discontinued operations	(593)	(1,888)	(4,147)	(6,566)
Net property operating income – discontinued operations	593	1,056	3,173	2,783
Change in other non-cash operating items	(5,473)	(14,260)	(35,661)	(73,487)
Option fee earned	–	(500)	–	(500)
Unit based compensation	–	–	–	175
Future income taxes	(250)	–	(550)	–
Rent amortization of above-and-below market rents	279	1,128	3,015	4,041
Amortization of deferred financing expenses	495	420	1,874	1,510
Amortization of deferred costs	602	506	2,480	1,750
Amortization of deferred leasing included within discontinued operations	–	113	108	376
Amortization of intangibles included within discontinued operations	–	254	244	1,515
Depreciation of income properties included within discontinued operations	–	465	622	1,892
Cash flows from operations	\$ 47,971	\$ 34,605	\$ 169,232	\$ 110,417

All items which are included in this reconciliation are non-cash items which are included in the calculation of funds from operations but are not included in the determination of cash flow from operations. The only item which is a cash item is the option fee earned, which is already included as a gross number in the gain on sale amount which is a part of cash flows from operations.

Capital Resources

The cash flows generated from operating the portfolio of \$169.2 million for the year ended December 31, 2006 represent the primary source of funds to fund total distributions to Unitholders of \$155.4 million. There are no material or unusual working capital requirements that currently exist other than deferred costs and capital expenditures as previously described 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 other than those funds classified as restricted cash.

Proceeds from the issuance of units together with proceeds on disposition of income properties, conventional mortgage financing and short-term bank financing, have been used mainly to fund net property acquisitions and capital expenditures of \$880.6 million and mortgage principal repayments of \$122.3 million for the year ended December 31, 2006.

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 bank 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 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, 2006, approximately \$103.7 million was still available under this line.

Management believes 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.

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. The Trust believes that this inclusion has broadened 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 \$115 million (in addition to those transactions described in “Subsequent Events”) and expects total acquisitions to decrease on a dollar basis in 2007 as compared to 2006 due to limited acquisition opportunities in both Canada and the United States.

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

Contractual Obligations

<i>(in thousands of dollars)</i>	Payments due by period				Total
	2007	2008–2009	2010–2011	2012 and thereafter	
Long Term Debt	\$ 120,159	\$ 284,658	\$ 280,141	\$ 2,338,217	\$ 3,023,175
Purchase Obligations ⁽¹⁾	17,792	–	–	–	17,792
Total Contractual Obligations	\$ 137,951	\$ 284,658	\$ 280,141	\$ 2,338,217	\$ 3,040,967

(1) The purchase obligations represent the equity required only for those transactions where the Trust is legally bound to complete the transactions and are in addition to any transactions listed below in “Subsequent Events”.

(2) Subsequent to year end, the Trust entered into agreements to develop a 1.9 million square foot office building in Calgary, AB fully leased to EnCana Corporation (“the Bow”) with a budgeted cost of approximately \$1.1 billion. Construction is expected to commence in the summer of 2007 and to be completed in 2011.

The Trust has no material capital or operating lease obligations.

Funding of Future Commitments

H&R’s capacity to fund future acquisitions, capital expenditures and commitments is in excess of \$400 million as at December 31, 2006. 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.

As at December 31, 2006, H&R had no additional material construction commitments in the short term 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. For the Bow, the Trust expects to secure long-term debt financing by the end of 2007. In the short term, the Trust expects to finance current construction costs via the Trust’s bank line, project specific, short-term bank financing and/or a future issue of units.

Off-Balance Sheet Items

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, 2006, such guarantees amounted to \$120.8 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 ten 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.

Financial Instruments and Other Instruments

The fair value of the mortgages payable is determined annually 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, 2006 has been estimated at \$3.147 billion (2005 – \$2.583 billion) compared with the carrying value of \$3.036 billion (2005 – \$2.397 billion).

As previously disclosed, the Trust uses foreign exchange forward contracts to protect itself from currency fluctuations between the Canadian and U.S. dollar. The Trust has a forward contract totalling US \$3.0 million which expires in January 2007. This contract is to hedge the cash flow from the three Nestle properties in the United States on which rent is paid in advance for the year. The fair value of this foreign exchange forward contract at December 31, 2006 has been estimated at \$0.03 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 for the 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, 2006 has been estimated at (\$0.1) million (2005 – \$2.2 million).

SECTION III

Summary of Quarterly Results

<i>(unaudited) (in thousands of dollars except per unit amounts)</i>	December 31, 2006	September 30, 2006 ⁽¹⁾	June 30, 2006 ⁽¹⁾	March 31, 2006 ⁽¹⁾
Rentals from income properties	\$ 150,634	\$ 140,649	\$ 135,555	\$ 128,929
Mortgage interest and other income	498	389	506	400
Net property operating income	24,059	23,619	23,318	23,689
Net earnings from continuing operations	19,979	19,036	19,101	19,671
Net earnings per unit from continuing operations				
(basic)	\$ 0.17	0.17	0.18	0.19
(diluted)	\$ 0.17	0.17	0.18	0.18
Net earnings	\$ 20,564	\$ 24,790	\$ 20,733	\$ 20,350
Net earnings per unit				
(basic)	\$ 0.18	\$ 0.22	\$ 0.20	\$ 0.19
(diluted)	\$ 0.18	\$ 0.22	\$ 0.20	\$ 0.18

<i>(unaudited) (in thousands of dollars except per unit amounts)</i>	December 31, 2005 ⁽¹⁾	September 30, 2005 ⁽¹⁾	June 30, 2005 ⁽¹⁾	March 31, 2005 ⁽¹⁾
Rentals from income properties	\$ 124,251	\$ 122,523	\$ 116,007	\$ 115,271
Mortgage interest and other income	197	231	755	733
Net property operating income	21,039	23,411	23,598	22,993
Net earnings from continuing operations	18,822	19,934	19,888	19,716
Net earnings per unit from continuing operations				
(basic)	0.18	0.21	0.21	0.22
(diluted)	0.18	0.21	0.21	0.21
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	\$ 0.22	\$ 0.22

(1) Certain items for all periods have been reclassified to conform with the presentation adopted in the current period.

Changes to the quarterly financial information are not reflective of seasonality or cyclicity but generally from new property acquisitions.

SECTION IV

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 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, 2006 audited consolidated financial statements of the Trust.

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 2006, no impairments were recognized while \$1.1 million of impairments were recognized during 2005.

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 2006 or 2005.

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.

The Trust depreciates its income properties on a straight-line basis over their estimated useful lives. In the event the allocation to either the building or paving and equipment 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.

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-and-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.

Fair Value of Financial Instruments

The Trust is required to determine and disclose annually the fair value of its mortgages payable. 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. 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.

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 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.

Changes to Significant Accounting Policies for 2007

The CICA issued three new accounting standards that are effective for the Trust's fiscal year commencing January 1, 2007, which are to be applied on a retroactive basis without restatement to prior periods. The changes that affect the Trust include Section 1530, Comprehensive Income; Section 3855, Financial Instruments – Recognition and Measurement; and Section 3865, Hedges.

Comprehensive Income

Comprehensive income, Section 1530, is comprised of net earnings and other comprehensive income ("OCI"), which represents changes in unitholders' equity during a period arising from transactions and other events with non-owner sources. OCI generally would include unrealized gains and losses on financial assets classified as available-for-sale, unrealized foreign currency translation adjustments net of hedging arising from self-sustaining foreign operations, and changes in the fair value of the effective portion of cash flow hedging instruments. H&R's consolidated financial statements will include a consolidated statement of other comprehensive income while the accumulated other comprehensive income ("AOCI"), will be presented as a separate category of unitholders' equity.

Financial Instruments – Recognition and Measurement

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial instruments are required to be measured at fair value on initial recognition, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial statements have been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other liabilities.

Financial assets and financial liabilities classified as held-for-trading are required to be measured at fair value with gains and losses recognized in net earnings during the current year.

Financial assets classified as held-to-maturity, loans and receivables and financial liabilities (other than those held-for-trading) are required to be measured at amortized cost using the effective interest method.

Available-for-sale financial assets are required to be measured at fair value with unrealized gains and losses recognized in OCI. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market should be measured at cost.

Derivative instruments must be recorded on the balance sheet at fair value including those derivatives that are embedded in a financial instrument or other contract but are not closely related to the host financial instrument or contract, respectively. Changes in the fair values of derivative instruments are required to be recognized in net earnings, except for derivatives that are designated as a cash flow hedge, in which case the fair value change for the effective portion of such hedge relationship is required to be recognized in OCI.

The standard permits the Trust to designate any financial instrument whose fair value can be reliably measured as held-for-trading on initial recognition or adoption of the standard, even if that instrument would not otherwise satisfy the definition of held-for-trading.

The standard specifically excludes Section 3065, Leases, from the definition of financial instruments, except for derivatives that are embedded in a lease contract. Other significant accounting implications arising on adoption of the standard include the initial recognition of certain financial guarantees at fair value on the balance sheet and the use of the effective interest method.

Hedges

Section 3865 specifies the criteria under which hedge accounting can be applied and how hedge accounting should be executed for each of the permitted hedging strategies: fair value hedges, cash flow hedges and hedges of a foreign currency exposure of a net investment in a self-sustaining foreign operation.

In a fair value hedging relationship, the carrying value of the hedged item will be adjusted by gains or losses attributable to the hedged risk and recognized in net earnings. The changes in the fair value of the hedged item, to the extent that the hedging relationship is effective as defined by the standard ("effective"), will be offset by changes in the fair value of the hedging derivative. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative will be recognized in OCI. The ineffective portion as defined by the standard ("ineffective") will be recognized in net earnings. The amounts recognized in AOCI will be reclassified to net earnings in those periods in which net earnings is affected by the variability in the cash flows of the hedged item. In hedging a foreign currency exposure of a net investment in a self-sustaining foreign operation, the effective portion of foreign exchange gains and losses on the hedging instruments will be recognized in OCI and the ineffective portion is recognized in net earnings.

Deferred gains or losses on the hedging instrument with respect to hedging relationships that were discontinued prior to the transition date but qualify for hedge accounting under the new standard will be recognized in the carrying amount of the hedged item and amortized to net earnings over the remaining term of the hedged item for fair value hedges, and for cash flow hedges will be recognized in AOCI and reclassified to net earnings in the same period during which the hedged item affects net earnings. However, for discontinued hedging relationships that do not qualify for hedge accounting under the new standards, the deferred gains and losses will be recognized in the opening balance of retained earnings on transition.

Impact of Adopting Sections 1530, 3855 and 3865

The transition adjustment attributable to the above described standards will be recognized in the opening balance of retained earnings or AOCI at January 1, 2007. The Trust is currently finalizing the impact on our consolidated financial statements.

Internal Controls over Financial Reporting

The Trust maintains appropriate information systems, procedures and controls to ensure that information that is publicly disclosed is complete, reliable and timely. The Chief Executive Officer and Chief Financial Officer evaluated, or caused an evaluation under their direct supervision of, the design and effectiveness of our disclosure controls and procedures (as defined in Multilateral Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings) as at December 31, 2006 and have concluded that such disclosure controls and procedures are operating effectively.

Management is responsible for establishing adequate internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. H&R's Chief Executive Officer and Chief Financial Officer assessed, or caused an assessment under their direct supervision of, the design of our internal controls over financial reporting (as defined in Multilateral Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings) as at December 31, 2006 and, based on that assessment, determined that our internal controls over financial reporting were appropriately designed.

No changes were made to the design of our internal controls over financial reporting during the three months ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The financial statements and MD&A were reviewed by the audit committee and the Board of Trustees, which approved them prior to their publication.

H&R's management, including the CEO and CFO, does not expect that H&R's controls and procedures will prevent or detect all misstatements due to error or fraud. Due to the inherent limitations in all control systems, an evaluation of controls can provide only reasonable, not absolute assurance, that all control issues and instances of fraud or error, if any, within H&R have been detected. H&R is continually evolving and enhancing its systems of controls and procedures.

SECTION V

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, and in the Trust's Annual Information Form.

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, 2006, the percentage of fixed rate debt to total debt was 97.7% (2005 – 97.3%). 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, 2006, the weighted average term to maturity of the mortgages was 11.1 years (2005 – 11.1 years) compared to the remaining average lease term of 12.6 years (2005 – 12.3 years). The Trust also minimizes financing risk by restricting total debt to 65% of aggregate assets as well as by obtaining nonrecourse debt wherever possible. At December 31, 2006, the debt to GBV ratio was 62.0% (2005 – 62.1%) while the percentage of non-recourse debt to total debt was 55.3% (2005 – 55.8%).

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 9% 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 contractual rent increases and discontinued operations) and the weighted average term remaining on their leases as at December 31, 2006:

Tenant	% of rentals from income properties	Lease term to maturity (years)
1. Bell Canada	8.9	17.8
2. TransCanada PipeLines Limited	6.6	14.0
3. Bell Mobility	5.3	19.0
4. Telus Communications	5.2	14.8
5. Rona Inc.	3.9	13.0
6. Canadian Tire Corp.	3.5	19.3
7. Royal Bank of Canada	2.8	4.5
8. Lowes Companies Inc.	2.5	12.3
9. Nestle USA	2.1	10.8
10. Shell Oil Products	1.8	15.8
Total	42.6	

As indicated above, the Trust actively pursues highly creditworthy tenants which is further evidenced by its high occupancy rate of over 99% at both December 31, 2006 and December 31, 2005.

Construction Risk

The Trust's construction commitments are subject to those risks usually attributable to construction projects, which include (i) construction or other unforeseeable delays; (ii) cost overruns; (iii) the failure of tenants to occupy and pay rent in accordance with existing lease agreements, some of which are conditional; and (iv) increases in interest rates during the period of the development. See also the risk relating to The Bow below. Management expects to mitigate these risks where possible by entering into fixed price construction contracts with general contractors and by attempting to obtain long-term financing as early as possible during construction.

Development Risk Relating to The Bow

The Trust entered into agreements to develop The Bow, a 1.9 million square foot head office complex in Calgary for a budgeted cost of approximately \$1.1 billion. The building is fully pre-leased to EnCana Corporation for 25 years. In addition, the Trust will develop a further 100,000 square feet of retail space. Construction is expected to commence in the summer of 2007 and be completed in 2011.

The Trust is currently bearing the risk for construction overruns and project delays as the Trust does not have a fixed price contract on this project. The Trust is also at risk for interest rate fluctuations on this project during the construction period as well as the leasing risk on the retail space. To mitigate these risks, management expects to enter into a fixed-price contract with a general contractor early in 2007 and to secure long-term debt financing by the end of 2007. There are however no assurances that the Trust can enter into either of such arrangements and that either arrangement can be entered into within the expected timeframe.

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 table showing that leases representing only 12.1% of our total square feet expire over the next 5 years.

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.

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 a portion of income earned in U.S. dollars.

As at December 31, 2006 and December 31, 2005, there was no material difference between the book value and market value of the Trust's existing forward hedge contract.

Environmental Risk

H&R is subject to various Canadian and U.S. 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.

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. 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.

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.

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.

Tax Risk

The Trust currently qualifies as a Mutual Fund Trust for Canadian income tax purposes and does not record a provision for income taxes on income earned by the Trust, its subsidiary trust and flow through entities. On December 21, 2006, The Minister of Finance (Canada) released draft legislation (the "Proposals") relating to the federal income taxation of publicly traded income trusts and certain other publicly traded flow-through entities.

Under the Proposals, certain distributions from a "specified investment flow-through" trust or partnership (a "SIFT") will no longer be deductible in computing a SIFT's taxable income, and a SIFT will be subject to tax on such distributions at a rate that is substantially equivalent to the general tax rate applicable to a Canadian corporation. However, the Proposals provide that distributions paid by a SIFT as returns of capital will not be subject to the tax.

The Proposals provide that a SIFT which was publicly listed before November 1, 2006 (an "Existing Trust") would become subject to the tax on distributions commencing with the 2011 taxation year end. However, an Existing Trust may become subject to this tax prior to the 2011 taxation year end if its equity capital increases beyond certain limits measured against the market capitalization of the Existing Trust at the close of trading on October 31, 2006.

Under the Proposals, the new taxation regime will not apply to a Real Estate Investment Trust (a "REIT") that meets prescribed conditions relating to the nature of its income and investments (the "REIT Conditions"). Unless an Existing Trust is able to meet all REIT Conditions, the Proposals, if enacted, would subject an Existing Trust to tax commencing in 2011, which would adversely impact the level of cash otherwise available for distribution.

As the Proposals are currently drafted, the Trusts and many Canadian REITs do not meet the REIT Conditions which contain a number of technical provisions that do not fully accommodate common real estate properties and business structures. If the Proposals are enacted as currently drafted, commencing in 2011, the Trust would become subject to tax on certain income and, at the date of substantive enactment, the Trust would record future income tax assets and liabilities in respect of accounting and tax basis differences that are expected to reverse in or after 2011, with a corresponding credit or charge to consolidated earnings for the period.

In respect of assets and liabilities of the Trust, its subsidiary trust and flow through entities, the net book value for accounting purposes of those net assets exceeds their tax basis by an amount of approximately \$409.3 million (2005 – \$405.8 million).

It is possible that changes will be made to the Proposals prior to their enactment. If the Proposals are not changed, the Trust may need to restructure its affairs in order to minimize, or if possible eliminate, their impact. There can be no assurances, however, that changes will be made to the Proposals or that the Trust would be able to restructure such that the Trust will not be subject to the tax contemplated by the Proposals.

Related Party Transactions

In March 2006, the Trust and H&R Property Management Ltd., (the "Property Manager") a company owned by family members of the Chief Executive Officer amended the Omnibus Property Management Agreement effective January 1, 2006 for the remaining terms of the agreement. The Property Manager provides property management services for substantially all the properties owned by the Trust including leasing services, for a fee of 2% (2005 – 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 2/3 of 1% (2005 -1%) of total acquisition costs, as defined in the agreement. The current agreement is for four years expiring December 31, 2009 with two automatic five-year extensions.

During the year ended December 31, 2006, the Trust accrued fees pursuant to this agreement of \$16.9 million (2005 – \$17.4 million), of which \$6.5 million (2005 – \$6.1 million) was capitalized to the cost of the income properties acquired and \$1.9 million (2005 – \$2.1 million) was capitalized to deferred expenses. The Trust has also reimbursed the Property Manager for certain direct property operating costs and tenant construction costs.

For the year ended December 31, 2006, the amount allocated to the Property Manager in accordance with the annual incentive bonus pool amounted to \$2.5 million (2005 – \$1.3 million) and has been expensed in the consolidated statements of earnings.

Pursuant to the above agreements, as at December 31, 2006, \$1.5 million (2005 – \$2.1 million) was payable to the Property Manager.

The Trust leases space to companies affiliated with the Property Manager. The rental income earned for the year ended December 31, 2006 is \$0.9 million (2005 – \$0.9 million).

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

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 February 28, 2007, there were 124,723,267 trust units 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 February 28, 2007, there were 1,854,666 options to purchase units outstanding.

SECTION VI

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 of approximately \$115 million in addition to the transactions discussed in "Subsequent Events" 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 2007 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 over 99%, leases representing only 12.1% of our total square feet will expire 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 2% between 2006 and 2005, with annualized distributions in 2006 increasing to \$1.334 per unit compared to \$1.304 for the year ended December 31, 2005. The percentage payout of 89.4% for the year ended December 31, 2006 has decreased slightly over the prior year's percentage of 90.2% due to the timing of the equity offerings in the second and fourth quarters and the deployment of those funds in property acquisitions.

Effective January 1, 2007, the Trust announced an increase in the monthly distributions from \$0.1112 to \$0.1142 per unit per month, representing an annualized 2007 distribution of \$1.370, a 3% increase over 2006. Even with this increase, management expects the payout ratio to remain to below 90% for 2007.

One principal challenge faced by the Trust in 2005 and 2006 was the weakness in its office leasing market throughout the GTA, resulting in higher vacancies and lower net effective rental rates. Management believes this trend will continue into 2007. Due to a limited supply of new acquisition opportunities in both Canada and the United States, the Trust expects total acquisitions to decrease as compared to 2006.

Subsequent Events

In January 2007, the Trust purchased a 100% undivided interest in a 64,862 square foot retail property located in Zionsville, IN for cash consideration of \$15.2 million.

In February 2007, the Trust disposed of a 55,900 square foot retail property located in Edmonton, AB for gross proceeds of \$13.8 million.

In February 2007, the Trust acquired land for approximately \$70 million to be used for the development of a 1.9 million square foot office building, to be called the Bow, in Calgary, AB. The building has a budgeted cost of approximately \$1.1 billion and is fully pre-leased to EnCana Corporation. In addition, there is expected to be a further 100,000 square feet of retail space. The buildings are expected to be completed by the fall of 2011.

In February 2007, the Trust purchased a 100% undivided interest in a 57,976 square foot industrial property located in Toronto, ON for cash consideration of \$8.6 million.

In February 2007, the Trust purchased a 55% interest in a 84,511 square foot office property in Springville, UT for cash consideration of \$9.6 million.

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, 2006 and 2005 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, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Handwritten signature of KPMG LLP in black ink, with a horizontal line underneath.

Chartered Accountants
Toronto, Canada
February 27, 2007

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
February 27, 2007



Thomas J. Hofstedter
President and Chief Executive Officer



Larry Froom
Chief Financial Officer

Consolidated Balance Sheets

<i>(In thousands of dollars)</i>	December 31, 2006	December 31, 2005
Assets		
Income properties (notes 2 and 18)	\$ 4,537,716	\$ 3,654,875
Deferred expenses (note 3)	61,167	54,456
Accrued rent receivable	82,872	60,451
Other assets (note 4)	97,285	74,553
	\$ 4,779,040	\$ 3,844,335
Liabilities and Unitholders' Equity		
Liabilities:		
Mortgages payable (note 5)	\$ 3,036,365	\$ 2,396,894
Bank indebtedness (note 6)	70,973	67,097
Intangible liabilities (note 7)	68,430	17,387
Accounts payable and accrued liabilities	59,431	55,128
	3,235,199	2,536,506
Non-controlling interest (note 8)	112,892	116,688
Unitholders' equity (note 9(a))	1,430,949	1,191,141
Commitments and contingencies (note 20)		
Subsequent events (note 24)		
	\$ 4,779,040	\$ 3,844,335

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, 2006	December 31, 2005
Operating revenue:		
Rentals from income properties (note 10)	\$ 555,767	\$ 478,052
Mortgage interest and other income	1,793	1,916
	557,560	479,968
Operating expenses:		
Property operating costs	174,478	153,652
Mortgage and other interest expense (note 11)	174,983	147,254
Depreciation of income properties	83,898	68,300
Amortization of deferred expenses and intangible costs (note 12)	29,516	19,721
	462,875	388,927
Net property operating income (note 18)	94,685	91,041
Trust expenses	9,101	6,866
Net earnings before income taxes, non-controlling interest and discontinued operations	85,584	84,175
Income taxes (note 22)	2,837	88
Net earnings before non-controlling interest and discontinued operations	82,747	84,087
Non-controlling interest (note 8)	(4,960)	(5,727)
Net earnings from continuing operations	77,787	78,360
Net earnings from discontinued operations (note 19)	8,650	8,293
Net earnings	\$ 86,437	\$ 86,653
Basic net earnings per unit (note 13):		
Continuing operations	\$ 0.71	\$ 0.82
Discontinued operations	0.08	0.09
	\$ 0.79	\$ 0.91
Diluted net earnings per unit (note 13):		
Continuing operations	\$ 0.70	\$ 0.81
Discontinued operations	0.08	0.09
	\$ 0.78	\$ 0.90

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, 2004	\$ 1,013,285	\$ 483,812	\$ (499,016)	\$ (22,101)	\$ 975,980
Proceeds from issuance of units (note 9(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
Proceeds from issuance of units (note 9(a))	306,959	—	—	—	306,959
Issue costs	(12,023)	—	—	—	(12,023)
Net earnings	—	86,437	—	—	86,437
Distributions to unitholders	—	—	(146,067)	—	(146,067)
Foreign currency translation adjustment	—	—	—	4,502	4,502
Unitholders' equity, December 31, 2006	\$ 1,570,400	\$ 656,902	\$ (771,191)	\$ (25,162)	\$ 1,430,949

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands of dollars)

Years ended	December 31, 2006	December 31, 2005
Cash provided by (used in):		
Operations:		
Net earnings	\$ 86,437	\$ 86,653
Items not affecting cash:		
Rent amortization (notes 10 and 19)	4,561	4,932
Depreciation of income properties	84,520	70,192
Amortization of deferred expenses and intangible costs (notes 12 and 19)	29,892	21,735
Gain on sale of income properties and land under development (note 19)	(6,028)	(6,116)
Unit-based compensation	-	175
Net earnings attributable to non-controlling interest (note 8)	5,511	6,333
Change in other non-cash operating items (note 14)	(35,661)	(73,487)
	169,232	110,417
Financing:		
Bank indebtedness	3,876	(28,781)
Mortgages payable:		
New mortgages payable	639,669	257,786
Principal repayments	(122,307)	(92,262)
Proceeds from issuance of units, net	288,680	262,004
Distributions to unitholders	(146,067)	(126,108)
Distributions to non-controlling interest (note 8)	(9,307)	(9,097)
	654,544	263,542
Investments:		
Income properties:		
Land under development	(27,576)	(1,583)
Proceeds on disposition of income properties and land under development	83,046	17,022
Acquisitions and capital expenditures	(880,587)	(410,344)
Mortgages receivable	7,860	23,624
	(817,257)	(371,281)
Increase in cash and cash equivalents	6,519	2,678
Cash and cash equivalents, beginning of year	9,309	6,631
Cash and cash equivalents, end of year	\$ 15,828	\$ 9,309
Supplemental cash flow information:		
Interest paid	\$ 176,325	\$ 150,684
Supplemental disclosure of non-cash financing and investing activities:		
Acquisitions of income properties through assumption of mortgages payable (note 21)	113,661	201,853
Acquisitions of income properties through repayment of mortgages receivable	-	15,328
Acquisition of income properties through issuance of Class B units of H&R Portfolio Limited Partnership (notes 8 and 21)	6,256	-
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, 2006 and 2005

H & R Real Estate Investment Trust (the “Trust”) is an unincorporated open-ended trust (note 9) 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:

These 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 the Trust also consolidates certain variable interest entities that are subject to control on a basis other than through ownership of a majority interest. The Trust consolidates its interest in joint ventures on a proportionate basis, eliminating its proportionate share of transactions with the joint venture.

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.

The Trust is required, pursuant to The Canadian Institute of Chartered Accountants (the “CICA”) Accounting Guideline 15, Consolidation of Variable Interest Entities (“AcG15”) 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.

(b) Income properties:

Income properties are recorded at cost less accumulated depreciation. The Trust reviews whether the income properties are impaired whenever events or changes in circumstances affect the ultimate value of the income property and indicate that the carrying amount may not be recoverable. 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 income 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, in-place operating leases and customer relationship value.

(c) Deferred expenses:

Leasing costs, such as commissions and tenant improvements, 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 capital expenditures recoverable from tenants are amortized on a straight-line basis. 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 a straight-line basis 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) 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 (note 22).

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.

(f) Unit option plan:

The Trust has a unit option plan available for officers, employees and certain trustees as disclosed in note 9(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.

(g) 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.

(h) 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 years. Actual results could differ from those estimates.

(i) 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 the Trust's 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.

(j) 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 earnings when this interest payment is received.

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 earnings.

(k) 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, capitalized interest and operating revenue and expenses during the period of development.

(I) Financial instruments:

The CICA issued three new accounting standards that are effective for the Trust's fiscal year commencing January 1, 2007, which are to be applied on a retroactive basis without restatement to prior periods. The changes that affect the Trust include Section 1530, Comprehensive Income; Section 3855, Financial Instruments – Recognition and Measurement; and Section 3865, Hedges.

(i) Comprehensive income:

Comprehensive income, Section 1530, is comprised of net earnings and other comprehensive income ("OCI"), which represents changes in unitholders' equity during a period arising from transactions and other events with non-owner sources. OCI generally would include unrealized gains and losses on financial assets classified as available-for-sale, unrealized foreign currency translation adjustments net of hedging arising from self-sustaining foreign operations and changes in the fair value of the effective portion of cash flow hedging instruments.

(ii) Financial instruments – Recognition and Measurement:

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial instruments are required to be measured at fair value on initial recognition, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial statements have been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other liabilities.

Derivative instruments must be recorded on the balance sheet at fair value including those derivatives that are embedded in a financial instrument or other contract but are not closely related to the host financial instrument or contract, respectively. Changes in the fair values of derivative instruments are required to be recognized in net earnings, except for derivatives that are designated as a cash flow hedge, in which case the fair value change for the effective portion of such hedge relationship is required to be recognized in OCI.

(iii) Hedges:

Section 3865 specifies the criteria under which hedge accounting can be applied and how hedge accounting should be executed for each of the permitted hedging strategies: fair value hedges, cash flow hedges and hedges of a foreign currency exposure of a net investment in a self-sustaining foreign operation.

Impact of adopting Sections 1530, 3855 and 3865:

The Trust is currently finalizing its assessment of the impact of these standards on its consolidated financial statements.

2. Income properties:

			2006	2005
	Cost	Accumulated depreciation and amortization	Net book value	Net book value
Land	\$ 883,063	\$ –	\$ 883,063	\$ 692,922
Land under a capitalized lease	7,570	121	7,449	–
Buildings	3,339,315	233,602	3,105,713	2,546,547
Paving and equipment	119,787	29,328	90,459	75,353
	4,349,735	263,051	4,086,684	3,314,822
Income properties held for sale (note 19)	51,062	1,181	49,881	68,660
Intangible assets on acquisitions	449,061	47,910	401,151	271,393
	\$ 4,849,858	\$ 312,142	\$ 4,537,716	\$ 3,654,875

Three retail properties and two industrial properties are currently listed for sale. The results of operations from these properties have been separately disclosed as discontinued operations (note 19).

Debt related to certain Canadian properties is held by 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 the Trust.

Legal title to each of the United States 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"), a subsidiary of the Trust. 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 United States property is available from the Company. This structure does not prevent distributions to the entity owners provided there are no conditions of default.

3. Deferred expenses:

			2006		2005	
	Cost	Accumulated amortization	Net book value	Net book value		
Deferred leasing	\$ 38,746	\$ 10,477	\$ 28,269	\$ 27,491		
Deferred financing	23,813	5,785	18,028	15,801		
Deferred costs	19,623	4,753	14,870	11,164		
	\$ 82,182	\$ 21,015	\$ 61,167	\$ 54,456		

4. Other assets:

			2006		2005	
Land under development			\$ 30,224	\$ 2,648		
Cash and cash equivalents			15,828	9,309		
Mortgages receivable			16,125	23,985		
Tenant inducements			14,785	15,896		
Prepaid expenses and sundry assets			12,447	18,063		
Accounts receivable			7,876	4,652		
			\$ 97,285	\$ 74,553		

Included in cash and cash equivalents at December 31, 2006 is approximately \$8,163 of restricted cash (2005 – \$4,282).

The mortgage receivable is secured by real property, bears interest at 5.3% (2005 – 5.2%) per annum and is repayable between 2007 and 2009.

5. 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 6.4% (2005 – 6.6%) per annum and mature between 2007 and 2035. Included in the mortgages payable at December 31, 2006 are U.S. dollar denominated mortgages of U.S. \$839,797 (2005 – U.S. \$651,678). The Canadian equivalents of these amounts are \$982,562 (2005 – \$755,946).

Future principal mortgage payments are as follows:

Years ending December 31:

2007	\$ 115,485
2008	156,830
2009	127,100
2010	115,855
2011	163,480
Thereafter	2,319,989
	2,998,739
Mortgages payable on assets held for sale (note 19)	24,436
Mortgage premiums	13,190
	\$ 3,036,365

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 \$3,814 (2005 – \$1,771).

6. Bank indebtedness:

The bank indebtedness of the Trust is secured by fixed charges over certain income properties and is due on demand. The total facility is \$180,000 and can be drawn in either Canadian or U.S. dollars (to a maximum of \$100,000 Canadian for U.S. borrowings). The amount available at December 31, 2006, after taking into account the bank indebtedness drawn of \$58,834 (2005 – \$67,097) and the outstanding letters of credit and other items, is \$103,703. The Canadian dollar bank indebtedness bears interest at rates approximating the prime rate of a Canadian chartered bank. At December 31, 2006, the Canadian prime interest rate was 6.0% (2005 – 5.0%) per annum.

There is additional bank indebtedness of \$12,139 (2005 – nil), held under a separate facility, to fund land under development owned by the Trust through a joint venture. The loan bears interest at prime plus 0.5% and is due on demand.

Included in bank indebtedness at December 31, 2006 is U.S. \$8,091 (2005 – U.S. \$26,366). The Canadian equivalents of these amounts are \$9,467 (2005 – \$30,584). The United States dollar bank indebtedness bears interest at LIBOR rates.

7. Intangible liabilities:

	2006		2005	
	Cost	Accumulated depreciation and amortization	Net book value	Net book value
Intangible liabilities on acquisitions of properties	\$ 73,607	\$ 5,177	\$ 68,430	\$ 17,387

8. 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”) issued to participating vendors in exchange for properties acquired by 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. To fund the distributions to Class B units, HRLP holds 6,974,555 units of the Trust at December 31, 2006 (2005 – 6,974,555).

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

	Amount	Number of units
As at December 31, 2004	\$ 119,452	6,974,555
Non-controlling interest from continuing operations	5,727	–
Non-controlling interest from discontinued operations	606	–
Distributions on Class B Units of HRLP	(9,097)	–
As at December 31, 2005	116,688	6,974,555
Issuance of Class B Units of HRLP on March 30, 2006	6,256	293,879
Redemption of Class B Units of HRLP on April 3, 2006	(6,256)	(293,879)
Non-controlling interest from continuing operations	4,960	–
Non-controlling interest from discontinued operations (note 19)	551	–
Distributions on Class B Units of HRLP	(9,307)	–
As at December 31, 2006	\$ 112,892	6,974,555

9. Unitholders' equity:

The Trust is an unincorporated open-ended Trust. 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 unitholder's 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:

As at 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
	110,624,316
Units held by a subsidiary (note 8)	(6,974,555)
As at December 31, 2005	103,649,761
As at December 31, 2005	110,624,316
Issued on March 30, 2006 (at a price of \$21.29 per unit)	293,879
Issued on April 28, 2006 (at a price of \$20.90 per unit)	5,985,000
Issued on November 8, 2006 (at a price of \$23.15 per unit)	6,500,000
Issued under the distribution reinvestment plan and direct unit purchase plan	1,126,119
Options exercised	55,365
	124,584,679
Units held by a subsidiary (note 8)	(6,974,555)
As at December 31, 2006	117,610,124

(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 vest at 33.3% per year from the grant date, being fully vested after three years, and expire ten years after the date of the grant.

A summary of the status of the plan as at December 31, 2006 and 2005 and the changes during the period ended on those dates are as follows:

	2006		2005	
	Units	Weighted average exercise price	Units	Weighted average exercise price
Outstanding, beginning of year	1,910,031	\$ 12.83	2,418,668	\$ 12.66
Exercised	(55,365)	13.36	(508,637)	12.02
Outstanding, end of year	1,854,666	12.81	1,910,031	12.83
Options exercisable at December 31	1,854,666	\$ 12.81	1,753,976	\$ 12.78

The options outstanding at December 31, 2006 are all vested and are exercisable at varying prices ranging from \$12.01 to \$13.36 (2005 – \$12.01 to \$13.36) with a weighted average remaining life of 5.1 years (2005 – 6.1 years).

(c) Unitholders' rights plan:

The Trust has adopted a Unitholders' Rights Plan ("Rights Plan") effective June 23, 2006 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 their 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 2009, unless terminated earlier.

(d) 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.

(e) Distributions:

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

10. Rentals from income properties:

	2006	2005
Gross rent and sundry income	\$ 538,162	\$ 457,421
Straight-lining of contractual rent increases	22,096	25,271
Rent amortization of above- and below-market rents	(2,945)	(3,749)
Rent amortization of tenant inducements	(1,546)	(891)
	\$ 555,767	\$ 478,052

11. Mortgage and other interest expense:

	2006	2005
Mortgage interest	\$ 172,949	\$ 144,895
Amortization of mortgage premium	(2,007)	(1,625)
Bank interest and charges	4,041	3,984
	\$ 174,983	\$ 147,254

12. Amortization of deferred expenses and intangible costs:

	2006	2005
Amortization of deferred leasing expenses	\$ 4,213	\$ 2,918
Amortization of deferred financing expenses	1,869	1,490
Amortization of deferred costs	2,461	1,647
Amortization of intangible assets on acquisitions	20,973	13,666
	\$ 29,516	\$ 19,721

13. Net earnings per unit:

	2006	2005
Net earnings:		
Basic net earnings	\$ 86,437	\$ 86,653
Add net earnings attributable to non-controlling interest (note 8)	5,511	6,333
Diluted net earnings	\$ 91,948	\$ 92,986
The weighted average number of units outstanding was as follows:		
Basic units	109,387,142	95,429,798
Effect of dilutive securities:		
Unit option plan	784,102	650,720
Non-controlling interest conversion to units (note 8)	6,974,555	6,974,555
Diluted units	117,145,799	103,055,073
Net earnings per unit:		
Basic	\$ 0.79	\$ 0.91
Diluted	0.78	0.90

14. Change in other non-cash operating items:

	2006	2005
Deferred expenses	\$ (19,500)	\$ (33,189)
Accrued rent receivable	(22,421)	(25,577)
Tenant inducements	(435)	–
Prepaid expenses and sundry assets	5,616	(8,478)
Accounts receivable	(3,224)	239
Accounts payable and accrued liabilities	4,303	(6,482)
	\$ (35,661)	\$ (73,487)

15. 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, management considers the weighted average term to maturity of long-term debt 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 group of tenants. Bell Canada is the only tenant that accounts for more than 8% of the Trust's rentals from income properties. As at December 31, 2006, in excess of 50% of the total debt was non-recourse to the Trust but have recourse to the specific property to which the mortgage applies.

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, certain hedges have been implemented to protect income earned in U.S. dollars.

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 these financial 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, 2006 has been estimated at \$3,146,936 (2005 – \$2,583,495) compared with the carrying value of \$3,036,365 (2005 – \$2,396,894).

At December 31, 2006, the Trust has a foreign exchange forward contract to sell U.S. 3,000 dollars for Canadian dollars at a rate of 1.1744 settling on January 10, 2007. The fair value of this forward foreign exchange contract at December 31, 2006 has been estimated at \$28 (2005 – \$241) as quoted by the Trust's banker, taking into account current foreign exchange rates. 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. 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, 2006 has been estimated at (\$51) (2005 – \$2,242).

16. Joint venture and co-ownership activities:

These consolidated financial statements include the Trust's proportionate share of assets, liabilities, revenue, expenses and cash flows of the joint ventures and co-ownerships. The Trust's proportionate share of these joint ventures and co-ownerships range between 20% and 98.5%, summarized as follows:

	2006	2005
Assets	\$ 164,322	\$ 137,196
Liabilities	88,254	63,587
Revenue	26,617	26,200
Expenses	18,674	17,891
Operating income from properties	7,943	8,309
Cash flows provided by operations	8,185	6,301
Cash flows provided by (used in) financing	20,011	(1,649)
Cash flows provided by (used in) investments	(27,307)	750

17. Related party transactions:

In March 2006, the Trust and H&R Property Management Ltd. (the "Property Manager"), a company owned by family members of the Chief Executive Officer, amended the Omnibus Property Management Agreement effective January 1, 2006 for the remaining terms of the agreement. The Property Manager provides property management services for substantially all properties owned by the Trust, including leasing services, for a fee of 2% (2005 – 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 2/3 of 1% (2005 – 1%) of total acquisition costs, as defined in the agreement. The current agreement is for four years expiring December 31, 2009 with two automatic five-year extensions.

During the year ended December 31, 2006, the Trust accrued fees pursuant to this agreement of \$16,891 (2005 – \$17,351), of which \$6,489 (2005 – \$6,135) was capitalized to the cost of the income properties acquired and \$1,949 (2005 – \$2,099) was capitalized to deferred expenses. The Trust has also reimbursed the Property Manager for certain direct property operating costs and tenant construction costs.

For the year ended December 31, 2006, the amount allocated to the Property Manager in accordance with the annual incentive bonus pool amounted to \$2,490 (2005 – \$1,300) and has been expensed in the consolidated statements of earnings.

Pursuant to the above agreements, as at December 31, 2006, \$1,526 (2005 – \$2,073) was payable to the Property Manager.

The Trust leases space to companies affiliated with the Property Manager. The rental income earned for the year ended December 31, 2006 is \$949 (2005 – \$915).

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

18. 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:

	2006	2005
Canada	\$ 3,206,454	\$ 2,624,419
United States	1,331,262	1,030,456
	\$ 4,537,716	\$ 3,654,875

Net property operating income:

2006	Canada	United States	Total
Operating revenue	\$ 457,633	\$ 99,927	\$ 557,560
Property operating costs	159,671	14,807	174,478
Mortgage and other interest	126,507	48,476	174,983
Depreciation of income properties	59,861	24,037	83,898
Amortization of deferred expenses and intangible costs	21,729	7,787	29,516
	367,768	95,107	462,875
Net property operating income	\$ 89,865	\$ 4,820	\$ 94,685
2005	Canada	United States	Total
Operating revenue	\$ 405,097	\$ 74,871	\$ 479,968
Property operating costs	142,645	11,007	153,652
Mortgage and other interest	110,386	36,868	147,254
Depreciation of income properties	50,529	17,771	68,300
Amortization of deferred expenses and intangible costs	15,037	4,684	19,721
	318,597	70,330	388,927
Net property operating income	\$ 86,500	\$ 4,541	\$ 91,041

19. Net earnings from discontinued operations:

There are five remaining properties currently held for sale. For the year ended December 31, 2006, there were an additional three industrial properties classified as discontinued operations, which were all sold in the latter half of 2006. The results of operations from these properties have been separately disclosed below:

	2006	2005
Operating revenue:		
Gross rent and sundry income	\$ 11,170	\$ 17,126
Straight-lining of contractual rent increases	(510)	419
Rent amortization of above- and below-market rents	(70)	(292)
Rental from income properties	10,590	17,253
Mortgage interest and other income	50	35
	10,640	17,288
Operating expenses:		
Property operating costs	4,839	7,919
Mortgage interest	1,665	2,812
Amortization of mortgage premium	(36)	(146)
Bank interest and charges	1	14
Depreciation of income properties	622	1,892
Amortization of deferred leasing expenses	108	376
Amortization of deferred financing expenses	5	20
Amortization of deferred costs	19	103
Amortization of intangible assets on acquisition	244	1,515
	7,467	14,505
Net property operating income	3,173	2,783
Gain on sale of income properties and land under development	6,028	6,116
Non-controlling interest (note 8)	(551)	(606)
Net earnings from discontinued operations	\$ 8,650	\$ 8,293

20. 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, 2006, the Trust has outstanding letters of credit totalling \$16,213 (2005 – \$17,295), including \$15,439 (2005 – \$16,435) 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 6).

At December 31, 2006, the Trust had issued guarantees amounting to \$120,822 (2005 – \$50,022) which expire between 2011 and 2016 and no amount has been provided for in the consolidated financial statements for these items. These amounts arise 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) 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.

(c) The Trust is a lessee under four ground leases that expire between 2021 and 2038.

Future minimum commitments under the leases are as follows:

2007	\$	216
2008		216
2009		216
2010		216
2011		217
Thereafter		2,599
	\$	3,680

(d) As at December 31, 2006, the Trust had entered into agreements to acquire properties for purchase prices aggregating \$15,227, including the transaction described in note 24.

21. Acquisitions:

During the year ended December 31, 2006, the Trust acquired 68 (2005 – 34) properties. 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:

	2006	2005
Assets		
Land	\$ 196,928	\$ 108,689
Land under a capitalized lease	7,117	–
Building	654,218	363,455
Paving and equipment	25,792	36,033
Sundry assets	6,075	–
Intangible above-market rent leases	10,038	28,205
Intangible acquired in-place lease costs	127,587	82,515
Customer relationship value	18,486	6,151
	1,046,241	625,048
Liabilities		
Mortgage payable	113,661	201,853
Intangible below-market rent leases	53,619	6,418
	167,280	208,271
Net assets acquired	\$ 878,961	\$ 416,777
Settled by:		
Cash	\$ 872,705	\$ 401,449
Issue of units (note 9(a))	6,256	–
Mortgage receivable	–	15,328
	\$ 878,961	\$ 416,777

22. Income taxes:

The Trust currently qualifies as a Mutual Fund Trust for Canadian income tax purposes and, as discussed in note 1, does not record a provision for income taxes on income earned by the Trust, its subsidiary trust and flow through entities. On December 21, 2006, The Minister of Finance (Canada) released draft legislation (the "Proposals") relating to the federal income taxation of publicly traded income trusts and certain other publicly traded flow-through entities.

Under the Proposals, certain distributions from a "specified investment flow-through" trust or partnership (a "SIFT") will no longer be deductible in computing a SIFT's taxable income, and a SIFT will be subject to tax on such distributions at a rate that is substantially equivalent to the general tax rate applicable to a Canadian corporation. However, the Proposals provide that distributions paid by a SIFT as returns of capital will not be subject to the tax.

The Proposals provide that a SIFT which was publicly listed before November 1, 2006 (an "Existing Trust") would become subject to the tax on distributions commencing with the 2011 taxation year end. However, an Existing Trust may become subject to this tax prior to the 2011 taxation year end if its equity capital increases beyond certain limits measured against the market capitalization of the Existing Trust at the close of trading on October 31, 2006.

Under the Proposals, the new taxation regime will not apply to a Real Estate Investment Trust (a "REIT") that meets prescribed conditions relating to the nature of its income and investments (the "REIT Conditions"). Unless an Existing Trust is able to meet all REIT Conditions, the Proposals, if enacted, would, subject an Existing Trust to tax commencing in 2011, which would adversely impact the level of cash otherwise available for distribution.

As the Proposals are currently drafted, the Trust and many Canadian REITs do not meet the REIT Conditions which contain a number of technical provisions that do not fully accommodate common real estate properties and business structures. If the Proposals are enacted as currently drafted, commencing in 2011, the Trust would become subject to tax on certain income and, at the date of substantive enactment, the Trust would record future income tax assets and liabilities in respect of accounting and tax basis differences that are expected to reverse in or after 2011, with a corresponding credit or charge to consolidated earnings for the period.

In respect of assets and liabilities of the Trust, its subsidiary trust and flow through entities, the net book value for accounting purposes of those net assets exceeds their tax basis by an amount of approximately \$409,281 (2005 – \$405,751).

It is possible that changes will be made to the Proposals prior to their enactment. If the Proposals are not changed, the Trust may need to restructure its affairs in order to minimize, or if possible eliminate, their impact. There can be no assurances, however, that the Trust will not be impacted by the proposal.

Income taxes consist of the following:

	2006		2005
Future income taxes	\$ 550	\$	–
Current income taxes	249		88
Withholding taxes	2,038		–
	\$ 2,837	\$	88

The Trust has certain subsidiaries in Canada and the United States which are subject to tax on their respective taxable income at the applicable legislated rates.

A future income tax liability as at December 31, 2006 of \$550 (2005 – nil) has been recorded to reflect the future tax obligations of the Canadian subsidiaries resulting from tax and book basis differences of Canadian income properties.

At December 31, 2006, the United States subsidiaries had accumulated net operating losses available for carryforward for income tax purposes of approximately \$47,588. These losses expire between 2018 and 2026. The net future tax assets of these corporate subsidiaries of \$13,183 consist of net operating losses and tax and book basis differences relating to United States income properties, against which a valuation allowance of \$13,183 has been recorded.

23. Comparative figures:

Certain 2005 comparative figures have been reclassified to conform with the presentation adopted in 2006.

24. Subsequent events:

- (a) In January 2007, the Trust acquired a retail property located in Indiana, United States for cash consideration of \$15,227.
- (b) In February 2007, the Trust acquired land for approximately \$70,000 to be used for the development of a 1.9 million square foot office building in Calgary, Alberta. The building has a budgeted cost of approximately \$1,100,000 and is fully pre-leased to EnCana Corporation. In addition, there is expected to be a further 100,000 square feet of retail space. The building is expected to be completed by the fall of 2011.
- (c) In February 2007, the Trust acquired an industrial building located in Ontario, Canada for cash consideration of \$8,550.
- (d) In February 2007, the Trust acquired a 55% interest in an 84,511 square foot office property in Utah, United States, for cash consideration of \$9,594.
- (e) In February 2007, the Trust disposed of a 55,900 square foot retail property located in Edmonton, Alberta for gross proceeds of \$13,800.

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 Trust

**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

Larry Froom
Chief Financial Officer

Nathan Uhr
Vice-President,
Acquisitions

Unitholder Information

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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
Blake, Cassels and Graydon LLP

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

Taxability of Distributions
48% of the distributions made by the
REIT to unitholders during 2006
were tax deferred. Management
estimates that between 50% and 60%
of the distributions to be made by the
REIT in 2007 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
May 18, 2007
1:00 p.m.
Toronto Board of Trade
1 First Canadian Place
Toronto, ON
M5X 1C1

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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