



2008 H&R ANNUAL REPORT

Stability through discipline



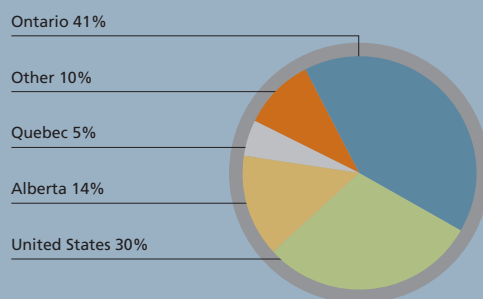
Profile

- > H&R Real Estate Investment Trust ("H&R REIT") is an open-ended real estate investment trust, which owns and manages a North American portfolio of office, industrial and retail properties comprising 42 million square feet, with a net book value of \$4.5 billion. H&R Finance Trust is an unincorporated investment trust, which primarily invests in notes issued by an H&R REIT subsidiary. The units of H&R REIT trade together with the units of H&R Finance Trust as "stapled units" (HR.UN) on the Toronto Stock Exchange. In this annual report, we refer to the combination of these two trusts as "H&R" or "the Trusts".

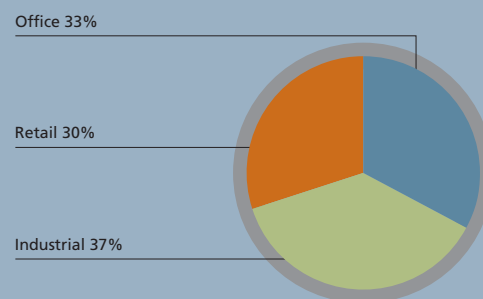
The foundation of H&R's success since inception in 1996 has been a disciplined strategy that leads to consistent and profitable growth. Additional information regarding H&R REIT and H&R Finance Trust is available at www.hr-reit.com and on www.sedar.com.

Portfolio as at December 31, 2008

> BOOK VALUE OF INCOME PROPERTIES BY GEOGRAPHIC REGION



BOOK VALUE OF INCOME PROPERTIES BY PROPERTY TYPE



Primary objectives

- > H&R REIT strives to achieve two primary objectives: to provide unitholders with reliable and growing cash distributions from a diversified portfolio of income-producing properties, and to increase the value of units through active management of H&R REIT's assets, accretive acquisition of additional properties, and development of new projects. We are committed to maximizing cash distributions and capital appreciation for unitholders while maintaining prudent risk management and conservative use of financial leverage.

Front and back cover photos: Architectural renderings of H&R's \$1.5 billion, two million square foot office complex called *The Bow* in downtown Calgary. The 58-storey, Class AAA office tower will be the largest and tallest in Canada west of Toronto. It is 100% leased for 25 years to EnCana Corporation, the leading North American unconventional natural gas producer and one of Canada's largest public companies. When it opens in 2012, *The Bow* will be part of a 3.3 million square foot cluster of prime rentable office premises owned and managed by H&R in Calgary's financial district.



Stability through discipline

H&R has a long track record of successfully executing a disciplined and proven strategy that has consistently provided stable increases in distributable cash. We achieve our primary objectives and mitigate risks through long-term property leasing and financing, combined with conservative management of assets and liabilities.

2008 Highlights

- Invested \$224 million in projects under development
- Completed construction of a \$140-million distribution facility in Ajax, Ontario
- Construction of *The Bow* office complex in Calgary – the largest in Canada – continued on schedule
- Raised \$591 million by issuing units and convertible debentures (\$288 million) and selling primarily non-core assets (\$303 million)
- Ended the year with a sound capital structure with debt to gross book value of 56%
- Average terms to maturity were 11.5 years for leases and 9.3 years for financing at year end
- Maintained portfolio occupancy rate at nearly 100% for the eleventh consecutive year
- Increased distributable cash by 7.5%
- Paid distributions to unitholders of \$1.44 per unit, up 5% from the previous year; reduced annual payments effective January 2009 to \$0.72 per stapled unit to preserve capital

| | 2008 | 2007 | 2006 |
|--|---------|-----------|---------|
| Rental income (millions) | \$ 609 | \$ 581 | \$ 527 |
| Net earnings (millions) | \$ 99 | \$ (2) | \$ 86 |
| Net earnings per unit (basic) | \$ 0.71 | \$ (0.02) | \$ 0.79 |
| Distributable cash* (millions) | \$ 222 | \$ 206 | \$ 174 |
| Distributable cash* per unit (basic) | \$ 1.57 | \$ 1.57 | \$ 1.49 |
| Cash distributions to unitholders (millions) | \$ 204 | \$ 180 | \$ 155 |
| Cash distributions per unit (basic) | \$ 1.44 | \$ 1.37 | \$ 1.33 |
| Assets (billions) | \$ 5.4 | \$ 5.1 | \$ 4.8 |
| Unitholders' equity (billions) | \$ 1.7 | \$ 1.6 | \$ 1.5 |

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

Note: H&R's 2008 Management's Discussion and Analysis of the combined financial position and the combined results of operations and accompanying notes for the year ended December 31, 2008 for the Trusts are accessible at www.hr-reit.com and www.sedar.com.

Stability through discipline

"H&R's large portfolio of commercial properties performed well in 2008 and is expected to continue to do so this year. Over the past 12 months, however, we have seen unprecedented turmoil and change in financial markets. Few would have predicted that the U.S. residential sub-prime mortgage fiasco would spark a credit crisis that has rattled stock markets and investor confidence around the world. These unusually difficult conditions have caused much uncertainty and confusion. In this letter, we will attempt to address some of the more frequent questions we receive from the investment community."

THOMAS J. HOFSTEDTER *President and CEO*

How has the credit crisis affected H&R?

- > The global credit crunch has significantly reduced the availability of debt and equity capital, and increased the cost of that capital, causing the market value of REITs worldwide to drop substantially. Consumer and business confidence has plunged, which prompted recessionary conditions in our North American markets.

Over the past twelve months, the trading price of H&R units declined sharply along with benchmark equity market indices. Investors were particularly concerned about the source of financing for the construction of our \$1.5-billion development project in Calgary – *The Bow*.



How did H&R adapt to the turbulence in financial markets?

- Difficult market circumstances dictated that tough measures be taken. In order to preserve capital to finance our commitments to *The Bow*, we reduced cash distributions by 50% starting in January 2009. This was not an easy decision for us after increasing cash distributions per unit in each of the past 11 years at a compound annual growth rate of 7%, but given the high cost of capital, we felt it was the right thing to do.

We have also been proactive with trades and suppliers, aggressively renegotiating contracts to reduce project costs in light of recent construction industry softness in the Calgary market. In addition, we are diligently managing the operating costs at all our properties and reconsidering the amounts and timing of all of our capital expenditures.

In order to maintain our strong balance sheet while funding promising development projects last year, we significantly reduced acquisitions, completed a major financing, and accelerated our disposition of non-core assets.

- We acquired only \$79 million of income properties in 2008, compared to \$261 million in the previous year and \$963 million in 2006.
- In June 2008 we raised \$288 million from an offering of trust units and convertible unsecured subordinated debentures.
- We sold 16 properties in 2008 for gross proceeds of \$303 million.

What have been H&R's key accomplishments over the past year?

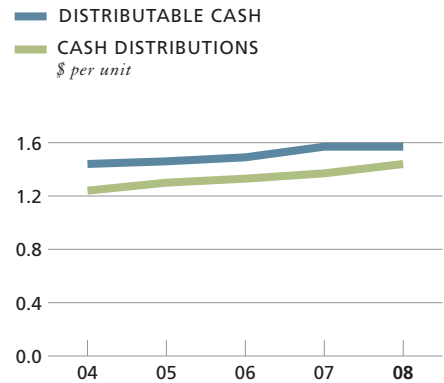
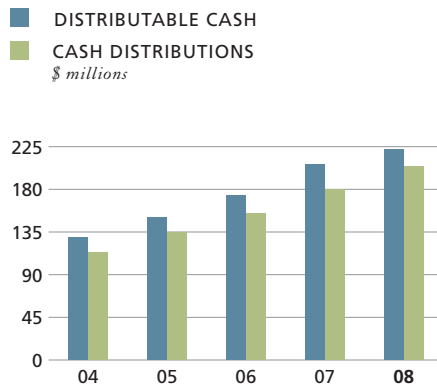
- > Due to rising commercial property prices resulting in lower returns, we shifted the primary focus of our investments from acquisitions to development projects, and invested \$224 million in 2008, primarily in the following projects:
 - We continued to build our \$1.5 billion office complex in Calgary – *The Bow*, spending \$212 million on this landmark project.
 - We completed the construction of a 910,000-square-foot distribution centre in Ajax, Ontario for Loblaws, which leased the \$140 million property for 20 years.
 - We completed our \$135 million expansion of Bell Canada's office complex in Mississauga, Ontario, which opened in January this year.



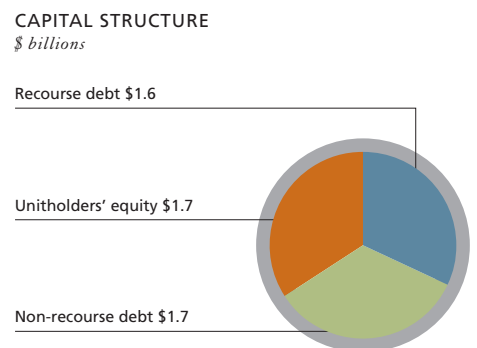
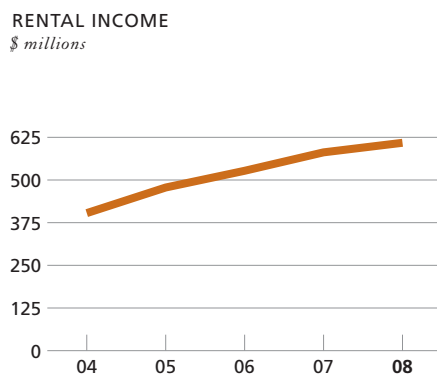
> *The Phase III expansion of Bell Canada's office complex in Mississauga, Ontario*

- > During a tumultuous period in credit, equity and property markets last year, we were proactive in raising the capital required to finance our new developments. In addition to gross proceeds of \$288 million from the bought deal offering of units and convertible debentures, we generated gross proceeds of \$303 million from the sale of non-core assets in 2008, and entered in to a conditional private placement for \$200 million of unsecured debentures.

Last year, we increased distributable cash by 7% and cash distributions per unit to unitholders by 5%. We also completed an internal re-organization to adopt a structure that is efficient from both an operational and tax perspective.



- > After surpassing the milestones of \$600 million in rental income and \$200 million in cash distributions, we ended 2008 with a strong capital structure, as reflected with ratios of debt to gross book value of 56% and non-recourse debt to total debt of 51%.

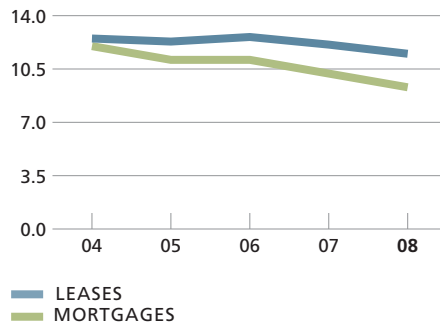


What are H&R's key strengths as we face these challenging market conditions?

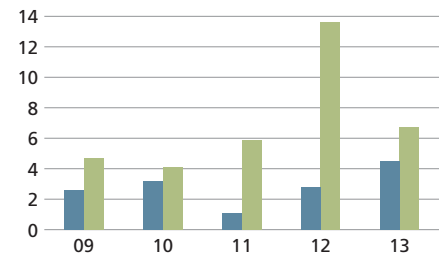
- > We continue to execute a proven and conservative strategy of locking in rental income over relatively long periods of time. We believe that H&R's portfolio has one of the longest average terms to maturity of any commercial real estate company in North America. Our 25 largest tenants, which contribute 63% of total rental income, are primarily investment grade tenants, and our leases often include contractual rent escalations. Furthermore, we strive to match these leases with fixed-rate, long-term mortgages. Only \$140 million or 4% of H&R's total mortgage principal will become due from 2009 to 2011.

By spreading out the maturities of our leases and mortgages, our operating strategy engenders a high portfolio occupancy rate. This helps shelter H&R's rental income from the impacts of market volatility, and stabilizes our distributable cash, making it more dependable and predictable. We also have a strong track record of successful commercial real estate ownership and development, and a highly qualified and experienced management team that maintains **stability through discipline**.

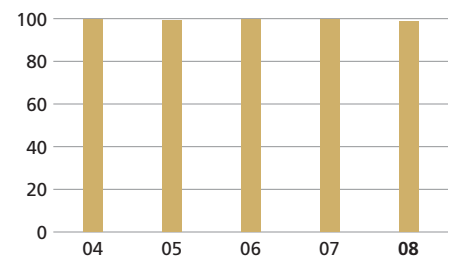
AVERAGE TERM TO MATURITY
Number of years



PERCENT OF LEASES EXPIRING
PERCENT OF MORTGAGE PRINCIPAL PAYABLE
%



OCCUPANCY
%





< Construction of
The Bow
in Calgary,
Alberta

How will more costly financing affect *The Bow* project in Calgary?

- > From a financial perspective, *The Bow* is 100% leased for a term of 25 years to the leading North American natural gas producer and one of Canada's largest public companies. Admittedly, we've seen with this project that real estate investment can be as much about timing as location. The cost of capital to build *The Bow* has been higher than we had projected. Last December, we agreed to a private placement of \$200 million from Fairfax Financial in the form of unsecured and redeemable 11.5% debentures, plus warrants to purchase H&R stapled units. We are offsetting higher financing costs by taking advantage of recessionary conditions in the construction industry in order to reduce costs. We have entered into fixed-price contracts covering approximately 70% of the budgeted hard construction costs of the project, and upon closing of *The Bow* construction financing, we expect to enter into an interest rate swap to limit our interest rate exposure on the financing.

As at year end 2008, H&R had invested \$402 million in the \$1.5 billion project, and we expect to spend \$375 million on *The Bow* this year. The new *Bow* skyscraper will reach 30 storeys by the end of this year and should be completed on time and on budget for full occupancy by early 2012. Our goal is to secure a strategic alliance with a joint-venture partner and use the proceeds to repay our construction financing, thereby leaving us with a 50% interest in this trophy project free and clear of any debt.

The two million square feet of office space will rise up 58 storeys to become the tallest and largest Canadian office tower west of Toronto, and its striking architectural design will permanently redefine Calgary's skyline.

What about the next 12 months for H&R?

- > Despite tough economic conditions, we anticipate our solid North American portfolio will continue to provide the stable income that is more typical of an investment-grade corporate bond. Importantly, the portfolio's critical mass, diversification by type of asset and region, and relatively low turnover of leases and mortgages will reduce H&R's risk exposure to the current economic and market cycles. Moreover, the portfolio is at virtually full occupancy, leased and financed long term, and with a relatively young average age of 15 years demands only modest capital expenditure.

Current financing challenges have made us wiser, and increased our resolve to execute the proven and prudent strategy that has always guided our investment decisions.

Hopefully, government stimulus initiatives will restore liquidity in commercial real estate financing within the next year. In the meantime, we will keep the hatches battened down and continue to build a legacy of **stability through discipline**.

We encourage investors to e-mail or call us if they have other pressing questions.

In closing, I would like to thank our key stakeholders – tenants, unitholders, lenders, trustees and employees. We genuinely appreciate your trust and the contributions you have made to help H&R succeed, and wish you the best in the year ahead.



THOMAS J. HOFSTEDTER *President and CEO*
MARCH 2009

> H&R REIT BOARD OF TRUSTEES

Thomas J. Hofstedter¹
President and Chief Executive Officer
 H&R REAL ESTATE INVESTMENT TRUST

Robert Dickson^{2, 4}
Managing Director
 MDC PARTNERS

Edward Gilbert^{1, 2, 3, 4}
Chief Operating Officer
 FIRM CAPITAL MORTGAGE INVESTMENT TRUST

The Honourable Robert P. Kaplan, P.C., Q.C.⁴
Business Consultant
Member of Parliament until 1993

Laurence A. Lebovic^{1, 3, 4}
Chief Executive Officer
 RUNNYMEDE DEVELOPMENT CORPORATION LTD.

Ronald C. Rutman^{2, 3, 4}
Partner
 ZEIFMAN & COMPANY, CHARTERED ACCOUNTANTS

> H&R FINANCE TRUST BOARD OF TRUSTEES

Thomas J. Hofstedter
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 H&R REAL ESTATE INVESTMENT TRUST

Marvin Rubner²
Manager and Founder
 YAD INVESTMENTS LIMITED

Shimshon (Stephen) Gross²
President
 LRG HOLDINGS INC.

Neil Sigler²
Vice President
 GOLD SEAL MANAGEMENT INC.

> OFFICERS

Thomas J. Hofstedter
President and Chief Executive Officer

Larry Froom
Chief Financial Officer

Nathan Uhr
Vice-President, Acquisitions
(for H&R REIT only)

Shawn Goldberg
Vice-President, Finance
(for H&R REIT only)

¹ Investment Committee
² Audit Committee
³ Compensation and Governance Committee
⁴ Nomination Committee

> AUDITORS

KPMG LLP

> LEGAL COUNSEL

Blake, Cassels & Graydon LLP

> TAXABILITY OF DISTRIBUTIONS

46% of the distributions made by H&R REIT and 23% of the distributions made by H&R Finance Trust to Unitholders during 2008 were tax deferred.

> PLAN ELIGIBILITY

RRSP, RRIF, DPSP

> STOCK EXCHANGE LISTING

Units and debentures of H&R are listed on the Toronto Stock Exchange under the trading symbols HR.UN and HR.DB.

> ANNUAL MEETING OF UNITHOLDERS

The AGM will take place on May 15, 2009 at 1:30 pm in the Gallery room of the TSX Broadcast Centre, The Exchange Tower, 130 King St. West, Toronto.

> 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 distributions of H&R REIT reinvested in additional stapled units of H&R at a 3% discount to the weighted average price of the stapled units on the TSX for the five trading days (the "Average Market Price") immediately preceding the cash distribution date. The Direct Unit Purchase Plan allows participants to purchase additional stapled 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 our Registrar and Transfer Agent.

> 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 within the Toronto area or 1-800-387-0825
 Fax: 416-643-5501
 E-mail: [inquiries@cibcmellon.com](mailto:inquiries@ cibcmellon.com)
 Website: www.cibcmellon.com

> CONTACT INFORMATION

Investors, investment analysts and others seeking financial information should go to our website at www.hr-reit.com, or e-mail info@hr-reit.com, or call 416-635-7520 and ask for Larry Froom, Chief Financial Officer, or fax 416-398-0040, or write to H&R Real Estate Investment Trust, 3625 Dufferin Street, Suite 500, Toronto, Ontario, Canada, M3K 1N4.



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H&R Increased Distributable Cash 7% in 2008;
Provides Update on The Bow Construction Financing

Toronto, Ontario, March 3, 2009 - H&R Real Estate Investment Trust (“H&R REIT”) and H&R Finance Trust (collectively, “H&R”) (TSX: HR.UN; HR.DB) announced today that their combined distributable cash increased by 3% in the three months ended December 31, 2008, and by 7% for the year as a whole, compared to the same periods in the previous year. As previously announced on October 1, 2008, H&R REIT completed an internal reorganization which resulted in, among other things, each issued and outstanding H&R REIT unit trading together with a unit of H&R Finance Trust as a “stapled unit” on the Toronto Stock Exchange. Accordingly, H&R is providing its financial summary presented herein on a combined basis as in management’s view, the value of H&R unitholders’ investment is based on the combined financial performance of H&R and the combined financial information would therefore be the most useful information to unitholders.

Financial Results

H&R management considers H&R’s distributable cash to be an indicative measure in evaluating H&R’s performance. The following table includes non-GAAP (Generally Accepted Accounting Principles) information that should not be construed as an alternative to net earnings or cash flows from operations and may not be comparable to similar measures presented by other issuers as there is no standardized meaning of distributable cash under GAAP. Financial information for the periods ending after October 1, 2008 is presented herein on a combined and/or stapled basis. Financial information for the periods ended prior to October 1, 2008 is presented for H&R REIT.

| | 3 months ended Dec. 31 | | 12 months ended Dec. 31 | |
|--|------------------------|--------|-------------------------|---------|
| | 2008 | 2007 | 2008 | 2007 |
| Combined distributable cash (millions) * | \$55.8 | \$54.1 | \$221.7 | \$206.2 |
| Combined distributable cash per stapled unit (basic) | \$0.38 | \$0.40 | \$1.57 | \$1.57 |
| Combined cash distributions (millions) | \$52.7 | \$46.3 | \$204.1 | \$180.0 |
| Combined cash distributions per stapled unit | \$0.36 | \$0.34 | \$1.44 | \$1.37 |

Combined distributable cash per Stapled Unit (basic) decreased 5% in the fourth quarter 2008 (unchanged for the year) due to dilution resulting from the securities offering completed in June 2008 and to costs associated with H&R’s internal reorganization. Combined cash distributions increased 14% in the fourth quarter, and rose 13% (5% per stapled unit) for the 2008 year.

The following table includes results reported in accordance with Canadian GAAP.

| | 3 months ended Dec. 31 | | 12 months ended Dec. 31 | |
|---|------------------------|---------|-------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Rentals from income properties (millions) | \$156.9 | \$149.7 | \$608.7 | \$580.7 |
| Combined net earnings (millions) * | \$46.0 | \$48.7 | \$98.5 | (\$2.2) |
| Combined net earnings per stapled unit (basic) | \$0.32 | \$0.38 | \$0.71 | (\$0.02) |
| Combined cash provided by operations (millions) * | \$73.8 | \$63.4 | \$235.1 | \$196.6 |

* Reconciliations of combined distributable cash to combined net earnings and to combined cash provided by operations are included in H&R’s combined MD&A.

H&R reported a 5% increase in rental income in both the fourth quarter and full year 2008, due primarily to property acquisitions. Combined net earnings decreased 6% (down 13% per stapled unit) in the fourth quarter and increased to \$98.5 million in 2008 from a loss of \$2.2 million in 2007. Combined cash provided by operations rose 16% in the fourth quarter and 20% for the year.

As at year end 2008, H&R reported financial ratios of 54.7% for debt to gross book value (calculated in



accordance with H&R REIT's declaration of trust) versus 58.8% as at December 31, 2007, and 51.4% for non-recourse debt to total debt (49.5% at year end 2007).

H&R's audited Combined Financial Statements and the notes thereto and Management's Discussion and Analysis (MD&A) relating thereto for the year ended December 31, 2008 are available on H&R REIT's website (www.hr-reit.com) and have been concurrently filed on SEDAR (www.sedar.com), as well as H&R REIT's audited Consolidated Financial Statements and the notes thereto, and H&R Finance Trust's audited Financial Statements and the notes thereto (each for the fiscal period ended December 31, 2008) and Management's Discussion and Analysis relating thereto.

The Bow Construction Financing

H&R REIT is pleased to announce that it has signed an engagement letter with RBC Capital Markets ("RBC") and TD Securities ("TD"), who will collectively act as co-lead arrangers and co-bookrunners for a \$425 million construction facility for H&R REIT's development project The Bow in Calgary on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals to commit up to \$250 million of the Financing contingent upon securing commitments for the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway. If H&R REIT is successful in signing definitive agreements for the Financing, it will have satisfied all of the conditions of the private placement with Fairfax Financial Holdings Limited ("Fairfax"), pursuant to which Fairfax has agreed to purchase, at par, \$200 million of debentures (the "Fairfax Debentures"). In combination with the funds arising from reduced distributions and the Fairfax Debentures, and on the assumption that the other strategic initiatives which have been undertaken by H&R REIT will be successful, H&R REIT believes that the Financing (if completed) will allow it to successfully complete construction of The Bow.

H&R REIT is currently building a two million square foot office building in Calgary's downtown financial district. The REIT spent \$49 million on the \$1.5 billion project during the fourth quarter 2008, bringing H&R REIT's total investment to \$402 million by year end. H&R REIT expects to spend approximately \$375 million on the trophy project over the next 12 months. Further information regarding the budgeted costs to complete The Bow and actual costs incurred as at December 31, 2008, as well as the estimated funds required and projected sources of funds for the 2009-2011 period, is available in H&R's combined MD&A and H&R REIT's MD&A.

Operating Strategy

H&R REIT's operating strategy is to take a disciplined approach to investing in quality commercial properties that produce sustainable and growing distributable cash and attractive returns on equity for unitholders in the long run. H&R REIT has a strong track record of leasing its properties long term to creditworthy tenants and matching those leases with primarily long-term, fixed-rate financing. As a result, H&R REIT reported an overall portfolio average 98.9% occupancy rate and average terms to maturity of 11.5 years for its leases and 9.3 years for its mortgages. Leases representing only 6.9% of total rentable area will expire from 2009 to 2011, during which only 14.7% of H&R REIT's total mortgage principal will become payable.

Monthly Distribution Declared

H&R also announced a combined monthly cash distribution of \$0.06 per Stapled Unit (representing \$0.72 on an annualized basis), which will be scheduled as follows.

| | Record date | Distribution date |
|------------|-------------|-------------------|
| March 2009 | March 17 | March 31 |
| April 2009 | April 16 | April 30 |
| May 2009 | May 14 | May 29 |



About H&R REIT and H&R Finance Trust

H&R REIT is an open-ended real estate investment trust, which owns a North American portfolio of 35 office, 124 industrial and 121 retail properties comprising 42 million square feet, with a net book value of \$4.7 billion. H&R Finance Trust is an unincorporated investment trust, which primarily invests in notes issued by an H&R REIT subsidiary. The units of H&R REIT trade together with the units of H&R Finance Trust as stapled units on the Toronto Stock Exchange. The foundation of H&R's success since inception in 1996 has been a disciplined strategy that leads to consistent and profitable growth. Additional information regarding H&R REIT and H&R Finance Trust is available at www.hr-reit.com and on www.sedar.com.

For more information, please contact Larry Froom, Chief Financial Officer, H&R REIT, 416-635-7520, or e-mail info@hr-reit.com.

Certain information in this news release contains forward-looking information within the meaning of applicable securities laws (also known as forward-looking statements) including, among others, statements relating to H&R REIT's and H&R Finance Trust's objectives, strategies to achieve those objectives, REIT's and H&R Finance Trust's beliefs, plans, estimates, and intentions, and similar statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts including, in particular, H&R REIT's expectation regarding future developments in connection with The Bow. Forward-looking statements generally can be identified by words such as "outlook", "objective", "may", "will", "expect", "intend", "estimate", "anticipate", "believe", "should", "plans", "project", "budget" or "continue" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect H&R REIT's and H&R Finance 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 H&R REIT's and H&R Finance Trust's estimates and assumptions that are subject to risk and uncertainties, including those discussed in H&R REIT's and H&R Finance Trust's materials filed with the Canadian securities regulatory authorities from time to time, which could cause the actual results and performance of H&R REIT and H&R Finance Trust to differ materially from the forward-looking statements contained in this news release. Those risks and uncertainties include, among other things: Unit prices; availability of cash for distributions; development and financing relating to The Bow development; liquidity; credit and tenant concentration; interest rates and financing; tax; ability to access capital markets; dilution; lease rollover; construction; real property; debentures; mezzanine financing credit; currency risk; environmental matters; redemption right; and unitholder liability. 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 is stable; local real estate conditions are stable; interest rates are relatively stable; and equity and debt markets continue to provide access to capital. H&R REIT and H&R Finance Trust caution that this list of factors is not exhaustive. Although the forward-looking statements contained in this news release are based upon what H&R REIT and H&R Finance Trust believe 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 news release are qualified by these cautionary statements. These forward-looking statements are made as of today, and H&R REIT and H&R Finance Trust, 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.

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Combined Financial Statements of

**H&R REAL ESTATE
INVESTMENT TRUST
AND H&R FINANCE TRUST**

Years ended December 31, 2008 and 2007



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AUDITORS' REPORT TO BOARD OF TRUSTEES

We have audited the combined balance sheets of H&R Real Estate Investment Trust and H&R Finance Trust as at December 31, 2008 and 2007 and the combined statements of earnings (loss), unitholders' equity and comprehensive income (loss) and cash flows for the years then ended. These financial statements are the responsibility of the Trusts' 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 combined financial statements present fairly, in all material respects, the financial position of the Trusts as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Chartered Accountants, Licensed Public Accountants

Toronto, Canada

March 3, 2009

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Combined Balance Sheets
(In thousands of dollars)

December 31, 2008 and 2007

| | 2008 | 2007 |
|---|---------------------|---------------------|
| Assets | | |
| Income properties (note 4) | \$ 4,536,492 | \$ 4,452,756 |
| Properties under development | 590,196 | 366,055 |
| Deferred expenses (note 5) | 47,496 | 45,078 |
| Accrued rent receivable | 117,266 | 100,357 |
| Cash and cash equivalents (note 6) | 22,187 | 24,695 |
| Mortgages and amounts receivable (note 7) | 90,071 | 16,265 |
| Other assets (note 8) | 36,190 | 45,567 |
| | \$ 5,439,898 | \$ 5,050,773 |

Liabilities and Unitholders' Equity

Liabilities:

| | | |
|--|---------------------|---------------------|
| Mortgages payable (note 9) | \$ 3,157,470 | \$ 3,022,391 |
| Convertible debentures (note 10) | 104,820 | - |
| Bank indebtedness (note 11) | 112,934 | 191,125 |
| Intangible liabilities (note 12) | 64,302 | 68,501 |
| Accounts payable and accrued liabilities | 131,506 | 91,849 |
| Future income tax liability (note 29) | 133,300 | 117,060 |
| | 3,704,332 | 3,490,926 |
| Non-controlling interest (note 13) | 75,797 | 103,211 |
| Unitholders' equity (notes 14 and 15) | 1,659,769 | 1,456,636 |
| Commitments and contingencies (note 27) | | |
| Subsequent events (notes 11(a) and 31) | | |
| | \$ 5,439,898 | \$ 5,050,773 |

See accompanying notes to combined financial statements.

Approved by the Trustees:

"Robert Dickson" _____ Trustee

"Thomas J. Hofstedter" _____ Trustee

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Combined Statements of Earnings (Loss)
(In thousands of dollars, except per unit amounts)

Years ended December 31, 2008 and 2007

| | 2008 | 2007 |
|---|------------------|-------------------|
| Operating revenue: | | |
| Rentals from income properties (note 16) | \$ 608,714 | \$ 580,679 |
| Mortgage interest and other income | 3,138 | 2,590 |
| | <u>611,852</u> | <u>583,269</u> |
| Operating expenses: | | |
| Property operating costs | 197,408 | 185,509 |
| Mortgage and other interest expense (note 17) | 175,314 | 175,231 |
| Depreciation of income properties | 95,871 | 87,853 |
| Amortization of deferred expenses and intangible costs (note 18) | 32,044 | 32,468 |
| | <u>500,637</u> | <u>481,061</u> |
| Net property operating income (note 25) | 111,215 | 102,208 |
| Net loss on foreign exchange | (7,090) | - |
| Impairment loss on income properties, intangible assets and intangible liabilities (note 4) | (53,665) | - |
| Trust expenses | (10,494) | (5,929) |
| Net earnings before income taxes, non-controlling interest and discontinued operations | 39,966 | 96,279 |
| Income taxes (note 29) | (17,226) | (118,332) |
| Net earnings (loss) before non-controlling interest and discontinued operations | 22,740 | (22,053) |
| Non-controlling interest (note 13) | (86) | 1,173 |
| Net earnings (loss) from continuing operations | 22,654 | (20,880) |
| Net earnings from discontinued operations (note 26) | 75,876 | 18,687 |
| Net earnings (loss) | <u>\$ 98,530</u> | <u>\$ (2,193)</u> |
| Basic net earnings (loss) per unit (note 19): | | |
| Continuing operations | \$ 0.15 | \$ (0.17) |
| Discontinued operations | 0.56 | 0.15 |
| | <u>\$ 0.71</u> | <u>\$ (0.02)</u> |
| Diluted net earnings (loss) per unit (note 19): | | |
| Continuing operations | \$ 0.15 | \$ (0.17) |
| Discontinued operations | 0.56 | 0.15 |
| | <u>\$ 0.71</u> | <u>\$ (0.02)</u> |

See accompanying notes to combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Combined Statements of Unitholders' Equity and Comprehensive Income (Loss)
(In thousands of dollars)

Years ended December 31, 2008 and 2007

Unitholders' Equity

| | Value of units | Accumulated net earnings | Accumulated distributions | Equity component of convertible debentures | Accumulated other comprehensive loss (note 15) | Total |
|--|-------------------|-----------------------------|------------------------------|---|--|--------------|
| Unitholders' equity, December 31, 2006 | \$ 1,570,400 | \$ 656,902 | \$ (771,191) | \$ — | \$ (25,162) | \$ 1,430,949 |
| Adjustment to unitholders' equity to comply with new accounting standards | — | (361) | — | — | (3,425) | (3,786) |
| Unitholders' equity, January 1, 2007 (restated) | 1,570,400 | 656,541 | (771,191) | — | (28,587) | 1,427,163 |
| Proceeds from issuance of units (note 14) | 268,577 | — | — | — | — | 268,577 |
| Issue costs | (9,866) | — | — | — | — | (9,866) |
| Net loss | — | (2,193) | — | — | — | (2,193) |
| Distributions to unitholders (note 14(c)) | — | — | (170,422) | — | — | (170,422) |
| Other comprehensive loss | — | — | — | — | (56,623) | (56,623) |
| Unitholders' equity, December 31, 2007 | 1,829,111 | 654,348 | (941,613) | — | (85,210) | 1,456,636 |
| Proceeds from issuance of units (note 14) | 344,903 | — | — | — | — | 344,903 |
| Issue costs | (7,781) | — | — | — | — | (7,781) |
| Equity component from issuance of convertible debentures, net of costs (note 10) | — | — | — | 6,767 | — | 6,767 |
| Exchange of Class B units of H&R Portfolio Limited Partnership (note 13) | 21,745 | — | — | — | — | 21,745 |
| Net earnings | — | 98,530 | — | — | — | 98,530 |
| Distributions to unitholders (note 14(c)) | — | — | (327,110) | — | — | (327,110) |
| Unit-based compensation (note 14(b)) | 74 | — | — | — | — | 74 |
| Other comprehensive income | — | — | — | — | 66,005 | 66,005 |
| Unitholders' equity, December 31, 2008 | \$ 2,188,052 | \$ 752,878 | \$ (1,268,723) | \$ 6,767 | \$ (19,205) | \$ 1,659,769 |

Comprehensive Income (Loss)

| | 2008 | 2007 |
|---|------------|-------------|
| Net earnings (loss) | \$ 98,530 | \$ (2,193) |
| Unrealized gain (loss) on translation of self-sustaining foreign operations | 40,515 | (53,629) |
| Transfer of realized loss on foreign exchange | 27,341 | — |
| Loss on derivatives designated as cash flow hedges | (1,777) | (2,454) |
| Transfer of realized loss on cash flow hedges to net earnings (loss) | 538 | 335 |
| Future income taxes (note 29) | (612) | (875) |
| Other comprehensive income (loss) | 66,005 | (56,623) |
| Comprehensive income (loss) | \$ 164,535 | \$ (58,816) |

See accompanying notes to combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Combined Statements of Cash Flows
(In thousands of dollars)

Years ended December 31, 2008 and 2007

| | 2008 | 2007 |
|---|------------|------------|
| Cash provided by (used in): | | |
| Operations: | | |
| Net earnings (loss) | \$ 98,530 | \$ (2,193) |
| Items not affecting cash: | | |
| Rent amortization (notes 16 and 26) | 4,813 | 1,059 |
| Depreciation of income properties | 96,400 | 92,704 |
| Amortization of deferred expenses and intangible costs (notes 18 and 26) | 32,062 | 33,828 |
| Gain on sale of income properties (note 26) | (71,201) | (9,686) |
| Future income taxes (note 29) | 15,628 | 115,635 |
| Net loss on foreign exchange | 7,341 | - |
| Impairment loss on income properties, intangible assets and intangible liabilities (note 4) | 53,665 | - |
| Other | 3,232 | 1,861 |
| Net earnings (loss) attributable to non-controlling interest (note 13) | 3,829 | (123) |
| Change in other non-cash operating items (note 20) | (9,177) | (36,496) |
| | 235,122 | 196,589 |
| Financing: | | |
| Bank indebtedness | (78,191) | 120,152 |
| Mortgages payable: | | |
| New mortgages payable | 101,854 | 249,653 |
| Principal repayments | (143,422) | (116,623) |
| Proceeds from issuance of convertible debentures, net (note 10) | 110,484 | - |
| Proceeds from issuance of units, net | 337,122 | 258,711 |
| Distributions to unitholders | (327,110) | (170,422) |
| Distributions to non-controlling interest (note 13) | (9,498) | (9,558) |
| | (8,761) | 331,913 |
| Investments: | | |
| Properties under development | (336,659) | (308,715) |
| Income properties: | | |
| Net proceeds on disposition of income properties | 147,347 | 41,793 |
| Acquisitions and capital expenditures | (36,262) | (252,573) |
| Mortgages and amounts receivable | (3,295) | (140) |
| | (228,869) | (519,635) |
| Increase (decrease) in cash and cash equivalents | (2,508) | 8,867 |
| Cash and cash equivalents, beginning of year | 24,695 | 15,828 |
| Cash and cash equivalents, end of year | \$ 22,187 | \$ 24,695 |
| Supplemental cash flow information: | | |
| Interest paid | \$ 200,369 | \$ 191,634 |
| Supplemental disclosure of non-cash financing and investing activities: | | |
| Acquisitions of income properties through assumption of mortgages payable (note 28) | 56,182 | 17,086 |
| Assumption of mortgages payable on disposition | 91,172 | - |
| Mortgages and amounts receivable granted to purchasers on disposition of income properties | 71,461 | - |

See accompanying notes to combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

These combined financial statements include the accounts of H&R Real Estate Investment Trust (the "REIT") and H&R Finance Trust ("Finance Trust"). These combined financial statements are presented as supplementary information to the financial statements of the REIT and Finance Trust (collectively, the "Trusts"), all of which are filed on SEDAR.

The REIT is an unincorporated open-ended trust and Finance Trust is an unincorporated investment trust. Unitholders of the Trusts participate pro rata in distributions of income and, in the event of termination of the Trusts, participate pro rata in the net assets remaining after satisfaction of all liabilities.

The combined financial statements is a result of the REIT's completion of an internal reorganization on October 1, 2008 pursuant to a Plan of Arrangement (the "Plan of Arrangement") as described in the REIT's information circular dated August 20, 2008 resulting in the stapling of the REIT and Finance Trust units. The Plan of Arrangement resulted in, among other things, the creation on October 1, 2008 of Finance Trust. Each unitholder received, for each REIT unit held, a unit of Finance Trust. Each issued and outstanding Finance Trust unit is stapled to a unit of the REIT on a one-for-one basis so as to form stapled units ("Stapled Units"), and such Stapled Units are listed and posted for trading on the Toronto Stock Exchange ("TSX"). The Stapled Units of each of the REIT and Finance Trust may only be transferred together as Stapled Units unless an event of "uncoupling" has occurred.

On October 1, 2008, the following steps were taken pursuant to the Plan of Arrangement:

- The REIT established Finance Trust pursuant to the Finance Trust Declaration of Trust, and subscribed for 146,054,669 units at a subscription price of approximately \$132,500;
- The REIT made a distribution to its unitholders, as a return of capital, consisting of one Finance Trust unit for each REIT unit;
- The REIT transferred certain intercompany loans receivable from H&R REIT (U.S.) Holdings Inc. ("U.S. Holdco"), a wholly-owned U.S. subsidiary of the REIT, to Finance Trust in consideration for cash of approximately U.S. \$125,000; and
- Finance Trust transferred certain loans to a wholly-owned U.S. subsidiary of the REIT in consideration for a note payable by such subsidiary in a principal amount of U.S. \$125,000 (the "Subco Note"). Finance Trust then transferred the Subco Note to U.S. Holdco in consideration for notes payable in the aggregate principal amount of U.S. \$125,000 (the "U.S. Holdco Notes").

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

The presentation of combined financial statements of the Trusts is useful to the unitholders on the following basis:

- The units of the REIT and Finance Trust are stapled (as noted above), resulting in the two Trusts being under common ownership.
- A support agreement between the REIT and Finance Trust ensures that until such time as an event of uncoupling occurs, when units are issued by the REIT, units must also be issued by Finance Trust simultaneously so as to maintain the stapled unit structure.
- The sole activity of Finance Trust is to provide capital funding to U.S. Holdco.
- The investment activities of Finance Trust are restricted in its Declaration of Trust to providing such funding to U.S. Holdco and to make temporary investments of excess funds.

1. Significant development commitments:

The REIT is currently undertaking significant development activities for the two million square foot office building in Calgary, Alberta (the "Bow"). The REIT has committed to incurring additional construction and development costs for this project of approximately \$1,145,000 over a four-year period, of which approximately \$375,000 is expected to be incurred during the next 12 months. The current difficult economic conditions have impacted the REIT's financing strategy. While the REIT is negotiating with lenders to obtain construction financing for the Bow and has entered into a conditional agreement for the issuance of \$200,000 of debentures, at present there is no financing arrangement in place for the Bow.

In December 2008, the REIT entered into an agreement with Fairfax Financial Holdings Limited ("Fairfax"), whereby Fairfax has agreed to purchase, on a private placement basis, \$200,000 of 11.5% debentures due five years from issuance. The private placement is conditional upon the REIT obtaining additional financing of \$400,000 and will expire on April 23, 2009.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

1. Significant development commitments (continued):

Subsequent to the year end, the REIT has signed an engagement letter with RBC Capital Markets ("RBC") and TD Securities ("TD"), who will collectively act as co-lead arrangers and co-bookrunners to arrange a \$425,000 construction facility for the REIT on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals for up to \$250,000 of the Financing, contingent upon securing the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway.

In addition to pursuing construction financing, the REIT has taken, or will consider taking, the following actions to partially fund its development commitment:

- (i) Reducing distributions - In December 2008, the REIT announced that it would decrease its cash distributions to unitholders to preserve cash flow. If necessary, the REIT can further preserve cash flow from a further decrease in cash distributions;
- (ii) Utilizing the REIT's cash and unused operating line of credit as of December 31, 2008, which totals approximately \$148,000. The operating line of credit is due in August of 2009 and is secured by charges on 27 properties. While the REIT's operating line of credit has been renewed annually since the REIT's inception, in light of current market conditions, there is no certainty that the REIT will be successful in renewing the line of credit due in August of 2009. Should the operating line not be renewed, the REIT will attempt to replace the line through conventional first mortgages on the properties currently securing the line;
- (iii) Selling an interest in the Bow;
- (iv) Selling or refinancing other assets; and
- (v) Issuance of units - however, in light of current market conditions, there is no assurance that a significant amount of financing can be raised.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies:

These combined financial statements have been prepared on a going concern basis in accordance with Canadian generally accepted accounting principles ("GAAP") which assumes that the REIT and Finance Trust will continue in operation for the foreseeable future and be able to realize their assets and discharge their liabilities and commitments in the normal course of business. The REIT's ability to obtain financing for its development commitments is a material uncertainty which may cast significant doubt on the ability of the REIT to continue as a going concern. The outcome is dependent on the successful completion of the actions taken or planned, some of which are described above (which management believes will mitigate the adverse conditions and events) which may cast doubt about the validity of the going concern assumption.

These combined financial statements have been prepared in accordance with GAAP and reflect the same accounting principles applied by the underlying entities.

(a) Principles of combination:

The principles used to prepare combined financial statements are similar to those used to prepare consolidated financial statements. The combined financial statements include the assets, liabilities, unitholders' equity, comprehensive income (loss) and operating results of the Trusts, after elimination of the following:

- (i) the REIT's notes payable to Finance Trust; and
- (ii) the REIT's interest expense and Finance Trust's interest income from the notes payable to Finance Trust.

The foreign exchange gain or loss recorded in net earnings as a result of exchanging Finance Trust's U.S. dollar note receivable from U.S. Holdco is not eliminated on combination as U.S. Holdco is a self-sustaining operation of the REIT, which results in the foreign exchange on the note payable being reported in accumulated other comprehensive income (loss).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

The combination of the REIT and Finance Trust does not result in the elimination of the equity of Finance Trust as neither of the Trusts holds any interest in the other. The equity of the REIT and Finance Trust will be presented by way of combining the two together. As a result, the creation of Finance Trust will result in an increase to equity for the issuance of such Finance Trust units, similar to the reporting of the distribution of Finance Trust units to unitholders by the REIT.

(b) Principles of consolidation:

The combined financial statements include the accounts of all entities in which the REIT holds a controlling interest. Finance Trust does not hold a controlling interest in any entity.

The REIT 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.

All material intercompany transactions and balances have been eliminated upon consolidation.

(c) Income properties:

Income properties are recorded at cost less accumulated depreciation. The REIT 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. An impairment is recognized 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. The impairment recognized is measured at the amount by which the carrying amount of the asset exceeds its fair value. Buildings are depreciated on a straight-line basis over its useful life for a period not to exceed 40 years. Paving and equipment are depreciated on a straight-line basis over its useful life, which is typically 10 years. Intangibles resulting from in-place leases are amortized over the related lease terms.

Upon acquisition of income properties, the REIT 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.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

(d) 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. 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.

(e) Revenue recognition:

The REIT 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.

(f) Income taxes:

Pursuant to the terms of the REIT's Declaration of Trust, the trustees intend to distribute or designate all taxable income to unitholders of the REIT and deduct such distributions and designations for Canadian income tax purposes.

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 amounts of these balances and their corresponding tax basis. 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 (note 29).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

Finance Trust qualifies as a mutual fund trust that is not a specified investment flow-through trust under the Income Tax Act (Canada). In accordance with the terms of Finance Trust's Declaration of Trust, all of the net income for tax purposes will be paid or payable to unitholders in the taxation year so that no income tax is payable by Finance Trust. For financial statement reporting purposes, the tax deductibility of Finance Trust's distributions is treated as an exemption from taxation as Finance Trust distributed and is committed to continue distributing all of its taxable income to its unitholders.

(g) Unit option plan:

The REIT has a unit option plan available for officers, employees and certain trustees as disclosed in note 14(a). Any consideration paid by optionholders on exercise of unit options is credited to unitholders' equity. All options granted under the option plan are fair valued and expensed over the vesting period of three years.

(h) Cash and cash equivalents:

The Trusts consider deposits in banks, certificates of deposit and short-term investments with original maturities of three months or less from the acquisition date as cash and cash equivalents.

(i) Foreign currency translation:

The REIT 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 rates in effect at the balance sheet dates and revenue and expenses are translated at the average exchange rates for the years. The foreign currency translation adjustment is recorded as a separate component of accumulated other comprehensive income (loss) until there is a reduction in the REIT's net investment in the foreign operations.

The U.S. dollar denominated bank indebtedness is designated as a hedge of the REIT'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 in other comprehensive income (loss).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

Finance Trust's U.S. dollar denominated assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the balance sheet date and revenue and expenses are translated at the actual exchange rates incurred, resulting in any gains (losses) recorded in earnings.

(j) Derivative financial instruments:

Derivative financial instruments are utilized by the REIT in its management of its foreign currency, interest rate and utility price exposures. The REIT 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 REIT also formally assesses, both at the hedge's inception and on an ongoing basis, whether hedging relationships will be highly effective. The fair value of the hedging instrument is recorded on the combined balance sheet. The effective portion of the hedge is recorded in other comprehensive income (loss) and the ineffective portion is recognized in net earnings (loss). Once the gain (loss) is realized, this amount is recorded in earnings over the appropriate period.

The REIT, 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 reported in other comprehensive income (loss) and recognized as an adjustment to interest expense over the term of the related mortgage.

(k) Financial instruments:

The Trusts have designated their cash and cash equivalents as held-for-trading, which is measured at fair value. Accounts receivable and mortgages and amounts receivable are classified as loans and receivables, which are measured at amortized cost. Mortgages payable, bank indebtedness and accounts payable and accrued liabilities are classified as other financial liabilities, which are also measured at amortized cost. The Trusts had neither available-for-sale, nor held-to-maturity instruments as at or during the year ended December 31, 2008.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

(l) Properties under development:

Properties under development are 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 property, 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, realty taxes, capitalized interest and operating revenue and expenses during the period of development.

(m) Future changes in accounting policies:

(i) Impact of adopting Handbook Section 3064:

In February 2008, The Canadian Institute of Chartered Accountants ("CICA") issued a new Handbook Section 3064, Goodwill and Intangible Assets. This new section replaces Section 3062, Goodwill and Other Intangible Assets, and establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. Handbook Section 1000, Financial Statement Concepts, was also amended to provide consistency with this new standard. The new and amended standards will be effective for the Trusts' 2009 fiscal year, and will be adopted on a retroactive basis with restatement of the prior years.

Commencing January 1, 2009, the REIT will no longer be able to defer capital cost expenditures recoverable from its tenants and record the depreciation of these deferred expenditures over the period which revenue is collected from tenants. This change requires the REIT to capitalize capital expenditures recoverable from its tenants and amortize it over the useful life of the asset. If the capitalization criteria is not met, the REIT must expense the full amount in the year incurred.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

2. Significant accounting policies (continued):

The adoption by the Trusts of the new and amended standards will require it to restate its 2008 quarterly and annual combined financial statements on January 1, 2009. The following table outlines the estimated impact as of January 1, 2009:

| | |
|-----------------------------------|----------|
| Income properties will increase | \$ 9,140 |
| Deferred costs will decrease | 19,220 |
| Unitholders' equity will decrease | 10,080 |

(ii) International financial reporting standards ("IFRS"):

The Canadian Accounting Standards Board ("AcSB") confirmed that the adoption of IFRS would be effective for the interim and annual periods beginning on or after January 1, 2011 for Canadian publicly accountable profit-oriented enterprises. IFRS will replace Canada's current GAAP for these enterprises. Comparative IFRS information for the previous fiscal year will also have to be reported. These new standards will be effective for the Trusts in the first quarter of 2011.

The Trusts are currently in the process of evaluating the potential impact of IFRS to its combined financial statements. This will be an ongoing process as the International Accounting Standards Board and the AcSB issue new standards and recommendations. The Trusts' combined financial performance and financial position as disclosed in the Trusts' current GAAP financial statements may be significantly different when presented in accordance with IFRS.

(n) 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. A significant estimate made by management relates to the budgeted cost to complete the Bow development. This estimate is based on various assumptions relating to the components of the construction process. These assumptions are based on information available to management currently and, given the possibility of change, the outcome of these estimates could differ from actual results.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

3. Impact of new accounting standards:

Effective January 1, 2008, the REIT adopted CICA Handbook Section 1535, Capital Disclosures; Section 3862, Financial Instruments - Disclosures; and Section 3863, Financial Instruments - Presentation.

Section 1535, Capital Disclosures, establishes guidelines for the disclosure of both qualitative and quantitative information regarding the Trusts' capital and how it is managed. The standard requires enhanced disclosures with respect to the Trusts' objectives, policies and processes for managing capital, quantitative data about what the Trusts regard as capital and whether the Trusts have complied with any capital requirements.

Section 3862, Financial Instruments - Disclosures, revises and enhances the disclosure requirements of Section 3861, Financial Instruments - Disclosure and Presentation. Section 3862 requires the Trusts to provide disclosures in its financial statements that enable users to evaluate the significance of financial instruments for the Trusts' financial position and performance, the nature and extent of risks arising from financial instruments to which the Trusts are exposed during the year and at the balance sheet date, and how the Trusts manage those risks. Section 3863, Financial Instruments - Presentation, carries forward unchanged the presentation requirements of Section 3861.

The additional disclosures as a result of adopting these sections have been detailed in notes 21 and 22.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

4. Income properties:

| | | | 2008 | 2007 |
|--|--------------|--|-------------------|-------------------|
| | Cost | Accumulated depreciation and amortization | Net book value | Net book value |
| Land | \$ 927,554 | \$ – | \$ 927,554 | \$ 846,014 |
| Buildings | 3,482,780 | (383,557) | 3,099,223 | 2,880,050 |
| Paving and equipment | 149,926 | (49,835) | 100,091 | 93,251 |
| | 4,560,260 | (433,392) | 4,126,868 | 3,819,315 |
| Intangible assets | 486,676 | (105,856) | 380,820 | 384,093 |
| Income properties held for sale (note 26) | 32,226 | (3,422) | 28,804 | 236,608 |
| Intangible assets held for sale (note 26) | – | – | – | 12,740 |
| | \$ 5,079,162 | \$ (542,670) | \$ 4,536,492 | \$ 4,452,756 |

One industrial and one retail property are currently held for sale as at December 31, 2008 (seven office, thirteen retail and two industrial properties as at December 31, 2007). The results of operations from these properties have been disclosed as part of discontinued operations (note 26).

During the year ended December 31, 2008, the seven income properties occupied by the tenant, Boscov's Department Stores, were impaired by \$53,237 following a test for impairment triggered by the tenant's bankruptcy announcement in August 2008 (includes the impairment charge discussed in note 26). In addition, \$428 representing the expiry of an option to purchase the remaining interest in another U.S. property previously included in other assets was written off, resulting in the total impairment loss for the year ended December 31, 2008 of \$53,665 (2007 - nil).

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 REIT.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

4. Income properties (continued):

Legal title to each of the United States properties is held by a separate legal entity which is 100% owned, directly or indirectly, by U.S. Holdco, a subsidiary of the REIT. 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 U.S. Holdco. This structure does not prevent distributions to the entity owners provided there are no conditions of default.

5. Deferred expenses:

| | | | 2008 | 2007 |
|------------------|------------------|-----------------------------|-------------------|-------------------|
| | Cost | Accumulated amortization | Net book value | Net book value |
| Deferred leasing | \$ 44,890 | \$ (16,614) | \$ 28,276 | \$ 26,925 |
| Deferred costs | 28,902 | (9,682) | 19,220 | 18,153 |
| | <u>\$ 73,792</u> | <u>\$ (26,296)</u> | <u>\$ 47,496</u> | <u>\$ 45,078</u> |

6. Cash and cash equivalents:

Cash and cash equivalents at December 31, 2008 includes cash on hand of \$19,871 (2007 - \$19,128) and bank term deposits of \$2,316 (2007 - \$5,567) at rates of interest varying between 0.75% to 2.05% (2007 - 3.78% to 4.60%); of these amounts approximately \$4,504 (2007 - \$12,158) is restricted cash.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

7. Mortgages and amounts receivable:

The REIT has mortgages receivable which are secured by real property as follows:

| | 2008 | 2007 |
|---|------------------|------------------|
| Mortgage receivable bearing interest at 5.30% per annum and repayable on December 13, 2009 | \$ 16,360 | \$ 16,265 |
| Mortgage receivable bearing interest at prime plus 1.15% per annum and repayable 60 days after demand, but not earlier than July 28, 2009 | 3,200 | — |
| Mortgage receivable bearing contractual interest at 6.00% per annum and repayable on December 1, 2010 | 57,050 | — |
| Mortgage receivable bearing interest at 6.00% per annum and repayable on December 1, 2013 | 3,000 | — |
| Amounts receivable* | 10,461 | — |
| | \$ 90,071 | \$ 16,265 |

*In conjunction with the sale of 10 income-producing properties, the purchaser agreed to assume an aggregate mortgage balance of \$82,575, and indemnify the REIT until such time that the lenders consent and release the REIT in respect of these mortgages. During the year ended December 31, 2008, the REIT was legally released from its obligation on eight properties. At December 31, 2008, the REIT has not been legally released from its mortgage obligation for the remaining two properties, resulting in an outstanding aggregate mortgage balance of \$10,461. As a result, the REIT recorded an amount receivable from the purchaser at fair value, which is equivalent to the contractual mortgages payable balance outstanding as at December 31, 2008 as they are due on demand, and continues to record the aggregate mortgages payable balance as at December 31, 2008. The mortgage receivable balance is due on demand if: (i) the lenders do not consent to the assumption of the mortgages payable balances by the purchaser, resulting in the outstanding mortgages payable balances being due on demand by the lender; and (ii) the purchaser fails to fulfill the contractual mortgage payments under the original debt agreements.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

8. Other assets:

| | 2008 | 2007 |
|------------------------------------|------------------|------------------|
| Tenant inducements | \$ 14,997 | \$ 17,000 |
| Prepaid expenses and sundry assets | 13,765 | 22,416 |
| Accounts receivable | 7,428 | 6,151 |
| | <u>\$ 36,190</u> | <u>\$ 45,567</u> |

9. 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 6.2% (2007 - 6.3%) per annum and mature between 2009 and 2035. Included in mortgages payable at December 31, 2008 are U.S. dollar denominated mortgages of U.S. \$861,232 (2007 - U.S. \$844,874). The Canadian equivalents of these amounts are \$1,050,703 (2007 - \$836,425).

Future principal mortgage payments are as follows:

| Years ending December 31: | |
|---|---------------------|
| 2009 | \$ 136,604 |
| 2010 | 122,082 |
| 2011 | 175,910 |
| 2012 | 408,377 |
| 2013 | 202,247 |
| Thereafter | <u>1,955,362</u> |
| | 3,000,582 |
| Mortgages payable due on demand* | 142,921 |
| Mortgages payable on assets sold (contractual amount \$10,461 - note 7) | 10,811 |
| Mortgages payable on assets held for sale (note 26) | 5,959 |
| Deferred financing cost and mark-to-market adjustment arising on acquisitions | (2,803) |
| | <u>\$ 3,157,470</u> |

*relates to seven non-recourse mortgages to the REIT for properties in which the tenant, Boscov's Department Stores, has filed for protection under Chapter 11 of the United States Bankruptcy Code. The REIT has handed over control of the income-producing properties to the lenders and therefore expects to be released from any further obligations under these non-recourse mortgages upon the transfer of title to the lenders.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

10. Convertible debentures:

In June 2008, the REIT completed a public offering of \$115,000 convertible unsecured subordinated debentures, bearing interest at the annual contractual rate of 6.65% and an effective interest rate of 9.10%. The debentures mature on June 30, 2013, and interest is payable semi-annually on June 30 and December 31. Each debenture is now convertible into freely tradable units of the REIT at the holder's option at: (i) any time prior to the maturity date; and (ii) the business day immediately preceding the date specified by the REIT for redemption of the debentures, at a conversion price of \$23.11 per unit, being a conversion rate of approximately 43.2713 units per \$1 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the Indenture governing the debentures.

As a result of the Plan of Arrangement, the REIT must deliver Stapled Units to the holders of the convertible debt if converted. The REIT has entered into a Support Agreement with Finance Trust whereby Finance Trust agreed to issue its units if the convertible debt holders convert (note 14(d)). The conversion price per Stapled Unit will be calculated as the conversion price of \$23.11. Upon conversion, the REIT must purchase equivalent units of Finance Trust equal to the fair market value (as determined by Finance Trust in consultation with the REIT) of each such Finance Trust unit at the time of such conversion.

The principal and interest amount of the debentures is payable at the option of the REIT and can be satisfied through the issuance of units of the REIT by way of issuing a variable number of units equal to the principal and accrued interest divided by 95% of the then fair market value of the units. The debentures may not be redeemed by the REIT on or before June 30, 2011. Thereafter, but prior to June 30, 2012, the debentures may be redeemed, in whole or in part, only if the current market price of a unit is at least 125% of the conversion price. On or after June 30, 2012 and prior to the maturity date, the debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

10. Convertible debentures (continued):

The REIT accounts for convertible debentures by valuing the holders' option to convert units and classifying such value as equity. The remaining value of the convertible debentures is classified as debt. Interest expense is recorded as a charge to income and is calculated at an effective rate with the difference between the coupon rate and the effective rate being credited to the debt component of the convertible debentures such that, at maturity, the debt component is equal to the face value of the then outstanding convertible debentures.

On issuance, the REIT recorded a liability of \$103,717, net of issue costs of \$4,239, and equity, which represents the holders' option to convert the debentures into Stapled Units, of \$6,767, net of issue costs of \$277.

11. Bank indebtedness:

The REIT has the following two facilities:

- (a) A general operating facility which is secured by fixed charges over certain income properties due on August 15, 2009. The total facility at December 31, 2008 is \$286,564 (2007 - \$200,000) 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, 2008, after taking into account the bank indebtedness drawn of \$112,934 (2007 - \$95,564) and the outstanding letters of credit and other items, is \$125,536 (2007 - \$53,181). The Canadian dollar bank indebtedness bears interest at rates approximating the prime rate of a Canadian chartered bank. At December 31, 2008, the Canadian prime interest rate was 3.5% (2007 - 6.0%) per annum.

In January 2009, the total facility was increased to \$299,775. The amount available at December 31, 2008 would have been \$138,747 had the new facility limit been in place at December 31, 2008.

The REIT may increase the general operating facility to a maximum amount of \$300,000 upon providing further income properties as security.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

11. Bank indebtedness (continued):

(b) A facility to finance and construct a distribution centre in Ajax, Ontario totalling \$3,722 (2007 - \$109,500). The amount available at December 31, 2008, after taking into account the bank indebtedness drawn of nil (2007 - \$83,422) and the outstanding letters of credit, is nil (2007 - \$22,356). The facility is due on demand.

During the year ended December 31, 2008, a facility of \$12,139 to fund a property under development in Mississauga, Ontario owned by the REIT through a joint venture was repaid.

Included in bank indebtedness at December 31, 2008 is U.S. \$7,600 (2007 - U.S. \$18). The Canadian equivalents of these amounts are \$9,272 (2007 - \$18). The U.S. dollar bank indebtedness bears interest at LIBOR rates.

12. Intangible liabilities:

| | | | 2008 | 2007 |
|---|-----------|--------------------------|----------------|----------------|
| | Cost | Accumulated amortization | Net book value | Net book value |
| Intangible liabilities on acquisitions of income properties | \$ 77,054 | \$ (12,752) | \$ 64,302 | \$ 64,757 |
| Intangible liabilities held for sale (note 26) | — | — | — | 3,744 |
| | \$ 77,054 | \$ (12,752) | \$ 64,302 | \$ 68,501 |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

13. Non-controlling interest:

Non-controlling interest represents the amount of equity related to the Class B units of a subsidiary partnership, H&R Portfolio Limited Partnership ("HRLP"), issued to participating vendors in exchange for properties acquired by HRLP. The accounts of HRLP are consolidated in these combined financial statements. Class B units of HRLP are only exchangeable on a one-for-one basis, at the option of the holder, into Stapled Units which have already been issued to HRLP. During the year ended December 31, 2008, 1,536,990 Class B units of HRLP were exchanged into Stapled Units. The conversion of these units has been accounted for as a rollover of the value recorded in non-controlling interest.

Holders of the Class B units of HRLP are entitled to receive distributions on a per unit amount equal to a per Stapled Unit amount provided to holders of Stapled Units. To fund the distributions to Class B units, HRLP holds 5,437,565 Stapled Units at December 31, 2008 (2007 - 6,974,555).

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

| | Amount | Number of units |
|---|------------|-----------------|
| As at December 31, 2006 | \$ 112,892 | 6,974,555 |
| Non-controlling interest from continuing operations | (1,173) | - |
| Non-controlling interest from discontinued operations (note 26) | 1,050 | - |
| Distributions on Class B units of HRLP | (9,558) | - |
| As at December 31, 2007 | 103,211 | 6,974,555 |
| Non-controlling interest from continuing operations | 86 | - |
| Non-controlling interest from discontinued operations (note 26) | 3,743 | - |
| Distributions on Class B units of HRLP | (9,498) | - |
| Exchange of Class B units of HRLP for Stapled Units | (21,745) | (1,536,990) |
| As at December 31, 2008 | \$ 75,797 | 5,437,565 |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

14. Unitholders' equity:

The REIT is an unincorporated open-ended trust. The beneficial interests in the REIT 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.

Finance Trust is an unincorporated investment trust. The beneficial interests in Finance 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 units of the REIT are stapled with the units of Finance Trust effective October 1, 2008. These Stapled Units are listed and posted for trading on the TSX. The REIT and Finance Trust entered into a support agreement ("Support Agreement") to coordinate the issuance of Stapled Units under various arrangements (note 14(d)).

The units of the Trusts are freely transferable and, other than as prescribed herein, the trustees of the REIT and Finance Trust shall not impose any restriction on the transfer of units. Provided that an event of uncoupling ("Event of Uncoupling") has not occurred: (a) each REIT unit may be transferred only together with a unit of Finance Trust; (b) no unit may be issued by the REIT to any person unless: (i) a unit of Finance Trust is simultaneously issued to such person; or (ii) the REIT has arranged that units will be consolidated (subject to any applicable regulatory approval) immediately after such issuance, such that each holder of a REIT unit will hold an equal number of Finance Trust units and units of the REIT immediately following such consolidation; and (c) a unitholder may require the REIT to redeem any particular number of units only if it also requires, at the same time, and in accordance with the provisions of the Finance Trust's Declaration of Trust, Finance Trust to redeem that same number of units of Finance Trust. Equivalent provisions apply with respect to the transfer, issuance, consolidation and redemption of Finance Trust units.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

14. Unitholders' equity (continued):

An Event of Uncoupling shall occur only: (a) in the event that unitholders of the REIT vote in favour of the uncoupling of units of the Trusts such that the two securities will trade separately; or (b) at the sole discretion of the trustees of Finance Trust, but only in the event of the bankruptcy, insolvency, winding-up or reorganization (under an applicable law relating to insolvency) of the REIT or U.S. Holdco or the taking of corporate action by the REIT or U.S. Holdco in furtherance of any such action or the admitting in writing by the REIT or U.S. Holdco of its inability to pay its debts generally as they become due. The trustees of the REIT and Finance Trust shall use all reasonable efforts to obtain and maintain a listing for the units of their respective Trust and, unless an Event of Uncoupling has occurred, the Stapled Units, on one or more stock exchanges in Canada.

The unitholders have the right to require the Trusts to redeem their units on demand. Provided that no Event of Uncoupling has occurred, unitholders who tender their units of one of the Trusts for redemption will also be required to tender for redemption corresponding units of the other Trust in accordance with the provisions of the respective Declaration of Trust. Upon the tender of their units for redemption, 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 the applicable Declaration of Trust. Upon valid tender for redemption of each unit of the REIT, the unitholder is entitled to receive a price per unit of the REIT as determined by a formula based on the market price of Stapled Units less an amount based on the principal amount of U.S. Holdco Notes per outstanding unit of Finance Trust. The redemption price payable by the REIT will be satisfied by way of a cash payment to the unitholder or, in certain circumstances, including where such payment would cause the REIT's monthly cash redemption obligations to exceed \$50 (subject to adjustment in certain circumstances or waiver by the trustees), an in specie distribution of notes of H&R Portfolio LP Trust (a subsidiary of the REIT). Upon valid tender of each unit of Finance Trust the unitholder is entitled to receive, except as provided below, a price per unit payable in cash equal to the Canadian dollar equivalent of the outstanding principal amount of the U.S. Holdco Notes as of the redemption date, divided by the total number of Finance Trust units issued and outstanding immediately prior to the redemption date. In certain circumstances, including where such payment would cause Finance Trust's monthly cash redemption obligations to exceed \$50 (subject to adjustment in certain circumstances or waiver by the trustees) the redemption price per Finance Trust unit being redeemed, to which a redeeming unitholder is entitled shall be the fair market value of the Finance Trust units being redeemed as determined by the trustees, which shall be payable by way of delivery of U.S. Holdco Notes.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

14. Unitholders' equity (continued):

The following number of REIT units and following October 1, 2008 Stapled Units are issued and outstanding:

| | |
|--|-------------------------------|
| As at December 31, 2006 | 124,584,679 |
| Issued on May 9, 2007 (at a price of \$25.30 per unit) Issued under the Distribution Reinvestment Plan and Unit Purchase Plan (the "DRIP") | 8,860,000 <u>2,005,316</u> |
| | 135,449,995 |
| Units held by a subsidiary (note 13) | <u>(6,974,555)</u> |
| As at December 31, 2007 | <u>128,475,440</u> |
| As at December 31, 2007 | 135,449,995 |
| Issued on June 6, 2008 (at a price of \$19.75 per unit) Issued under the DRIP | 8,734,250 <u>2,848,606</u> |
| | 147,032,851 |
| Units held by a subsidiary (note 13) | <u>(5,437,565)</u> |
| As at December 31, 2008 | <u>141,595,286</u> |

(a) Unit option plan:

As at December 31, 2007, a maximum of 5,800,000 units were authorized to be issued to the REIT's officers, employees and certain trustees. All such options were issued prior to December 31, 2003. On September 19, 2008, an amendment to the unit option plan was approved increasing the maximum units authorized by 3,000,000 units to a total of 8,800,000 units as at December 31, 2008. The exercise price of each option approximated the market price of the REIT's units on the date of grant. The options vested 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.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

14. Unitholders' equity (continued):

A summary of the status of the plan as at December 31, 2008 and 2007 and the changes during the years ended on those dates are as follows:

| | 2008 | | 2007 | |
|----------------------------------|-----------|---------------------------------|-----------|---------------------------------|
| | Units | Weighted average exercise price | Units | Weighted average exercise price |
| Outstanding, beginning of year | 1,854,666 | \$ 12.81 | 1,854,666 | \$ 12.81 |
| Granted | 600,000 | 16.56 | – | – |
| Outstanding, end of year | 2,454,666 | \$ 13.73 | 1,854,666 | \$ 12.81 |
| Options exercisable, end of year | 1,854,666 | \$ 12.81 | 1,854,666 | \$ 12.81 |

The options outstanding at December 31, 2008 are exercisable at varying prices ranging from \$12.01 to \$16.56 (2007 - \$12.01 to \$13.36) with a weighted average remaining life of 4.7 years (2007 - 4.1 years). The vested options are exercisable at varying prices ranging from \$12.01 to \$13.36 (2007 - \$12.01 to \$13.36) with a weighted average remaining life of 3.1 years (2007 - 4.1 years).

(b) Unit-based compensation:

During the year ended December 31, 2008, 600,000 options were granted (2007 - nil). The fair value of the unit options used to compute compensation expense is the estimated fair value of each option grant on the grant date. This was calculated using an option pricing model with the following weighted average assumptions: expected distribution yield is 8.69%; expected volatility is 22.57%; risk free interest rate is 3.18%; and expected option life in years is four. The weighted average grant-date fair value of the options is \$775, resulting in total compensation cost of \$74 (2007 - nil) recognized in income and charged to unitholders' equity for the year ended December 31, 2008.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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Years ended December 31, 2008 and 2007

14. Unitholders' equity (continued):

(c) Distributions:

Under the REIT's Declaration of Trust, subject to the discretion of the trustees in certain circumstances, the REIT is required to distribute not less than 80% of Distributable Cash of the REIT, (as defined in the Declaration of Trust), and net realized capital gains and net recapture income. Distributable Cash, in accordance with the Declaration of Trust, represents consolidated net income of the REIT as determined in accordance with GAAP adjusted to add back and deduct certain specified amounts and to make any other adjustments determined by the trustees at their discretion. The REIT is required under the Declaration of Trust to distribute annually an amount equal to any excess of income of the REIT for tax purposes over distributions otherwise made for the year. For the year ended December 31, 2008, the REIT declared per unit distributions of \$1.4026 (2007 - \$1.3704).

Pursuant to Finance Trust's Declaration of Trust, unitholders of Finance Trust are entitled to receive all of the Distributable Cash of Finance Trust, as defined in the Declaration of Trust. Distributable Cash means, subject to certain exceptions, all amounts received by Finance Trust less certain costs, expenses or other amounts payable by Finance Trust, and less any amounts which, in the opinion of the trustees, may reasonably be considered to be necessary to provide for the payment of any costs or expenditures that have been or will be incurred in the activities and operations of Finance Trust and to provide for payment of any tax liability of Finance Trust. For the period ended December 31, 2008, Finance Trust paid per unit distributions of \$0.037.

The details of the distributions are as follows:

| | 2008 | 2007 |
|---|-------------------|-------------------|
| Cash distributions to unitholders | \$ 194,610 | \$ 170,422 |
| October 1, 2008 non-cash distribution as a return of capital, pursuant to the Plan of Arrangement | 132,500 | — |
| | <u>\$ 327,110</u> | <u>\$ 170,422</u> |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

14. Unitholders' equity (continued):

(d) Support Agreement:

Pursuant to the provision of the Declarations of Trust for Finance Trust and the REIT, at all times, each REIT unit must be "stapled" to a Finance Trust unit (and each Finance Trust unit must be "stapled" to a REIT unit) unless there is an Event of Uncoupling. As part of the Plan of Arrangement, the REIT and Finance Trust entered into the Support Agreement which provided, among other things, for the co-ordination of the declaration and payment of all distributions so as to provide for simultaneous record dates and payment dates; for co-ordination so as to permit the REIT to perform its obligations pursuant to the REIT's Declaration of Trust, Unit Option Plan, DRIP and Unitholder Rights Plan; for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable and permit the REIT to perform its obligations arising under any security issued by the REIT (including securities convertible, exercisable or exchangeable into Stapled Units); for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable the REIT to perform its obligations or exercise its rights under its convertible debentures; and for Finance Trust to take all such actions and do all such things as are necessary or desirable to issue Finance Trust units simultaneously (or as close to simultaneously as possible) with the issue of REIT units and to otherwise ensure at all times that each holder of a particular number of REIT units holds an equal number of Finance Trust units, including participating in and cooperating with any public or private distribution of Stapled Units by, among other things, executing prospectuses or other offering documents.

In the event that the REIT issues additional REIT units, pursuant to the Support Agreement, the REIT and Finance Trust will coordinate so as to ensure that each subscriber receives both REIT units and Finance Trust units, which shall trade together as Stapled Units. Prior to such event, the REIT shall provide notice to Finance Trust to cause Finance Trust to issue and deliver the requisite number of Finance Trust units to be received by and issued to, or to the order of, each subscriber as the REIT directs. In consideration of the issuance and delivery of each such Finance Trust unit, the REIT (on behalf of the purchaser) or the purchaser, as the case may be, shall pay (or arrange for the payment of) a purchase price equal to the fair market value (as determined by Finance Trust in consultation with the REIT) of each such Finance Trust unit at the time of such issuance. The remainder of the subscription price for Stapled Units shall be allocated to the issuance of REIT units to be issued by the REIT.

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Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

15. Accumulated other comprehensive loss:

| | 2008 | 2007 |
|---|--------------------|--------------------|
| Accumulated other comprehensive loss on cash flow hedges: | | |
| Balance, beginning of year | \$ (6,419) | \$ (3,425) |
| Loss on derivatives designated as cash flow hedges | (1,777) | (2,454) |
| Transfer of realized loss on cash flow hedges to net earnings (loss) | 538 | 335 |
| Future income taxes (note 29) | (612) | (875) |
| Balance, end of year | (8,270) | (6,419) |
| Accumulated other comprehensive loss on translation of foreign operations: | | |
| Balance, beginning of year | (78,791) | (25,162) |
| Unrealized gain (loss) on translation of self-sustaining foreign operations | 40,515 | (53,629) |
| Transfer of realized loss on foreign exchange to net earnings (loss) | 27,341 | - |
| Balance, end of year | (10,935) | (78,791) |
| Total accumulated other comprehensive loss | \$ (19,205) | \$ (85,210) |

16. Rentals from income properties:

| | 2008 | 2007 |
|--|-------------------|-------------------|
| Rentals from income properties | \$ 597,731 | \$ 564,155 |
| Straight-lining of contractual rent | 15,796 | 17,772 |
| Rent amortization of above- and below-market rents | (2,753) | 531 |
| Rent amortization of tenant inducements | (2,060) | (1,779) |
| | \$ 608,714 | \$ 580,679 |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

17. Mortgage and other interest expense:

| | 2008 | 2007 |
|----------------------------------|------------|------------|
| Mortgage interest | \$ 189,717 | \$ 181,587 |
| Convertible debenture interest | 5,482 | – |
| Amortization of mortgage premium | (1,741) | (2,175) |
| Bank interest and charges | 4,649 | 3,698 |
| | 198,107 | 183,110 |
| Capitalized interest | (22,793) | (7,879) |
| | \$ 175,314 | \$ 175,231 |

18. Amortization of deferred expenses and intangible costs:

| | 2008 | 2007 |
|---|-----------|-----------|
| Amortization of deferred leasing expenses | \$ 5,101 | \$ 4,218 |
| Amortization of deferred costs | 3,420 | 3,067 |
| Amortization of intangible assets on acquisitions | 23,523 | 25,183 |
| | \$ 32,044 | \$ 32,468 |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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Years ended December 31, 2008 and 2007

19. Net earnings (loss) per unit:

| | 2008 | 2007 |
|--|-------------------|-------------------|
| Net earnings (loss) | \$ 98,530 | \$ (2,193) |
| Add net earnings (loss) attributable to non-controlling interest (note 13) | 3,829 | (123) |
| Diluted net earnings (loss) | \$ 102,359 | \$ (2,316) |

The weighted average number of units outstanding was as follows:

| | 2008 | 2007 |
|--|--------------------|--------------------|
| Basic units | 134,995,304 | 124,185,228 |
| Effect of dilutive securities: | | |
| Unit option plan | 384,875 | 842,894 |
| Non-controlling interest conversion to units (note 13) | 6,659,750 | 6,974,555 |
| Diluted units | 142,039,929 | 132,002,677 |
| Net earnings (loss) per unit: | | |
| Basic | \$ 0.71 | \$ (0.02) |
| Diluted | \$ 0.71 | \$ (0.02) |

The convertible debentures are currently anti-dilutive; therefore, the potential conversion into REIT units has not been included in the calculation of diluted units.

20. Change in other non-cash operating items:

| | 2008 | 2007 |
|--|-------------------|--------------------|
| Deferred expenses | \$ (12,547) | \$ (9,651) |
| Accrued rent receivable | (16,911) | (17,900) |
| Tenant inducements | (224) | (4,048) |
| Prepaid expenses and sundry assets | 8,188 | (9,999) |
| Accounts receivable | (1,277) | 1,725 |
| Accounts payable and accrued liabilities | 13,594 | 3,377 |
| | \$ (9,177) | \$ (36,496) |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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21. Capital risk management:

The REIT's primary objectives when managing capital are:

- (a) to provide unitholders with stable and growing cash distributions, generated by revenue it derives from investments in income-producing real estate properties; and
- (b) to maximize unit value through the ongoing active management of the REIT's assets, the acquisition of additional properties and the development and construction of projects which are pre-leased to creditworthy tenants.

The REIT considers its capital to be its unitholders' equity, non-controlling interest, mortgages payable, convertible debentures and bank indebtedness. As long as the REIT complies with its investment and debt restrictions set out in its Declaration of Trust, it is then free to determine the appropriate level of capital in context with its cash flow requirements, overall business risks and potential business opportunities. As a result of this, the REIT will make adjustments to its capital based on its investment strategies and changes in economic conditions.

The REIT's level of indebtedness is subject to the limitations set out in its Declaration of Trust. The REIT is limited to a total indebtedness to gross book value ratio of 65% (excluding the indebtedness from the Bow development, convertible debentures and U.S. Holdco Notes payable to Finance Trust). As at December 31, 2008, this ratio was 54.6%. Management uses this ratio as a key indicator in managing the REIT's capital.

Finance Trust's primary objective when managing capital is to provide unitholders with a cash distribution from the interest income it earns on its notes receivable. Finance Trust manages its capital by adhering to the investment restrictions outlined in its Declaration of Trust.

In addition to the above covenant, the REIT's general operating facility (note 11(a)) has the following covenants which are required to be calculated on a combined basis of the REIT's and Finance Trust's financial statements:

- (a) a minimum debt to service coverage ratio of 1.2. As at December 31, 2008, the actual debt to service coverage ratio was 1.36;

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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Years ended December 31, 2008 and 2007

21. Capital risk management (continued):

- (b) the indebtedness of the income properties pledged as security cannot exceed 67% of the fair market value. The REIT is in compliance with this covenant; and
- (c) the unitholders' equity and non-controlling interest must exceed \$1,300,000. The REIT is in compliance with this covenant.

The REIT's mortgage providers also have minimum limits on debt to service coverage ratios ranging from 1.10 to 1.50 as at December 31, 2008. The REIT monitors these ratios and is in compliance with such external requirements.

With respect to unitholders' equity, the level of capital changes with the recognition of income, payment of distributions or the issuance of additional units if required.

22. Risk management:

(a) Credit risk:

The REIT 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 significant tenants. Management has diversified the REIT'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 rental income from income-producing properties are Bell Canada, TransCanada PipeLines Limited, Telus Communications and Bell Mobility. Each of these companies that have a public debt rating is rated with at least a BBB rating by a recognized rating agency.

The REIT is also exposed to credit risk as a lender of mezzanine financing 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 held as security. Risk is further mitigated by the REIT's investment guidelines which generally allows for the provision of construction financing only after 70% of the project has been pre-leased.

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Notes to Combined Financial Statements (continued)
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Years ended December 31, 2008 and 2007

22. Risk management (continued):

(b) Liquidity risk:

In addition to the liquidity risk as described under the heading "Significant Development Commitments" appearing in note 1, the REIT is subject to liquidity risk on its mortgages payable, convertible debentures and bank indebtedness whereby it may not be able to refinance or pay its debt obligations when they become due.

The recent turmoil in the global markets has brought about a strong focus on liquidity as the capital markets have undergone dramatic change. Sources of funds are scarce and lenders are expected to become more conservative with their loans in the near future.

Management's strategy to managing liquidity risk is to ensure, to the extent possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the REIT's reputation. In order to meet this strategy, the REIT strives to enter into long-term leases with creditworthy tenants which assists in the REIT's attempt to fulfill its primary goal of maintaining a predictable cash flow. The REIT attempts to appropriately structure the term of the mortgages to closely match the term of the lease. This strategy enables the REIT to meet its contractual monthly mortgage obligations. Due to the long-term length of the mortgages, a significant amount of principal has been prepaid by the time the mortgage matures.

The contractual obligations for mortgages payable are disclosed in note 9 to the combined financial statements. The contractual principal repayments on maturity through 2013 are: 2009 - \$49,010; 2010 - \$20,590; 2011 - \$70,246; 2012 - \$303,739; and 2013 - \$102,312. Excluded in the contractual repayments are mortgages payable on assets sold of \$10,461 (note 7) and mortgages due on demand of \$142,921 (note 9).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

22. Risk management (continued):

The REIT also has contractual obligations for convertible debentures of \$115,000 maturing in 2013 as described in note 10.

Management measures its liquidity risk through review of financial covenants contained in debt agreements and in accordance with the Declaration of Trust. In order to maintain liquidity, the REIT has a credit facility due August 2009 available to draw on to fund its obligations.

The unitholders of the Trusts are entitled to redeem their units for cash, but this is limited as described in note 14.

(c) Market risk:

The REIT is subject to currency and interest rate risk. The REIT's objective is to manage and control market risk exposure within acceptable parameters, while optimizing the return on risk.

(i) Currency risk:

A portion of the REIT's properties are located in the United States and, therefore, the REIT is subject to foreign currency fluctuations that may impact its financial position and results. In order to mitigate the risk, the REIT's debt on these properties is also held in U.S. dollars to act as a natural hedge.

A 10 cent strengthening of the Canadian dollar against the U.S. dollar at December 31, 2008 would have decreased other comprehensive income by approximately \$29,000 and increased net earnings by approximately \$5,200 for the year ended December 31, 2008. This analysis assumes that all the variables, in particular interest rates, remain constant (a 10 cent weakening of the Canadian dollar against the above currencies at December 31, 2008 would have had the equal but opposite effect).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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Years ended December 31, 2008 and 2007

22. Risk management (continued):

(ii) Interest rate risk:

The REIT is exposed to interest rate risk on its borrowings. It minimizes this risk by obtaining long-term fixed interest rate debt. At December 31, 2008, the percentage of fixed rate debt to total debt was 96.7%. As at December 31, 2008, the REIT does not account for any of its fixed rate financial liabilities as held for trading. Therefore, a change in interest rates at the reporting date would not affect net income with respect to these fixed rate instruments.

The bank indebtedness is subject to variable interest rates. An increase in interest rates of 100 basis points for the year ended December 31, 2008 would have decreased net earnings by approximately \$1,100. This analysis assumes that all other variables, in particular foreign exchange rates, remain constant.

(d) Fair values:

The fair values of the REIT's mortgages and amounts 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, 2008 has been estimated at \$2,935,035 (2007 - \$2,976,786) compared with the carrying value of \$3,157,470 (2007 - \$3,022,391).

The REIT had an electricity contract to swap floating for fixed price rates as a cash flow hedge of price volatility of the REIT's electricity costs in Ontario, Canada. The electricity swap contract hedged a monthly notional amount of approximately 4,000 MWh and ended in June 2008. The fair value of this contract at December 31, 2007 had been estimated at (\$30).

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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22. Risk management (continued):

The REIT had entered into a forward contract to lock in the government of Canada ten-year bond yield on a mortgage for a distribution centre in Ajax, Ontario which settled in April 2008. The REIT had accounted for this contract as a cash flow hedge. During the year ended December 31, 2008, the REIT realized a loss on this forward contract of \$1,807. The fair value of this forward contract at December 31, 2007 had been estimated at (\$2,475).

23. Joint venture and co-ownership activities:

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

| | 2008 | 2007 |
|--|------------|------------|
| Assets | \$ 157,557 | \$ 163,152 |
| Liabilities | 92,292 | 90,043 |
| Revenue | 39,211 | 27,000 |
| Expenses | 26,484 | 19,112 |
| Operating income from properties | 12,727 | 7,887 |
| Cash flows provided by operations | 10,788 | 10,486 |
| Cash flows used in financing | (18,960) | (8,582) |
| Cash flows provided by (used in) investments | 9,373 | (2,274) |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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24. Related party transactions:

H&R Property Management Ltd. (the "Property Manager"), a company owned by family members of the Chief Executive Officer, provides property management services for substantially all properties owned by the REIT, including leasing services, for a fee of 2% of gross revenue. The Property Manager also provides support services in connection with the acquisition, disposition and development activities of the REIT and is also entitled to an incentive fee. Acquisitions and development support services are provided for a fee of 2/3 of 1% of total acquisition and development costs, as defined in the agreement and effective January 1, 2007. Effective January 1, 2008, the support services relating to dispositions of income properties are provided for a fee of 10% of the gain on sale of income properties adjusted for the add back of accumulated depreciation and amortization. Prior to January 1, 2008, the disposition fee was 7.5% of the gain on sale of income properties without any adjustment for accumulated depreciation and amortization. This change had no impact for the year ended December 31, 2008 as the disposition fee was nil. The current agreement expires on December 31, 2009 with two automatic five-year extensions.

During the year ended December 31, 2008, the REIT recorded fees pursuant to this agreement of \$14,494 (2007 - \$15,194), of which \$553 (2007 - \$1,748) was capitalized to the cost of the income properties acquired, \$2,111 (2007 - \$2,002) was capitalized to properties under development and \$2,317 (2007 - \$1,052) was capitalized to deferred expenses. The REIT has also reimbursed the Property Manager for certain direct property operating costs and tenant construction costs.

For the year ended December 31, 2008, a further amount of \$3,520 (2007 - \$3,660) has been earned by the Property Manager, pursuant to the above agreement, in accordance with the annual incentive fee, payable to the Property Manager. Of this amount, \$1,500 (2007 - nil) has been waived by the Property Manager and \$2,020 (2007 - \$3,660) has been expensed in the combined statements of earnings (loss). In addition, the Property Manager has waived the 2009 annual incentive fee.

Pursuant to the above agreements, as at December 31, 2008, \$1,022 (2007 - \$3,254) was payable to the Property Manager.

The REIT leases space to companies affiliated with the Property Manager. The rental income earned for the year ended December 31, 2008 is \$1,160 (2007 - \$1,130).

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Notes to Combined Financial Statements (continued)
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24. Related party transactions (continued):

The REIT received interest from a related company of the Property Manager. The interest income earned for the year ended December 31, 2008 is nil (2007 - \$385).

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

25. Segmented disclosures:

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

Capital assets are attributed to countries based on the location of the properties.

Income properties and properties under development:

| | 2008 | 2007 |
|---------------|---------------------|---------------------|
| Canada | \$ 3,763,373 | \$ 3,699,210 |
| United States | 1,363,315 | 1,119,601 |
| | <u>\$ 5,126,688</u> | <u>\$ 4,818,811</u> |

Net property operating income:

| 2008 | Canada | United States | Total |
|---|-------------------|-----------------|-------------------|
| Operating revenue | \$ 499,242 | \$ 112,610 | \$ 611,852 |
| Property operating costs | (178,370) | (19,038) | (197,408) |
| Mortgage and other interest expense | (119,996) | (55,318) | (175,314) |
| Depreciation of income properties | (69,105) | (26,766) | (95,871) |
| Amortization of deferred expenses and intangible costs | (24,274) | (7,770) | (32,044) |
| <u>Net property operating income</u> | <u>\$ 107,497</u> | <u>\$ 3,718</u> | <u>\$ 111,215</u> |

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Notes to Combined Financial Statements (continued)
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25. Segmented disclosures (continued):

| 2007 | Canada | United States | Total |
|---|------------------|-----------------|-------------------|
| Operating revenue | \$ 472,204 | \$ 111,065 | \$ 583,269 |
| Property operating costs | (168,880) | (16,629) | (185,509) |
| Mortgage and other interest expense | (122,297) | (52,934) | (175,231) |
| Depreciation of income properties | (61,892) | (25,961) | (87,853) |
| Amortization of deferred expenses and intangible costs | (24,490) | (7,978) | (32,468) |
| Net property operating income | \$ 94,645 | \$ 7,563 | \$ 102,208 |

26. Net earnings from discontinued operations:

During the year ended December 31, 2008, the REIT changed its plan to sell 11 properties, including four Boscov's Department Stores, which had been included in discontinued operations for the year ended December 31, 2007. These income properties were reclassified to continuing operations as market interest changed during the selling process following the decline in the general economy. The loss from these 11 properties is \$31,722 for the year ended December 31, 2008, which includes the impairment provision on the four Boscov's Department Stores of \$32,102 for the year ended December 31, 2008.

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Notes to Combined Financial Statements (continued)
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26. Net earnings from discontinued operations (continued):

The REIT sold 16 properties during the year ended December 31, 2008. There are two remaining properties held for sale as at December 31, 2008. For the year ended December 31, 2007, there were seven properties classified as discontinued operations, in addition to the 11 properties discussed above, which were all sold in 2007. The results of operations from these properties have been separately disclosed below:

| | 2008 | 2007 |
|--|-----------|-----------|
| Operating revenue: | | |
| Rentals from income properties | \$ 21,321 | \$ 35,215 |
| Straight-lining of contractual rent | 36 | 530 |
| Rent amortization of above- and below-market rents | – | 189 |
| Rentals from income properties | 21,357 | 35,934 |
| Mortgage interest and other income | 4 | 14 |
| | 21,361 | 35,948 |
| Operating expenses: | | |
| Property operating costs | 7,574 | 11,233 |
| Mortgage interest | 5,000 | 8,621 |
| Amortization of mortgage premium | (181) | (179) |
| Bank interest and charges | 3 | 8 |
| Depreciation of income properties | 529 | 4,851 |
| Amortization of deferred leasing expenses | 8 | 216 |
| Amortization of deferred costs | 10 | 31 |
| Amortization of intangible assets on acquisitions | – | 1,113 |
| | 12,943 | 25,894 |
| Net property operating income | 8,418 | 10,054 |
| Income taxes | – | (3) |
| Gain on sale of income properties | 71,201 | 9,686 |
| Non-controlling interest (note 13) | (3,743) | (1,050) |
| Net earnings from discontinued operations | \$ 75,876 | \$ 18,687 |

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Notes to Combined Financial Statements (continued)
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27. Commitments and contingencies:

- (a) The REIT has entered into agreements to develop the Bow, a two million square foot office building in Calgary, Alberta, fully pre-leased to EnCana Corporation for a 25-year term with a budgeted cost of approximately \$1,500,000. This budget includes 1,361 parking stalls on both the North and South blocks. Construction commenced in the spring of 2007 and is planned to be completed in 2012 to meet the completion timetable. In certain circumstances, should the delivery of tranches of space within the project be delayed, the REIT will be liable to the tenant for certain delay costs which may be significant. As at December 31, 2008, the REIT had not yet secured long-term debt or construction financing or arranged a fixed price contract with a general contractor and, as a result, the REIT is bearing the risk of financing and project cost overruns. As at December 31, 2008, the total cost incurred on the project amounted to \$402,031.
- (b) In the normal course of operations, the REIT has issued letters of credit in connection with financings, operations and acquisitions. As at December 31, 2008, the REIT has outstanding letters of credit totalling \$51,791 (2007 - \$54,952), including \$22,566 (2007 - \$21,503) which has been pledged as security for certain mortgages payable. These letters of credit are secured in the same manner as the bank indebtedness (note 11).
- (c) At December 31, 2008, the REIT had issued guarantees amounting to \$51,340 (2007 - \$112,554) which expire between 2011 and 2017 and no amount had been provided for in the combined financial statements for these items. These amounts arise where the REIT has guaranteed a co-owner's share of the mortgage liability. The REIT has recourse to the co-owner's share of the assets in the event the guarantees are called upon.
- (d) On December 23, 2008, the REIT entered into an agreement (the "Private Placement Agreement") with Fairfax, pursuant to which Fairfax has agreed to purchase, at par on a private placement basis, debentures for \$200,000 (the "Debentures"), bearing interest at 11.5% per annum, due on the fifth anniversary of the issue date with interest payable semi-annually. Completion of the private placement is subject to the satisfaction of certain conditions.

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Notes to Combined Financial Statements (continued)
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27. Commitments and contingencies (continued):

- (i) The Debentures will be redeemable, at the REIT's option, after the fourth anniversary of the issue date, at a redemption price equal to the principal amount thereof plus accrued and unpaid interest. The Debentures will require the REIT, at the holders' option, to effect repurchases upon a change of control at 101% of the principal amount plus accrued and unpaid interest, and will contain similar covenants, events of defaults and remedies as the REIT's outstanding convertible debentures. Furthermore, the Debentures will be unsecured and will rank equally with the REIT's current and future unsecured debt including the REIT's outstanding convertible debentures.
- (ii) Contemporaneously with the issue of these Debentures, Fairfax will be granted warrants to purchase 28,571,429 Stapled Units at an exercise price of \$7.00 per Stapled Unit (or net proceeds of approximately \$200,000 if exercised in full), which are exercisable for a period of five years from the date of grant.
- (iii) The agreement is conditional upon, among other things, the occurrence of the following events by closing: (a) receipt by the REIT of construction financing commitments of no less than \$400,000 for the development of the Bow in Calgary, (b) monthly unitholder cash distributions per Stapled Unit being no greater than \$0.06 until closing; and (c) TSX approval. Closing of the transactions contemplated in the Private Placement Agreement is expected to occur on the second business day following satisfaction of all conditions to the Private Placement Agreement and if conditions are not satisfied or waived within 120 days from the date the Private Placement Agreement was entered into, the Private Placement Agreement will be cancelled. As at December 31, 2008, these conditions have not been satisfied.
- (e) The REIT 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 combined financial statements.

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28. Acquisitions:

During the year ended December 31, 2008, the REIT acquired an interest in eight (2007 - 16) income properties. The following table summarizes the acquired net assets at fair value on their respective dates of acquisition:

| | 2008 | 2007 |
|--|------------------|-------------------|
| Assets: | | |
| Land | \$ 11,692 | \$ 49,362 |
| Building | 64,569 | 159,274 |
| Paving and equipment | 2,794 | 23,935 |
| Sundry assets | — | 465 |
| Intangible above-market rent leases | 97 | 2,816 |
| Intangible acquired in-place lease costs | 6,660 | 33,843 |
| Customer relationship value | 906 | 6,283 |
| | <u>86,718</u> | <u>275,978</u> |
| Liabilities: | | |
| Mortgages payable | 56,182 | 17,086 |
| Intangible below-market rent leases | 1,626 | 8,676 |
| | <u>57,808</u> | <u>25,762</u> |
| Net assets acquired | \$ 28,910 | \$ 250,216 |
| Settled by: | | |
| Cash | \$ 24,080 | \$ 250,216 |
| Sundry assets | 4,830 | — |
| | <u>\$ 28,910</u> | <u>\$ 250,216</u> |

29. Income taxes:

The REIT currently qualifies as a mutual fund trust for Canadian income tax purposes. On June 22, 2007, legislation relating to the federal income taxation of a specified investment flow-through trust or partnership (a "SIFT"), received royal assent (the "SIFT Rules"). A SIFT includes a publicly-listed or traded partnership or trust, such as an income trust and a real estate investment trust. The REIT is a SIFT, as discussed below.

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Notes to Combined Financial Statements (continued)
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29. Income taxes (continued):

Under the SIFT Rules, following a transition period for qualifying SIFTs, certain distributions from 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. Distributions paid by a SIFT as returns of capital will not be subject to the tax.

A SIFT which was publicly listed before November 1, 2006 (an "Existing Trust") will 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. The REIT has not exceeded such limits.

Under the SIFT Rules, the new taxation regime will not apply to a real estate investment trust that meets prescribed conditions relating to the nature of its income and investments (the "REIT Conditions"). As currently structured, the REIT does not meet the REIT Conditions and, therefore, is a SIFT. Accordingly, commencing in 2011, the REIT will become subject to tax on distributions of certain income. The REIT intends to take the necessary steps to qualify for the REIT Conditions prior to 2011.

Prior to the SIFT Rules, income earned by the REIT and distributed annually to unitholders was not, and would not be, subject to taxation in the REIT, but was taxed at the unitholder level. For financial statement reporting purposes, the tax deductibility of the REIT's distributions was treated as an exemption from taxation as the REIT distributed and was committed to continue distributing all of its income to its unitholders. Accordingly, prior to the SIFT Rules, the REIT did not record a provision for income taxes, or future income tax assets or liabilities, in respect of the REIT or its investments in its subsidiary trusts.

Due to the SIFT Rules, the REIT commenced recognizing future income tax assets and liabilities with respect to the temporary differences between the carrying amounts and tax basis of its assets and liabilities, including those related to its subsidiary trusts, that are expected to reverse in or after 2011. Future income tax assets and liabilities are recorded using tax rates and laws expected to apply when the temporary differences are expected to reverse.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
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29. Income taxes (continued):

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

The tax effects of temporary differences that give rise to significant portions of the future income tax assets and liabilities are as follows:

| | 2008 | 2007 |
|---------------------------------|-------------------|-------------------|
| Future income tax liabilities: | | |
| Income properties | \$ 109,121 | \$ 103,446 |
| Properties under development | 5,437 | — |
| Deferred expenses | 915 | — |
| Accrued rent receivable | 27,868 | 24,300 |
| Mortgages receivable | 405 | — |
| Mortgages payable | 1,176 | 520 |
| Convertible debentures | 1,743 | — |
| | <u>146,665</u> | <u>128,266</u> |
| Future income tax assets: | | |
| Intangible liabilities | 11,369 | 10,306 |
| Deferred expenses | — | 320 |
| Issue costs | 1,996 | 580 |
| | <u>13,365</u> | <u>11,206</u> |
| Net future income tax liability | <u>\$ 133,300</u> | <u>\$ 117,060</u> |

At December 31, 2008, the U.S. subsidiaries had accumulated net operating losses and deferred interest deductions available for carryforward for income tax purposes of approximately \$91,375. The losses expire between 2018 and 2028. The deferred interest deductions do not generally expire. The net future tax assets of these corporate subsidiaries of \$49,352 consist of net operating losses, deferred interest deductions and tax and book basis differences relating to U.S. income properties and accrued rent receivable against which a valuation allowance of \$49,352 has been recorded.

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

29. Income taxes (continued):

Income tax expense consists of the following:

| | 2008 | 2007 |
|---|------------------|-------------------|
| Income tax expense included in the determination of net earnings (loss) from continuing operations: | | |
| Current | \$ 1,598 | \$ 2,697 |
| Future | 15,628 | 115,635 |
| | <u>17,226</u> | <u>118,332</u> |
| Future income taxes included in the determination of other comprehensive income (loss) | 612 | 875 |
| | <u>\$ 17,838</u> | <u>\$ 119,207</u> |

A reconciliation of expected income taxes based upon the 2008 and 2007 statutory rates to the recorded income tax expense is as follows:

| | 2008 | 2007 |
|---|------------------|-------------------|
| Income taxes computed at the Canadian statutory rate of nil, applicable to the REIT for 2008 and 2007 | \$ – | \$ – |
| Future income taxes arising from a change in tax status with the enactment of the SIFT Rules | – | 133,950 |
| Increase (decrease) of future income taxes arising from changes in: | | |
| Tax rates | – | (15,500) |
| Estimate of expected reversal of temporary differences | 16,900 | (2,050) |
| Future income taxes applicable to Canadian corporate subsidiaries | (660) | 110 |
| U.S. income taxes | 1,598 | 2,697 |
| Future income taxes included in the determination of other comprehensive income (loss) | (612) | (875) |
| | <u>\$ 17,226</u> | <u>\$ 118,332</u> |

H&R REAL ESTATE INVESTMENT TRUST AND H&R FINANCE TRUST

Notes to Combined Financial Statements (continued)
(In thousands of dollars, except unit and per unit amounts)

Years ended December 31, 2008 and 2007

30. Comparative figures:

Certain 2007 comparative figures have been reclassified to conform with the financial statement presentation adopted in 2008.

31. Subsequent events:

- (a) In February 2009, the REIT sold a 115,000 square foot retail building located in Austell, Georgia for gross proceeds of \$16,400.
- (b) The REIT has signed an engagement letter with RBC and TD, who will collectively act as co-lead arrangers and co-bookrunners to arrange a \$425,000 construction facility for the REIT on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals for up to \$250,000 of the Financing, contingent upon securing the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway.

**COMBINED MANAGEMENT DISCUSSION AND
ANALYSIS OF H&R REAL ESTATE INVESTMENT
TRUST AND H&R FINANCE TRUST**

For the Year ended December 31, 2008

Dated: March 3, 2009

COMBINED MANAGEMENT'S DISCUSSION AND ANALYSIS

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SECTION I

FORWARD-LOOKING DISCLAIMER

Management's discussion and analysis ("MD&A") of the combined consolidated financial position and the consolidated results of operations of H&R Real Estate Investment Trust ("the REIT") and H&R Finance Trust ("Finance Trust" and collectively with the REIT, the "Trusts") combined together as the Trusts ("the Trusts") for the year ended December 31, 2008 should be read in conjunction with the Trusts combined financial statements and the notes thereto for the years ended December 31, 2008 and 2007. Historical results, including trends which might appear, should not be taken as indicative of future operations or results. Certain prior period items have been reclassified to conform with the presentation adopted in the current period.

Certain information in this MD&A contains forward-looking information within the meaning of applicable securities laws (also known as forward-looking statements) including, among others, statements made or implied under the headings "Impact of Current Market Conditions", "Results of Operations", "Financial Condition", "Liquidity and Capital Resources" and "Outlook" relating to the Trusts objectives, strategies to achieve those objectives, the Trusts beliefs, plans, estimates, projections and intentions, and similar statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts including, in particular, the REIT's expectation regarding future developments in connection with the Bow. Forward-looking statements generally can be identified by words such as "outlook", "objective", "may", "will", "expect", "intend", "estimate", "anticipate", "believe", "should", "plans" "project", "budget" or "continue" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect the Trusts current beliefs and are based on information currently available to management.

Forward-looking statements are provided for the purpose of presenting information about management's current expectations and plans relating to the future and readers are cautioned that such statements may not be appropriate for other purposes. These statements are not guarantees of future performance and are based on the Trusts estimates and assumptions that are subject to risks and uncertainties, including those described below under "Risks and Uncertainties" and those discussed in the Trusts materials filed with the Canadian securities regulatory authorities from time to time, which could cause the actual results and performance of the Trusts to differ materially from the forward-looking statements contained in this MD&A. Those risks and uncertainties include, among other things, risks related to: Unit prices; availability of cash for distributions; development and financing relating to the Bow development; liquidity; credit risk and tenant concentration; interest rate and other debt related risk; tax risk; ability to access capital markets; dilution; lease rollover risk; construction risks; currency risk; unitholder liability; mezzanine financing credit risk; competition for real property investments; and environmental matters. 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 is stable; local real estate conditions are stable; interest rates are relatively stable; and equity and debt markets continue to provide access to capital. The Trusts cautions that this list of factors is not exhaustive. Although the forward-looking statements contained in this MD&A are based upon what the Trusts believe are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements. Furthermore, readers are also urged to examine the REIT's and Finance Trust's materials filed with the Canadian securities regulatory authorities from time to time as they may contain discussions on risks and uncertainties which could cause the actual results and performance of the REIT and Finance Trust to differ materially from the forward-looking statements contained in this MD&A. However, neither Finance Trust nor any of its trustees or officers, assumes any responsibility for the completeness of the information contained in the REIT's materials filed with the Canadian securities regulatory authorities or for any failure of the REIT or its trustees or officers to disclose events or facts which may have occurred or which may affect the significance or accuracy of any such information.

All forward-looking statements in this MD&A are qualified by these cautionary statements. These forward-looking statements are made as of March 3, 2009 and the Trusts, 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, 2008 and 2007 is unaudited.

NON-GAAP FINANCIAL MEASURES

Same-asset property operating income, distributable cash (“DC”), funds from operations (“FFO”) and Gross Book Value (“GBV”) are all supplemental financial measures used by management to track the Trusts financial performance. Such measures are not recognized under Canadian generally accepted accounting principles (“GAAP”) and therefore do not have standardized meanings prescribed by GAAP. These non-GAAP financial measures should not be construed as alternatives to comparable financial measures calculated in accordance with GAAP. Further, the Trusts method of calculating such supplemental financial measures may differ from the methods of other real estate investment trusts or other issuers and accordingly, such supplemental financial measures used by management may not be comparable to similar measures presented by other real estate investment trusts or other issuers.

OVERVIEW

The REIT is an unincorporated open-ended trust created by a Declaration of Trust and governed by the laws of the Province of Ontario. The REIT 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 comprising part of the Stapled Units (as defined below), redeemed at any time on demand payable in cash (subject to monthly limits) and/or *in specie*, provided that the corresponding Finance Trust units are being contemporaneously redeemed. Finance Trust is an unincorporated investment trust. Finance Trust was established pursuant to a Plan of Arrangement (the “Plan of Arrangement”) on October 1, 2008 as an open-ended limited purpose unit trust pursuant to its Declaration of Trust. Each issued and outstanding Finance Trust unit is “stapled” to a unit of the REIT on a one-for-one basis such that Finance Trust units and the REIT units trade together as stapled units (“Stapled Units”), and such Stapled Units are listed and posted for trading on the Toronto Stock Exchange (“TSX”). Apart from provisions necessary to achieve such stapling, each the REIT unit and Finance Trust unit retains its own separate identity and is separately listed (but not posted for trading) on the TSX (unless there is an event of uncoupling, in which case Finance Trust units will cease to be listed on the TSX).

The REIT 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 REIT’s assets, acquisition of additional properties and the development and construction of projects which are pre-leased to creditworthy tenants.

The REIT’s strategy to accomplish these two objectives is to accumulate a diversified portfolio of high quality office, industrial and retail properties in Canada and the United States occupied by creditworthy tenants on a long-term basis.

The primary purpose of Finance Trust is to be a flow-through vehicle to allow the REIT to indirectly access the capital markets in a tax-efficient manner by indirectly borrowing money from the REIT’s unitholders. Finance Trust’s primary activity will be to hold debt issued by U.S. Holdco. Subject to cash flow requirements, Finance Trust intends to distribute to its unitholders, who are also unitholders of the REIT, all of its cash flow, consisting primarily of interest paid by U.S. Holdco, less administrative and other expenses and amounts to satisfy liabilities.

Mechanics of “Stapling” the Units of Finance Trust and the REIT

Pursuant to the provisions of the Declarations of Trust for Finance Trust and the REIT at all times each the REIT unit must be “stapled” to a Finance Trust unit (and each Finance Trust unit must be “stapled” to a the REIT unit) unless there is an “event of uncoupling” (as described below). As part of the Plan of Arrangement, as described in the REIT’s information circular dated August 20, 2008, the REIT and Finance Trust entered into a support agreement (the “Support Agreement”) which provided, among other things, for the co-ordination of the declaration and payment of all distributions so as to provide for simultaneous record

dates and payment dates; for co-ordination so as to permit the REIT to perform its obligations pursuant to the REIT's Declaration of Trust, Unit Option Plan, Dividend Reinvestment Plan ("DRIP") and Unitholder Rights Plan; for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable and permit the REIT to perform its obligations arising under any security issued by the REIT (including securities convertible, exercisable or exchangeable into Stapled Units); for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable the REIT to perform its obligations or exercise its rights under its convertible debentures; and for Finance Trust to take all such actions and do all such things as are necessary or desirable to issue Finance Trust units simultaneously (or as close to simultaneously as possible) with the issue of REIT units and to otherwise ensure at all times that each holder of a particular number of REIT units holds an equal number of Finance Trust units, including participating in and cooperating with any public or private distribution of Stapled Units by, among other things, executing prospectuses or other offering documents.

In the event that the REIT issues additional REIT units, pursuant to the Support Agreement, the REIT and Finance Trust will coordinate so as to ensure that each subscriber receives both REIT units and Finance Trust units, which shall trade together as Stapled Units. Prior to such event, the REIT shall provide notice to Finance Trust to cause Finance Trust to issue and deliver the requisite number of Finance Trust units to be received by and issued to, or to the order of, each subscriber as the REIT directs. In consideration of the issuance and delivery of each such Finance Trust unit, the REIT (solely as agent for and on behalf of the purchaser) or the purchaser, as the case may be, shall pay (or arrange for the payment of) a purchase price equal to the fair market value (as determined by Finance Trust in consultation with the REIT) of each such Finance Trust unit at the time of such issuance. The remainder of the subscription price for Stapled Units shall be allocated to the issuance of REIT units by the REIT. The proceeds received by Finance Trust from any such issuance shall be invested in additional notes of the same series as the U.S. Holdco Notes.

An event of uncoupling ("Event of Uncoupling") shall occur only: (a) in the event that unitholders of the REIT vote in favour of the uncoupling of units of Finance Trust and units of the REIT such that the two securities will trade separately; or (b) at the sole discretion of the trustees, but only in the event of the bankruptcy, insolvency, winding-up or reorganization (under an applicable law relating to insolvency) of the REIT or U.S. Holdco or the taking of corporate action by the REIT or U.S. Holdco in furtherance of any such action or the admitting in writing by the REIT or U.S. Holdco of its inability to pay its debts generally as they become due.

Investment Restrictions

Under Finance Trust's Declaration of Trust, the assets of Finance Trust may be invested only in:

- (a) U.S. Holdco Notes; and
- (b) temporary investments in cash, term deposits with a Canadian chartered bank or trust company registered under the laws of a province of Canada, short-term government debt securities, or money market instruments (including banker's acceptances) of, or guaranteed by, a Schedule 1 Canadian bank ("Cash Equivalents"), but only if each of the following conditions are satisfied: (a) if the Cash Equivalents have a maturity date, the trustees hold them until maturity; (b) the Cash Equivalents are required to fund expenses of Finance Trust, a redemption of units, or distributions to unitholders, in each case before the next distribution date; and (c) the purpose of holding the Cash Equivalents is to prevent funds from being non-productive, and not to take advantage of market fluctuations.

The Finance Trust Declaration of Trust provides that Finance Trust shall not make any investment, take any action or omit to take any action which would result in the units of Finance Trust not being considered units of a "mutual fund trust" for purposes of the Income Tax Act (Canada) or that would disqualify Finance Trust as a "fixed investment trust" under the Internal Revenue Code of 1986 as amended (the "Code") and the applicable regulations. In order to qualify as a "fixed investment trust" under the Code, Finance Trust generally may not acquire assets other than the U.S. Holdco Notes or certain investments in cash or cash equivalents.

H&R REIT and H&R FINANCE TRUST - MD&A – December 31, 2008

| | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|---------|-------------|------------------------|---------|-------------|
| | 2008 | 2007 | Change % | 2008 | 2007 | Change % |
| DISTRIBUTABLE CASH PER UNIT ⁽¹⁾ | \$0.381 | \$0.401 | (5) | \$1.565 | \$1.572 | n/a |
| CASH DISTRIBUTIONS PAID PER UNIT | \$0.360 | \$0.343 | (5) | \$1.440 | \$1.370 | 5 |
| PAYOUT RATIO | 94.5% | 85.5% | 11 | 92.0% | 87.2% | 6 |
| FUNDS FROM OPERATIONS PER UNIT ⁽¹⁾ | \$0.306 | \$0.431 | (29) | \$1.592 | \$1.731 | (8) |

⁽¹⁾ Distributable cash and funds from operations are reconciled to cash provided by operations being the most comparable GAAP measure to this non-GAAP financial measure. See pages 22 and 36.

| | December 31 2008 | December 31 2007 |
|---|---------------------|---------------------|
| Average remaining term to maturity of leases (years) | 11.5 | 12.1 |
| Average remaining term to maturity of mortgages (years) | 9.3 | 10.2 |
| Weighted average contractual interest rate of mortgages | 6.2% | 6.3% |

The geographic diversification of the REIT's portfolio (excluding the seven Boscov's Department Stores which filed for Chapter 11 protection with a United States bankruptcy court) as at December 31, 2008 is outlined in the charts below:

| NUMBER OF PROPERTIES | Ontario Properties | United States Properties | Alberta Properties | Quebec Properties | Other Properties | Total Properties |
|-------------------------|-----------------------|-----------------------------|-----------------------|----------------------|---------------------|---------------------|
| Office | 22 | 3 | 4 | 1 | 4 | 34 |
| Industrial | 58 | 17 | 19 | 11 | 19 | 124 |
| Retail | 32 | 76 | 5 | 5 | 4 | 122 |
| Total | 112 | 96 | 28 | 17 | 27 | 280 |

| (in thousands of square feet) | Ontario Sq.ft. | United States Sq.ft. | Alberta Sq.ft. | Quebec Sq.ft. | Other Sq.ft. | Total Sq.ft. |
|----------------------------------|-------------------|-------------------------|-------------------|------------------|-----------------|-----------------|
| Office | 4,937 | 304 | 1,406 | 452 | 884 | 7,983 |
| Industrial | 11,031 | 7,392 | 2,810 | 2,850 | 1,176 | 25,259 |
| Retail | 1,746 | 4,619 | 515 | 498 | 634 | 8,012 |
| Total | 17,714 | 12,315 | 4,731 | 3,800 | 2,694 | 41,254 |

H&R REIT and H&R FINANCE TRUST - MD&A – December 31, 2008

| LEASE EXPIRIES | 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 |
| 2009 | 0.7 | 18.69 | 1.6 | 5.11 | 0.3 | 6.56 | 2.6 | 8.93 |
| 2010 | 0.6 | 19.70 | 2.3 | 6.22 | 0.3 | 25.06 | 3.2 | 10.51 |
| 2011 | 0.7 | 17.48 | 0.3 | 13.69 | 0.1 | 11.08 | 1.1 | 15.86 |
| 2012 | 0.7 | 17.66 | 2.0 | 5.13 | 0.1 | 21.74 | 2.8 | 8.86 |
| 2013 | 0.7 | 16.29 | 3.4 | 5.65 | 0.4 | 9.26 | 4.5 | 7.63 |
| | 3.4 | 17.91 | 9.6 | 5.84 | 1.2 | 13.73 | 14.2 | 9.40 |

| MORTGAGES PAYABLE * | Years | Periodic Amortized Principal (\$000's) | Principal on Maturity (\$000's) | Total Principal (\$000's) | % of Total Principal | Weighted Average Interest Rate on Maturity |
|---|---------|--|---------------------------------|---------------------------|----------------------|--|
| | | | | | | |
| 2010 | 101,492 | 20,590 | 122,082 | 4.1% | 6.8% | |
| 2011 | 105,664 | 70,246 | 175,910 | 5.9% | 6.5% | |
| 2012 | 104,638 | 303,739 | 408,377 | 13.6% | 6.7% | |
| 2013 ⁽⁵⁾ | 99,935 | 102,312 | 202,247 | 6.7% | 7.5% | |
| Thereafter | | | 1,955,362 | 65.0% | | |
| | | | 3,006,542 | 100.0% | | |
| Mortgages payable due on demand ⁽¹⁾ | | | 142,921 | | | |
| Mortgages payable on assets sold ⁽²⁾ | | | 10,461 | | | |
| Mortgage premiums ⁽³⁾ | | | 11,085 | | | |
| Mortgage origination costs ⁽⁴⁾ | | | (13,539) | | | |
| Total | | | 3,157,470 | | | |

* includes mortgages on income properties held for sale (based on original contractual repayment terms)

- (1) This figure includes seven non-recourse mortgages to the REIT for properties in which the tenant (Bosco's Department Stores) has filed for protection under Chapter 11 of the United States Bankruptcy Code. The REIT has handed over control of the income producing properties to the lenders and therefore expects to be released from any further obligations under these non-recourse mortgages. GAAP requires the REIT to show the full liability until such time as the lender accepts transfer of title to the properties and releases the REIT's subsidiaries from its debt obligations. As a result, \$142.9 million is now listed as currently due on demand
- (2) In conjunction with the sale of 10 income-producing properties, the purchaser agreed to assume an aggregate mortgage balance of \$82.6 million and indemnify the REIT until such time that the lenders consent and release the REIT in respect of these mortgages. During the year ended December 31, 2008, the REIT was legally released from its obligation on eight properties. At December 31, 2008, the REIT has not been legally released from its mortgage obligation for the remaining two properties, resulting in an outstanding original contractual balance of \$10.5 million.
- (3) 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 and are recognized in interest over the life of the applicable mortgage

- (4) Mortgage origination costs are deducted from the REIT's mortgages payable balances and are recognized in interest over the life of the applicable mortgage
- (5) Three mortgages with a current outstanding balance of \$34.4 million have a prepayment option in 2013. Should the REIT not exercise this option, the interest rate on these three mortgages will increase by 2% per annum each, until the expiry of the mortgages which range from 2028 and 2033

| OCCUPANCY LEVELS AND AVERAGE RENT PER SQUARE FOOT | Year ended December 31 | Office | Industrial | Retail | Total* |
|--|---------------------------|----------------|---------------|----------------|---------------|
| Occupancy ⁽¹⁾ | 2008 | 98.9% | 98.6% | 99.9% | 98.9% |
| | 2007 | 99.0% | 100.0% | 99.6% | 99.7% |
| Occupancy – same asset ⁽²⁾ | 2008 | 98.9% | 98.4% | 99.9% | 98.8% |
| | 2007 | 99.2% | 100.0% | 99.9% | 99.8% |
| Average rent per square foot ⁽³⁾ | 2008 | \$19.12 | \$5.84 | \$13.19 | \$9.84 |
| | 2007 | \$18.75 | \$5.39 | \$11.47 | \$9.24 |

* weighted average total

(1) Excluding Boscov's Department Stores for 2008

(2) Same asset refers to those properties owned by the REIT for the entire two-year period ended December 31, 2008 and excludes any assets classified as discontinued operations and Boscov's Department Stores

(3) For continuing operations only and excluding Boscov's Department Stores

IMPACT OF CURRENT MARKET CONDITIONS

The recent turmoil in the global markets has brought about a strong focus on liquidity as the capital markets have undergone dramatic change. Sources of funds are scarce and lenders have become more conservative with their loans.

The REIT is currently undertaking significant development activities for the two million square foot office building in Calgary, Alberta ("the Bow"). The REIT has committed to incurring additional construction and development costs for this project of approximately \$1.1 billion (including capitalized interest of \$183 million) over a four year period of which approximately \$375 million is expected to be incurred during the next 12 months. The current difficult economic conditions have impacted the REIT's financing strategy. While the REIT is negotiating with lenders to obtain construction financing for the Bow and has entered into a conditional agreement for the issuance of \$200 million of debentures described below, at present there is no financing arrangement in place for the Bow.

In December 2008, the REIT entered into an agreement with Fairfax Financial Holdings Limited ("Fairfax"), whereby Fairfax has agreed to purchase on a private placement basis, \$200 million of 11.5% debentures due five years from issuance. The private placement is conditional upon, among other things, the REIT obtaining construction financing for the Bow in the principal amount of \$400 million and will terminate on April 23, 2009.

Subsequent to year end, the REIT has signed an engagement letter with RBC Capital Markets ("RBC") and TD Securities ("TD"), who will collectively act as co-lead arrangers and co-bookrunners to arrange a \$425 million construction facility for the REIT on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals for up to \$250 million of the Financing contingent upon securing the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway.

In addition to pursuing construction financing, the REIT has taken, or will consider taking, the following actions to partially fund its development commitment:

- (i) Reducing distributions - In December 2008, the REIT announced that it would decrease its cash distributions to unitholders to retain cash. If necessary, the REIT can further preserve cash through a further decrease in cash distributions;
- (ii) Utilizing the REIT's cash and unused operating line of credit as of December 31, 2008, which totals approximately \$148 million. The operating line of credit is due in August of 2009, and is secured by charges on 27 properties. While the REIT's operating line of credit has been renewed annually since its inception, in light of current market conditions, there is no certainty that the REIT will be successful in renewing the line of credit due in August of 2009. Should the operating line not be renewed, the REIT will attempt to replace the line through conventional first mortgages on the properties currently securing the line;
- (iii) Selling an interest in the Bow;
- (iv) Selling or refinancing other assets; and
- (v) Issuance of units – however, in light of current market conditions, there is no assurance that a significant amount of financing can be raised.

The combined financial statements have been prepared on a going concern basis in accordance with GAAP, which assumes that the REIT will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. The REIT's ability to obtain financing for its development commitments is a material uncertainty which may cast significant doubt on the ability of the REIT to continue as a going concern. The outcome is dependent on the successful completion of the actions taken or planned, some of which are described above, (which management believes will mitigate the adverse conditions and events) which may cast doubt about the validity of the going concern assumption.

PLAN OF ARRANGEMENT

On October 1, 2008 the REIT completed an internal reorganization pursuant to a Plan of Arrangement (the "Plan of Arrangement") as described in the REIT's information circular dated August 20, 2008. The Plan of Arrangement resulted in, among other things, the creation on October 1, 2008 of H&R Finance Trust ("Finance Trust"). Each unitholder received, for each REIT unit held, a unit of Finance Trust. Each issued and outstanding Finance Trust unit is stapled to a unit of the REIT on a one-for-one basis so as to form stapled units ("Stapled Units"), and such Stapled Units are listed and posted for trading on the TSX.

On October 1, 2008, the following steps were taken pursuant to the Plan of Arrangement:

1. The REIT established Finance Trust pursuant to the Finance Trust Declaration of Trust, and subscribed for 146,054,669 units at a subscription price of approximately \$132.5 million.
2. The REIT made a distribution to its unitholders, as a return of capital, consisting of one Finance Trust unit for each REIT unit.
3. The REIT transferred certain intercompany loans receivable from H&R REIT (U.S.) Holdings Inc. (U.S. Holdco"), a wholly-owned U.S. subsidiary of the REIT to finance Trust in consideration for cash of approximately U.S. \$125 million.
4. Finance Trust transferred certain loans to a wholly-owned U.S. subsidiary of the REIT in consideration for a note payable by such subsidiary in a principal amount of U.S. \$125 million (the "Subco Note"). Finance Trust then transferred the Subco Note to U.S. Holdco in consideration for notes payable in the aggregate principal amount of U.S. \$125 million (the "U.S. Holdco Notes"). The assets of Finance Trust must be primarily invested in U.S. Holdco Notes.
5. The REIT and Finance Trust entered into the Support Agreement.

SECTION II

SELECTED ANNUAL INFORMATION

The following table summarizes certain financial information of the Trusts for the years indicated below:

| (in thousands of dollars except per unit amounts) | Year Ended December 31 2008 | Year Ended December 31 2007 ⁽¹⁾ | Year Ended December 31 2006 ⁽¹⁾ |
|--|--|--|--|
| Rentals from income properties | \$608,714 | \$580,679 | \$527,466 |
| Mortgage interest and other income | 3,138 | 2,590 | 1,832 |
| Net property operating income | 111,215 | 102,208 | 87,125 |
| Net earnings (loss) from continuing operations | 22,654 | (20,880) | 70,682 |
| Net earnings (loss) per unit from continuing operations | | | |
| (basic) | 0.15 | (0.17) | 0.65 |
| (diluted) ⁽²⁾ | 0.15 | (0.17) | 0.64 |
| Net earnings (loss) | \$98,530 | (\$2,193) | \$86,437 |
| Net earnings (loss) per unit | | | |
| (basic) | 0.71 | (0.02) | 0.79 |
| (diluted) ⁽²⁾ | 0.71 | (0.02) | 0.78 |
| Total assets | 5,439,898 | 5,050,773 | 4,779,040 |
| Mortgages payable | 3,157,470 | 3,022,391 | 3,036,365 |
| Distributable cash per unit | \$1.57 | \$1.57 | \$1.49 |
| Cash distributions per unit | \$1.44 | \$1.37 | \$1.33 |

Notes:

- (1) Certain items have been reclassified to conform with the presentation adopted in the current year.
- (2) The calculation to determine "net earnings (loss) per unit from continuing operations (diluted)" and "net earnings (loss) per unit (diluted)" gives effect to the issue of units pursuant to outstanding options where dilutive and non-controlling interest conversion to units.

Over the last few years, total assets of the REIT have increased substantially principally due to property acquisitions and developments. As a result, rentals from income properties and net property operating income have increased reflecting the greater number of income properties owned by the REIT. In addition, mortgages payable have also increased due to debt placed or assumed on property acquisitions and in order to take advantage of the low cost of debt.

As a result of the capital and credit markets tightening due to the sub prime fallout, the REIT does not expect the same level of acquisition activity and is expecting a net reduction in properties during 2009 as the REIT expects to sell some non-strategic assets. The increase in the value invested in the REIT's development projects over the next year will continue to drive the growth in the REIT's total assets.

SECTION III

RESULTS OF OPERATIONS

| (in thousands of dollars except per unit amounts) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|--------|------------------------|-----------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| | Unaudited | Unaudited | % | | | % |
| Operating revenue: | | | | | | |
| Rentals from income properties | \$156,935 | \$149,728 | 5 | \$608,714 | \$580,679 | 5 |
| Mortgage interest and other income | 848 | 554 | 53 | 3,138 | 2,590 | 21 |
| | 157,783 | 150,282 | 5 | 611,852 | 583,269 | 5 |
| Operating expenses: | | | | | | |
| Property operating costs | 54,395 | 49,462 | 10 | 197,408 | 185,509 | 6 |
| Mortgage and other interest expense | 44,541 | 43,112 | 3 | 175,314 | 175,231 | 0 |
| Depreciation of income properties | 24,497 | 22,177 | 10 | 95,871 | 87,853 | 9 |
| Amortization of deferred expenses and intangible costs | 6,919 | 8,165 | (15) | 32,044 | 32,468 | (1) |
| | 130,352 | 122,916 | 6 | 500,637 | 481,061 | 4 |
| Net property operating income | 27,431 | 27,366 | 0 | 111,215 | 102,208 | 9 |
| Net loss on foreign exchange | (10,915) | - | n/a | (7,090) | - | n/a |
| Impairment loss on income properties, intangible assets and intangible liabilities | (3,434) | - | n/a | (53,665) | - | n/a |
| Trust expenses | (3,664) | (1,522) | 141 | (10,494) | (5,929) | 77 |
| Net earnings before income taxes, non-controlling interest and discontinued operations | 9,418 | 25,844 | (64) | 39,966 | 96,279 | (58) |
| Income taxes | (4,595) | 19,852 | (123) | (17,226) | (118,332) | 85 |
| Net earnings (loss) before non-controlling interest and discontinued operations | 4,823 | 45,696 | | 22,740 | (22,053) | |
| Non-controlling interest | 806 | (2,466) | | (86) | 1,173 | |
| Net earnings (loss) from continuing operations | 5,629 | 43,230 | | 22,654 | (20,880) | |
| Net earnings from discontinued operations | 40,355 | 5,461 | | 75,876 | 18,687 | |
| Net earnings (loss) | \$45,984 | \$48,691 | | \$98,530 | (\$2,193) | |
| Basic net earnings (loss) per unit | | | | | | |
| Continuing operations | \$0.03 | \$0.34 | | \$0.15 | (\$0.17) | |
| Discontinued operations | 0.29 | 0.04 | | 0.56 | 0.15 | |
| | \$0.32 | \$0.38 | | \$0.71 | (\$0.02) | |
| Diluted net earnings (loss) per unit | | | | | | |
| Continuing operations | \$0.03 | \$0.34 | | \$0.15 | (\$0.17) | |
| Discontinued operations | 0.29 | 0.04 | | 0.56 | 0.15 | |
| | \$0.32 | \$0.38 | | \$0.71 | (\$0.02) | |

The changes for both the three months and the year ended December 31, 2008 are mainly due to the impairment loss on income properties, intangible assets and liabilities from the write down of the Boscov's Department Stores to fair market value, the loss on foreign exchange, future income taxes, the gains realized on disposals of income properties in the net earnings from discontinued operations and the increased rental income from asset acquisitions.

The changes to disclosure requirements that apply for the fiscal year beginning January 1, 2008 are outlined in Section V.

Rentals from Income Properties

Rentals from income properties ("rentals") include all amounts earned from tenants related to lease agreements, including basic rent, parking income, operating cost recoveries and realty tax recoveries. Rentals from properties sold or where an asset meets the definition of being held for sale during the year ended December 31, 2008 and 2007 have been recorded under net earnings from discontinued operations.

| Rentals from Income Properties (in thousands of dollars) | <u>Three months ended December 31</u> | | | <u>Year ended December 31</u> | | |
|--|---------------------------------------|-----------|---------|-------------------------------|-----------|----------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Same-asset – current rentals | \$142,582 | \$137,946 | \$4,636 | \$550,633 | \$546,012 | \$4,621 |
| Same-asset – straight-lining of contractual rent increases | 3,660 | 3,289 | 371 | 16,117 | 16,681 | (564) |
| Acquisitions – current rentals and straight-lining of contractual rent increases | 9,948 | 6,358 | 3,590 | 33,170 | 8,903 | 24,267 |
| Boscov's Department Stores | 745 | 2,135 | (1,390) | 8,794 | 9,083 | (289) |
| Total rentals | \$156,935 | \$149,728 | \$7,207 | \$608,714 | \$580,679 | \$28,035 |

Total rentals have increased by \$7.2 million for the three months ended December 31, 2008 as compared to the three months ended December 31, 2007 and by \$28.0 million for the year ended December 31, 2008 over the respective same 2007 period due primarily to acquisitions. The REIT added 18 new properties between January 1, 2007 and December 31, 2008.

The increase in same-asset current rentals of \$4.6 million for Q4 2008 as compared to Q4 2007 is primarily due to the following items:

- the U.S. portfolio's rental income increased by \$6.8 million due to the decrease in the Canadian dollar as compared to the U.S. dollar and an increase in property operating costs which are recoverable from tenants;
- rental income from properties in Canada increased by \$2.1 million in Q4 2008 as compared to Q4 2007 due primarily to increased property operating costs which are recoverable from tenants;
- rental income decreased by \$3.4 million due to an adjustment to the amortization calculation of rent amortization of above- and below- market rents for a specific tenant. The cumulative amount of the correction was recorded in Q4 2008; and
- rental income was lower by \$0.6 million due to an increase in vacancies.

The increase in same-asset current rentals of \$4.6 million for the year ended December 31, 2008 as compared to 2007 is primarily due to the following reasons:

- rental income increased by \$6.4 million primarily due to increased property operating costs which are recoverable from tenants;

- rental income was lower by \$3.4 million due to an adjustment to the amortization calculation of rent amortization of above- and below- market rents for a specific tenant. The cumulative amount of the correction was all recorded in Q4 2008;
- an increase of \$0.6 million is due to the decrease in straight-lining of contractual rent increases. This decrease results in an increase in same-asset current rentals as there is a direct inverse relationship between these two items; and
- new leases provided an increase of \$1.2 million of rental income for the 2008 year as compared to the 2007 year. These increases were throughout the portfolio. Some of the new leases (with rental increases) included 55 West Drive (\$0.3 million), 2121 Cornwall (\$0.1 million), 4441-76th Street (\$0.3 million), 1 Kenview (\$0.1 million), and 2 East Beaver Creek (\$0.2 million).

Property Operating Costs

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 2008, building operating costs, realty taxes, utilities and property management fees represented 23.6%, 52.1%, 10.0%, and 5.4% respectively of total property operating costs (Q4 2007 – 21.0%, 52.7%, 11.6% and 5.8%).

For the year ended December 31, 2008, these costs represented 19.8%, 53.4%, 11.6% and 5.8% respectively of total property operating costs (December 31, 2007 – 17.5%, 54.5%, 12.2% and 7.0%).

| Property Operating Costs (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|----------|---------|------------------------|-----------|----------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Same-asset property operating costs | \$52,098 | \$47,702 | \$4,396 | \$188,964 | \$182,539 | \$6,425 |
| Acquisitions | 2,136 | 1,402 | 734 | 6,005 | 1,804 | 4,201 |
| Boscov’s Department Stores | 161 | 358 | (197) | 2,439 | 1,166 | 1,273 |
| Total property operating costs | \$54,395 | \$49,462 | \$4,933 | \$197,408 | \$185,509 | \$11,899 |

The main contributor to the increased operating costs for Q4 2008 as compared to Q4 2007 is due to an increase in same-asset property operating costs. For the year ended December 31, 2008 as compared to 2007, acquisitions contributed to 35% of the increase, as there were 18 new properties acquired by the REIT over the last 24 months. Offsetting this increase in Q4 2008, is H&R Property Management Ltd. waiving \$1.5 million of the incentive bonus to which they were entitled based on the property management agreement.

Same-asset property operating costs have increased by \$4.4 million for the three months ended December 31, 2008 and have increased by \$6.4 million for the year ended December 31, 2008 over their respective 2007 periods. The majority of the increase is due to an increase in repairs and maintenance and realty taxes. The increase for the twelve months ended December 31, 2008 in property operating costs for Boscov’s Department Stores related to a bad debt provision of \$1.0 million which was recorded during Q3 2008 for rent that was charged but not received in August 2008.

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| Same-Asset Property Operating Income (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|---------|------------------------|-----------|-----------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Same-asset rentals | \$146,242 | \$141,235 | \$5,007 | \$566,750 | \$562,693 | \$4,057 |
| Same-asset - property operating costs | 52,098 | 47,702 | 4,396 | 188,964 | 182,539 | 6,425 |
| Total same-asset - property operating income | \$94,144 | \$93,533 | \$611 | \$377,786 | \$380,154 | (\$2,368) |
| Total same-asset – property operating income excluding straight-lining of contractual rent | \$90,484 | \$90,244 | \$240 | \$361,669 | \$363,473 | (\$1,804) |

As can be seen above, total same-asset property operating income has increased by \$0.6 million for the three months ended December 31, 2008 and has decreased by \$2.4 million for the year ended December 31, 2008 as compared to previous periods. The reason for the increase in the three months is due partially to a weakening of the Canadian dollar during Q4 2008 as compared to Q4 2007. This is more evident when the same-asset property income is split between Canada and the U.S. as shown below.

The decrease for the year ended December 31, 2008 over the 2007 year is due primarily to the adjustment of the amortization calculation of rent amortization of above- and below- market rents for a specific tenant.

| Canada (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|-----------|-----------|------------------------|-----------|-----------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Same-asset total rentals | \$117,209 | \$119,050 | (\$1,841) | \$466,404 | \$463,300 | \$3,104 |
| Same-asset property operating costs | 46,451 | 44,349 | 2,102 | 172,207 | 167,498 | 4,709 |
| Same-asset property operating income | \$70,758 | \$74,701 | (\$3,943) | \$294,197 | \$295,802 | (\$1,605) |

| United States | Three months ended December 31 | | | Year ended December 31 | | |
|--------------------------------------|--------------------------------|----------|---------|------------------------|----------|---------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Same-asset total rentals | 29,033 | 22,185 | 6,848 | 100,346 | 99,393 | 953 |
| Same-asset property operating costs | 5,647 | 3,353 | 2,294 | 16,757 | 15,041 | 1,716 |
| Same-asset property operating income | \$23,386 | \$18,832 | \$4,554 | \$83,589 | \$84,352 | (\$763) |

| | | | | | | |
|---|-----------------|----------|-------|------------------|-----------|-----------|
| Total same-asset property operating income | \$94,144 | \$93,533 | \$611 | \$377,786 | \$380,154 | (\$2,368) |
|---|-----------------|----------|-------|------------------|-----------|-----------|

The decrease in the Canadian same-asset property operating income is mainly due to the correction of the rent amortization as previously mentioned.

The increase in the U.S. same-asset property operating income for the quarter is due to the strengthening of the U.S. dollar during the last quarter of the year. Had the U.S. same-asset property operating income been reported in U.S. dollars, the dollar value would have been virtually the same for the three months ended December 31, 2008 as it was for the three months ended December 31, 2007 as well as for the respective twelve month periods.

Mortgage Interest and other Income

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|------------------------------------|--------------------------------|-------|--------|------------------------|---------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Mortgage interest and other income | \$848 | \$554 | \$294 | \$3,138 | \$2,590 | \$548 |

Interest income increased when comparing both Q4 2008 to Q4 2007 and for the year ended December 31, 2008 as compared to December 31, 2007. The increase is primarily due to the timing of equity offerings and the deployment of those funds. In 2007, an equity offering was completed in May as opposed to the securities offering in 2008 that was completed in June. It took longer for the REIT to deploy the funds in 2008 as opposed to 2007, resulting in higher interest income earned. In addition, there were two new vendor takeback mortgages which the REIT granted upon the sale of 110 Bloor St., W in December of 2008 along with a new mortgage receivable granted in July 2008 to a joint venture in which the REIT has an 80% ownership.

Mortgage and Other Interest Expense

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|-------------------------------------|--------------------------------|----------|--------|------------------------|-----------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| | | | % | | | % |
| Mortgage interest | \$49,419 | \$45,588 | 8 | \$189,717 | \$181,587 | 4 |
| Convertible debenture interest | 2,426 | - | n/a | 5,482 | - | n/a |
| Amortization of mortgage premium | (421) | (487) | (14) | (1,741) | (2,175) | (20) |
| Bank interest and charges | 806 | 1,066 | (24) | 4,649 | 3,698 | 26 |
| | 52,230 | 46,167 | 13 | 198,107 | 183,110 | 8 |
| Capitalized interest | (7,689) | (3,055) | 152 | (22,793) | (7,879) | 189 |
| Mortgage and other interest expense | \$44,541 | \$43,112 | 3 | \$175,314 | \$175,231 | n/a |

There was a slight increase in mortgage interest expense for the fourth quarter and for the year. The repayment of mortgages maturing and the refinancing of a \$35 million mortgage, in which the interest rate was reduced from 10.75% to 4.96% during the first quarter of 2008, partially offset the increase in mortgages payable over the corresponding periods and the change in the Canadian/U.S. exchange rate (for the fourth quarter). Included in mortgage interest for the three months ended December 31, 2008 is an accrual of \$2.1 million and for the year ended December 31, 2008 is an accrual of \$2.8 million which relates to interest accrued for the mortgages on the Boscov's Department Stores after the lender had taken control of the properties. Upon the lender taking title to the properties and releasing the REIT's subsidiaries from all obligations under these mortgages this accrual will be reversed into income.

During the three months ended June 30, 2008, the REIT issued \$115 million of convertible debentures. These debentures on which interest is payable semi-annually, resulted in interest expense of \$2.4 million for the three month period and \$5.5 million for the twelve month period.

Bank interest and charges decreased for the three months and increased for the twelve months ended December 31, 2008 as compared to the comparative 2007 periods. This was primarily due to timing and use of borrowed funds year over year. In addition, there was increased utilization of the general operating facility during the first and second quarter of 2008 as compared to 2007.

The amount of capitalized interest will continue to increase as the REIT continues to fund its development projects. The majority of this increase is due to the Bow development.

As at December 31, 2008 and 2007, the REIT's weighted average contractual mortgage rate was 6.2% and 6.3%, respectively.

Depreciation of Income Properties

| | Three months ended December 31 | | | Year ended December 31 | | |
|-----------------------------------|--------------------------------|----------|--------|------------------------|----------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| (in thousands of dollars) | | | % | | | % |
| Depreciation of income properties | \$24,497 | \$22,177 | 10 | \$95,871 | \$87,853 | 9 |

Depreciation of income properties is charged to income on a straight-line basis over the estimated useful life of the property. The increase is due primarily to the continued acquisition of properties during 2008 and 2007.

Amortization of Deferred Expenses and Intangible Costs

| | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|---------|-----------|------------------------|----------|---------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| (in thousands of dollars) | | | | | | |
| Amortization of deferred leasing expenses | \$1,435 | \$1,094 | \$341 | \$5,101 | \$4,218 | \$883 |
| Amortization of deferred costs | 934 | 863 | 71 | 3,420 | 3,067 | 353 |
| Amortization of intangible assets on acquisitions | 4,550 | 6,208 | (1,658) | 23,523 | 25,183 | (1,660) |
| Total amortization | \$6,919 | \$8,165 | (\$1,246) | \$32,044 | \$32,468 | (\$424) |

Amortization of deferred leasing expenses increased slightly when comparing Q4 2008 to Q4 2007 and for the year ended December 31, 2008 as compared to December 31, 2007 due to new and renewed leases which came into effect throughout the entire portfolio.

Amortization of deferred costs increased when comparing Q4 2008 to Q4 2007 and for the year ended December 31, 2008 as compared to December 31, 2007. This change is due to timing of projects being incurred in the REIT's ongoing capital projects.

Amortization of intangible assets on acquisitions of properties decreased from Q4 2007 to Q4 2008 and for the year ended December 31, 2008 as compared to December 31, 2007. The reason for the decrease is due to an adjustment in the calculation of amortization of one property. The entire amount was recorded in Q4 2008. For acquisitions of properties after September 12, 2003, the acquisition cost is allocated to land, buildings, paving and equipment and intangible assets. These intangible assets 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.

Impairment Loss on Income Properties, Intangible Assets and Intangible Liabilities

| | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|------|--------|------------------------|------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| (in thousands of dollars) | | | % | | | % |
| Impairment loss on income properties, intangible assets and intangible liabilities | \$3,434 | - | n/a | \$53,665 | - | n/a |

On August 4, 2008, a tenant, Boscov's Department Stores, filed for Chapter 11 protection with a United States bankruptcy court. The tenant terminated all seven leases. The seven stores had a gross leasable area of approximately 1,679,000 square feet. As at December 31, 2008, these seven properties had non-recourse mortgages outstanding totalling \$142.9 million.

Management has handed over control of the income properties to the mortgage lender and therefore expects to be released from any further obligations under these non-recourse mortgages. Because the lender has not accepted transfer of title and has not legally released the REIT's subsidiaries from its debt obligation, GAAP requires the income properties to be written down to their fair value. Management has written the properties down to \$130.4 million which is \$12.5 million lower than the mortgages balance outstanding. Once title is transferred to the lenders, management expects a reversal of approximately \$12.5 million impairment loss as the REIT will write off the mortgage balance and income properties balance. The total writedown incurred for the year ended was \$53.2 million (December 31, 2007 – nil).

In addition, during Q4 2008, the REIT had an option to purchase the remaining interest in a U.S. property. This option expired this quarter, and as a result, an additional \$0.4 million, which previously was included in sundry assets, was written off.

| Net Loss on Foreign Exchange | Three months ended | | | Year ended | | |
|--|--------------------|------|----------|-----------------|------|----------|
| | December 31 | | | December 31 | | |
| (in thousands of dollars) | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Realized loss on foreign exchange – the REIT | \$27,341 | - | \$27,341 | \$27,341 | - | \$27,341 |
| Unrealized loss on foreign exchange – the REIT | 3,825 | - | 3,825 | - | - | - |
| Gain on foreign exchange – Finance Trust | (20,251) | - | (20,251) | (20,251) | - | (20,251) |
| Net loss on foreign exchange | \$10,915 | - | \$10,915 | \$7,090 | - | \$7,090 |

The REIT's net loss on foreign exchange represents the net change due to the following. The change in the foreign exchange rate from January 17, 2008 (the date of management's intention to repay USD \$125 million of the loan which no longer would represent its net investment in U.S. Holdco to October 1, 2008 (the date the loan was repaid)). The cumulative amount of foreign currency, which was reported in other comprehensive income, was realized and reduced by \$27.3 million. The REIT was required to reverse the unrealized loss that was recorded on its financial statements after completion of the Plan of Arrangement. These two losses were offset by the gain on foreign exchange recorded in Finance Trust due to a difference in exchange rates between the date the note was issued and December 31, 2008.

| Trust Expenses | Three months ended December 31 | | | Year ended December 31 | | |
|----------------------------------|--------------------------------|---------|--------|------------------------|---------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| (in thousands of dollars) | | | % | | | % |
| Trust expenses | \$3,664 | \$1,522 | 141 | \$10,494 | \$5,929 | 77 |

Trust expenses are primarily comprised of salaries, professional fees and trustee fees. Trust expenses increased quarter over quarter and increased for the year.

During Q4 2008, the REIT was required to expense \$1.6 million of costs incurred with the Plan of Arrangement. For the year, \$3.8 million of costs were expensed. These are non-recurring expenses.

Salaries, professional fees and trustee fees represented approximately 20.6%, 16.8% and 6.4% for Q4 2008 and 25.8%, 21.2% and 5.6% for the year ended December 31, 2008 of normalized trust expenses (excluding the reorganization costs). The percentages for Q4 2007 are 44.0%, 30.3% and 3.7% while for the year ended December 31, 2007, the percentages are 39.8%, 33.2% and 5.3%.

For the year ended December 31, 2008, total trust expenses amounted to 1.7% of rentals from income properties (December 31, 2007 - 1.0%).

H&R REIT and H&R FINANCE TRUST - MD&A – December 31, 2008

| Income Taxes (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|------------|----------|------------------------|------------|-------------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Current income taxes at U.S. federal applicable state statutory rates | \$46 | \$162 | (\$116) | \$326 | \$413 | (\$87) |
| U.S. federal withholding taxes | (391) | 501 | (892) | 1,272 | 2,284 | (1,012) |
| Future income taxes at Canadian corporate and applicable provincial statutory rates | 4,940 | (20,515) | 25,455 | 15,628 | 115,635 | (100,007) |
| Total income taxes | \$4,595 | (\$19,852) | \$24,447 | \$17,226 | \$118,332 | (\$101,106) |
| Future income taxes included in the determination of other comprehensive income (loss) | (10) | 875 | (885) | 612 | 875 | (263) |

The REIT is generally subject to tax in Canada under the Tax Act with respect to its taxable income each year, except to the extent such taxable income is paid or made payable to Unitholders and deducted by the REIT for tax purposes.

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

Due to the enactment of the specified investment flow-through ("SIFT") rules on June 22, 2007, the REIT commenced recognizing future income tax assets and liabilities with respect to the temporary differences between the carrying amounts and tax basis of its assets and liabilities, including those related to its subsidiary trusts, that are expected to reverse in or after 2011. The SIFT rules are not expected to apply to the REIT until 2011 as it provides a transition period for publicly traded trusts that existed prior to November 1, 2006. In addition, the SIFT rules will not apply to an entity that qualifies for the REIT exemption. On December 20, 2007, the Minister of Finance announced his intention to introduce technical amendments to the SIFT rules to make it easier to qualify for the REIT exemption, including removing any distinction between Canadian and foreign real properties. Legislation for these technical amendments was introduced in the House of Commons on February 6, 2009.

The REIT does not currently meet certain technical requirements for the REIT exemption. Management is of the view that it can make changes that are within its control, and restructure its investment in H&R Portfolio Limited Partnership ("HRLP") in order to qualify for the REIT exemption prior to 2011. As the REIT currently does not qualify, GAAP requires the REIT to prepare its accounts on the basis that the new rules currently apply. Future income tax assets or liabilities are recorded using tax rates and laws expected to apply when the temporary differences are expected to reverse. The SIFT rules resulted in the REIT including a future income tax liability of \$133.3 million in the consolidated balance sheet at December 31, 2008, with a future income tax expense of \$4.9 million reflected as a charge to consolidated earnings for the three months ended December 31, 2008 and a future income tax recovery of \$0.01 reflected as a charge to other comprehensive income. The charge to the consolidated earnings for the year ended December 31, 2008 amounts to \$15.6 million and a future income tax expense of \$0.6 million is reflected as a charge to other comprehensive income. Temporary differences expected to reverse in or after 2011 have been measured using a tax rate of 29.5% in 2011 and 28% thereafter.

Future income tax recovery relating to other comprehensive income of \$0.01 million for the quarter ended December 31, 2008 (Q4 2007 – (\$0.9 million)) and income tax expense for the year ended December 31, 2008 of \$0.6 million (December 31, 2007 - \$0.9 million) represent future taxes to be paid on other comprehensive income. This liability will decrease as other comprehensive income is transferred to earnings.

For the quarter ended December 31, 2008, current income taxes amounted to \$0.05 million (Q4 2007 - \$0.2 million). For the year ended December 31, 2008, current income taxes amounted to \$0.3 million (December 31, 2007 - \$0.4 million). Substantially all the current income taxes are due to various U.S. state taxes.

Under United States tax law, the REIT may be subject to tax on a portion of its United States source income. The REIT 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 REIT.

On September 21, 2007, the fifth protocol (the "Protocol") to the Canada-U.S. Income Tax Convention was signed. The Protocol was ratified in December 2008, and provides for the eventual elimination of withholding taxes on interest payments between related parties. The 10% withholding tax on cross-border interest payments between related parties (such as between the REIT and its wholly-owned U.S. subsidiary) will be reduced as follows:

7% as of January 1, 2008 (retroactively); 4% as of January 1, 2009 and 0% as of January 1, 2010 and later years. Therefore, the REIT is expecting a refund of approximately \$0.5 million for interest paid from January 1, 2008 to September 30, 2008. For the year ended December 31, 2008, the REIT was subject to U.S. withholding tax of \$1.3 million (December 31, 2007 - \$2.3 million), based on taxable U.S. source income of \$17.4 million (December 31, 2007 - \$22.8 million).

See the "Tax Risk" section for a discussion of draft legislation proposed by the Minister of Finance regarding the federal income taxation of publicly listed or traded income trusts and certain other flow-through entities.

Non-controlling Interest

Net earnings attributable to the Class B unitholders of HRLP, a subsidiary partnership, have been segregated and deducted from the net earnings of the REIT. For a further discussion regarding non-controlling interest, please refer to "Financial Condition".

The non-controlling interest is separated between continuing operations and discontinued operations. The amount of non-controlling interest added to income from continuing operations for Q4 2008 is \$0.8 million (Q4 2007 – (\$2.5 million)). For the year ended December 31, 2008, the amount of non-controlling interest deducted from income from continuing operations is \$0.1 million (December 31, 2007 - (\$1.2 million)). See "Net Earnings from Discontinued Operations" below for the non-controlling interest deducted from income from discontinued operations.

Net Earnings from Discontinued Operations

When the REIT decides to sell an asset that no longer fits its investment strategy and re-distribute the proceeds towards more attractive opportunities or when a tenant exercises an option under the terms of its lease to purchase a property, or when the REIT 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 presented on the income statement in net earnings from discontinued operations as summarized below:

Net Earnings from Discontinued Operations

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|---------|-----------|------------------------|----------|-----------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| Net property operating income | \$1,156 | \$3,197 | (\$2,041) | \$8,418 | \$10,054 | (\$1,636) |
| Income taxes | - | - | - | - | (3) | 3 |
| Gain on sale of income properties | 41,079 | 2,563 | 38,516 | 71,201 | 9,686 | 61,515 |
| Non-controlling interest | (1,880) | (299) | (1,581) | (3,743) | (1,050) | (2,693) |
| Net earnings from discontinued operations | \$40,355 | \$5,461 | \$34,894 | \$75,876 | \$18,687 | \$57,189 |

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During the three months ended December 31, 2008, the REIT sold one income property (December 31, 2007 – two) for gross proceeds of \$79.0 million (2007 – \$8.7 million). During the year ended December 31, 2008, the REIT sold 16 properties (2007 – seven) for gross proceeds of \$302.7 million (2007 - \$43.8 million). The net earnings from discontinued operations include the results from these properties as well as from the properties currently held for sale.

2008 Dispositions

| Property | Property Type | Date Sold | Square Footage | Gross Proceeds (\$ Millions) | Ownership Interest disposed |
|---|---------------|-------------|------------------|------------------------------|-----------------------------|
| 6580 Millcreek Dr., Mississauga, ON | Industrial | Mar 05, 08 | 249,634 | \$21.2 | 100% |
| 6590 Millcreek Dr., Mississauga, ON | Industrial | Mar 05, 08 | 225,694 | \$19.2 | 100% |
| 1750 Deptford Centre Rd., Deptford, NJ | Retail | May 20, 08 | 175,752 | \$13.8 | 55% |
| 720 Maloney Blvd., Gatineau, QC | Retail | June 26, 08 | 283,970 | \$43.6 | 100% |
| 220 Chain Lake Dr., Halifax, NS | Retail | June 26, 08 | 138,027 | \$17.4 | 100% |
| 1701 Merivale Rd., Ottawa, ON | Retail | June 26, 08 | 127,489 | \$32.7 | 100% |
| 1160 Desserte Ouest, Laval, QC | Retail | June 26, 08 | 116,147 | \$10.9 | 100% |
| 878-894, 900 Tower St., S, Fergus, ON | Retail | June 26, 08 | 105,955 | \$9.1 | 100% |
| 1345-1365 Huron St. and 1250-1270 Highbury Ave., London, ON | Retail | June 26, 08 | 87,529 | \$15.2 | 100% |
| 448 St. Clair St., Chatham, ON | Retail | June 26, 08 | 71,423 | \$8.7 | 100% |
| 110 North Front St., Belleville, ON | Retail | June 26, 08 | 66,714 | \$10.2 | 100% |
| 857 Cecile Blvd., Hawkesbury, ON | Retail | June 26, 08 | 54,950 | \$3.8 | 100% |
| 900 Aberdeen Ave., Hawkesbury, ON | Retail | June 26, 08 | 17,032 | \$4.3 | 100% |
| 21 College St. W., Belleville, ON | Retail | June 26, 08 | 5,211 | \$0.3 | 100% |
| 2810 Matheson Blvd., E., Mississauga, ON | Office | Aug 19, 08 | 129,103 | \$13.3 | 50% |
| 110 Bloor St., W., Toronto, ON | Retail | Dec 5, 08 | 86,164 | \$79.0 | 100% |
| Total | | | 1,940,794 | \$302.7 | |

2007 Dispositions

| Property | Property Type | Date Sold | Square Footage | Gross Proceeds (\$ Millions) | Ownership Interest disposed |
|---|---------------|------------|----------------|------------------------------|-----------------------------|
| 4211-137 th Ave. & 4204-137 th Ave., Edmonton, AB | Retail | Feb 01, 07 | 55,900 | \$13.8 | 100% |
| 300 Biscayne Cr., Brampton, ON | Industrial | Mar 28, 07 | 31,606 | 5.7 | 100% |
| 388 Markland St., Markham, ON | Industrial | Jul 4, 07 | 79,039 | 7.1 | 100% |
| 1459 Tiger Park Lane, Gulf Breeze, FL | Retail | Aug 21, 07 | 14,490 | 4.2 | 100% |
| 1157 Azalea Ave., Richmond, VA | Retail | Aug 21, 07 | 13,905 | 4.3 | 100% |
| 1350-1380 Matheson Blvd., E., & 5391 Ambler Dr., Mississauga, ON | Industrial | Nov 1, 07 | 110,059 | 8.4 | 100% |
| 780 O'Brien Rd., Renfrew, ON | Retail | Dec 21, 07 | 2,700 | 0.3 | 100% |
| Total | | | 307,699 | \$43.8 | |

Properties currently held for sale

| Property | Property Type | Square Footage | Ownership Interest |
|---------------------------------------|---------------|----------------|--------------------|
| 75 Frontenac Dr., Markham, ON | Industrial | 243,614 | 100% |
| 2435 East-West Connector, Austell, GA | Retail | 115,396 | 100% |
| Total | | 359,010 | |

DISTRIBUTABLE CASH

Management uses distributable cash, which is defined in the Declaration of Trust and of which at least 80% must be distributed to Unitholders, as a relevant measure of its ability to earn and distribute cash returns to Unitholders.

A primary objective of the Trusts is to provide Unitholders with stable growing cash distributions, hence management considers DC to be an indicative measure in evaluating the Trusts performance. However, DC should not be construed as an alternative to net earnings or cash provided by operations determined in accordance with GAAP as an indicator of the Trusts performance. (See also “Non-GAAP Financial Measures”). Depreciation, accrued rent, gains or losses on sales, future income taxes and other non-cash items are added to, or deducted from, net earnings to determine the amount of cash available for distribution. The most substantial adjustment to calculate DC 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 Trusts have also issued Stapled Units to mirror the Class B Units of HRLP which gave rise to the non-controlling interest adjustment in determining net earnings. As these Stapled Units have been issued and are outstanding and monthly distributions are made thereon as with all other units, DC 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 and outstanding.

In connection with the REIT’s development of the Bow (as defined below under “Liquidity and Capital Resources – Capital Resources”), the REIT has provided a loan to a wholly-owned subsidiary of the REIT, and is charging an interest rate of 9% per annum. The interest earned on this loan is eliminated on consolidation but as the REIT considers it a cost of the project, the difference between the interest capitalized to the project in accordance with GAAP (currently 6.2%) and the 9% charged has been added back to DC.

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| Distributable Cash | Three months ended December 31 | | Year ended December 31 | |
|--|-----------------------------------|----------|---------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| (in thousands of dollars except unit and per unit amounts) | | | | |
| Net earnings (loss) | \$45,984 | \$48,691 | \$98,530 | (\$2,193) |
| Add (deduct) | | | | |
| Depreciation of income properties | 24,506 | 22,557 | 96,400 | 92,704 |
| Net variable interest entities adjustment | - | 75 | - | 302 |
| Straight-lining of contractual rent | (3,960) | (3,614) | (15,832) | (18,302) |
| Amortization of intangible assets on acquisitions | 4,550 | 6,222 | 23,523 | 26,296 |
| Amortization of above- and below-market rent | 3,292 | (350) | 2,753 | (720) |
| Amortization of mortgage premium | (466) | (532) | (1,922) | (2,354) |
| Gain on sale of income properties | (41,079) | (2,563) | (71,201) | (9,686) |
| Unit based compensation | 66 | - | 74 | - |
| Impairment loss on income properties, intangible assets and intangible liabilities | 3,434 | - | 53,665 | - |
| Interest differential on the Bow project | 2,669 | 890 | 7,594 | 2,360 |
| Net loss on foreign exchange | 11,166 | - | 7,341 | - |
| Withholding taxes | (391) | 501 | 1,272 | 2,284 |
| Future income taxes | 4,940 | (20,515) | 15,628 | 115,635 |
| Net earnings (loss) attributable to non-controlling interest | 1,074 | 2,765 | 3,829 | (123) |
| Distributable cash | \$55,785 | \$54,127 | \$221,654 | \$206,203 |
| Distributions to unitholders | \$183,274 | \$43,877 | \$327,110 | \$170,422 |
| Distributions to non-controlling interest | 1,965 | 2,390 | 9,498 | 9,558 |
| Total distributions paid | \$185,239 | \$46,267 | \$336,608 | \$179,980 |
| Total distributions paid as a return of capital | \$132,500 | - | \$132,500 | - |
| Total distributions paid in cash | 52,739 | 46,267 | 204,108 | 179,980 |
| Weighted average number of units (in thousands of units) | 146,502 | 135,047 | 141,655 | 131,160 |
| Diluted weighted average number of units (in thousands of units) | 146,502 | 135,786 | 142,040 | 132,003 |
| Basic (adjusted for conversion of non-controlling interest) DC per unit | \$0.381 | \$0.401 | \$1.565 | \$1.572 |
| Diluted DC per unit | \$0.381 | \$0.399 | \$1.561 | \$1.562 |
| Cash distributions paid per unit | \$0.360 | \$0.343 | \$1.440 | \$1.370 |
| Total cash distributions paid per unit as a % of DC | 94.5% | 85.5% | 92.0% | 87.2% |

The major reasons for the net decrease in basic DC per unit of \$0.020 for the quarter ended December 31, 2008 as compared to the quarter ended December 31, 2007 and \$0.007 for the year ended December 31, 2008 as compared to the year ended December 31, 2008 are outlined below.

DC decreased due to the sale of 23 properties (\$346.5 million) over the previous 24 months. Additional decreases were caused by tenants that went bankrupt over the past year and the interest expense from the

convertible debentures. As well, there were non-recurring expenses incurred in conjunction with the creation of Finance Trust and unit dilution due to additional issuance of units during the year.

These decreases were partially offset by increases in DC due to the interest capitalized on the Bow project. The other two items that positively affected DC was an increase in the foreign exchange rate for Q4 2008 as compared to Q4 2007 and the acquisitions incurred over the past 24 months (\$249.2 million).

If the non-recurring expenses of \$1.6 million for Q4 2008 and \$3.8 million for the 2008 year, which were incurred in accordance with the Plan of Arrangement, and the \$2.1 million for the three months and \$2.8 million for the year ended December 31, 2008 of interest expense on the mortgages relating to Boscov's Department Stores were adjusted for, DC would have been \$0.406 per unit for the three months and \$1.611 per unit for the year ended December 31, 2008.

The realized loss on foreign exchange was added back to the calculation of distributable cash. This was done since this was not a cash transaction, but rather a reduction of other comprehensive income.

Distributions made for the respective three months ended December 31, 2008 and 2007 amounted to \$185.2 million and \$46.3 million. Distributions made for the year ended December 31, 2008 and 2007 amounted to \$336.6 million and \$180.0 million, respectively. The percentage of cash distributions paid as a percentage of DC outlined above increased slightly quarter over quarter and for the year ended December 31, 2008 as compared to 2007.

The tax deferred portion of distributions for 2008 for the REIT's portion of the distribution is 46% as compared to 47% for the year ended December 31, 2007. 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.

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The following is a reconciliation of the Trusts distributable cash to cash provided by operations.

| (in thousands of dollars) | Three months ended December 31 | | Year ended December 31 | |
|---|-----------------------------------|----------|---------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Distributable cash | \$55,785 | \$54,127 | \$221,654 | \$206,203 |
| Change in other non-cash operating items | 11,937 | 3,361 | (9,177) | (36,496) |
| Straight-lining of contractual rent increases | 3,960 | 3,614 | 15,832 | 18,302 |
| Net variable interest entities adjustment | - | (75) | - | (302) |
| Rent amortization of tenant inducements | 538 | 430 | 2,060 | 1,779 |
| Amortization of deferred leasing expenses | 1,435 | 1,109 | 5,109 | 4,434 |
| Amortization of deferred costs | 934 | 871 | 3,430 | 3,098 |
| Amortization of mortgage premium | 466 | 532 | 1,922 | 2,354 |
| Interest differential on the Bow Project | (2,669) | (890) | (7,594) | (2,360) |
| Withholding taxes | 391 | (501) | (1,272) | (2,284) |
| Other | 1,129 | 852 | 3,232 | 1,861 |
| Unit based compensation | (66) | - | (74) | - |
| Cash provided by operations | \$73,840 | \$63,430 | \$235,122 | \$196,589 |

Note:

All of the above-noted adjustments made in order to reconcile cash provided by operations to DC of the Trusts are discretionary in nature and the basis for each such adjustment is discussed below.

The Trusts definition of DC does not adjust for the change in other non-cash operating items, which represents balance sheet changes only and therefore is subtracted from DC in order to reconcile to cash provided by operations.

Straight-lining of contractual rent is deducted in calculating DC because the REIT does not receive this cash in the current period. Therefore straight-lining of contractual rent must be added back to reconcile to cash provided by operations.

Even though these are non-cash items, the REIT deducts rent amortization of tenant inducements, amortization of deferred leasing expenses, amortization of deferred financing expenses and amortization of deferred costs to arrive at DC as it is the REIT's intention that DC 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 provided by operations.

Amortization of mortgage premium is deducted in calculating DC 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 provided by operations.

The Bow interest differential, while added back for DC purposes as discussed above has been eliminated on consolidation and must therefore be deducted when calculating cash provided by operations.

Withholding taxes which are added back to DC are deducted when reconciling back to cash provided by operations as these amounts are deducted in determining net income, which flows into cash provided by operations.

Other includes amortization relating to changing the amortization method on financial instruments from the straight line method to the effective interest rate method and the transfer of realized loss on cash flow hedges from accumulated other comprehensive loss to net earnings and the accretion expense on the convertible debentures.

Unit based compensation is added back when calculating DC as this is a non-cash item. This item is included in equity, so must be deducted when reconciling back to cash provided by operations.

SEGMENTED INFORMATION

The REIT invests in office, industrial and retail properties in both Canada and the United States.

The REIT 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 REIT manages all assets on a similar basis.

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

Net property operating income for the three months ended December 31, 2008

| (in thousands of dollars) | Canada | United States | Total |
|--|-----------|---------------|-----------|
| Operating revenue | \$127,001 | \$30,782 | \$157,783 |
| Property operating costs | (49,096) | (5,299) | (54,395) |
| Mortgage and other interest expense | (28,659) | (15,882) | (44,541) |
| Depreciation of income properties | (17,500) | (6,997) | (24,497) |
| Amortization of deferred expenses and intangible costs | (4,747) | (2,172) | (6,919) |
| Net property operating income | \$26,999 | \$432 | \$27,431 |

Net property operating income for the three months ended December 31, 2007

| (in thousands of dollars) | Canada | United States | Total |
|--|-----------|---------------|-----------|
| Operating revenue | \$125,219 | \$25,063 | \$150,282 |
| Property operating costs | (45,627) | (3,835) | (49,462) |
| Mortgage and other interest expense | (31,168) | (11,944) | (43,112) |
| Depreciation of income properties | (16,339) | (5,838) | (22,177) |
| Amortization of deferred expenses and intangible costs | (6,360) | (1,805) | (8,165) |
| Net property operating income | \$25,725 | \$1,641 | \$27,366 |

Net property operating income for the year ended December 31, 2008

| (in thousands of dollars) | Canada | United States | Total |
|--|------------------|----------------|------------------|
| Operating revenue | \$499,242 | \$112,610 | \$611,852 |
| Property operating costs | (178,370) | (19,038) | (197,408) |
| Mortgage and other interest expense | (119,996) | (55,318) | (175,314) |
| Depreciation of income properties | (69,105) | (26,766) | (95,871) |
| Amortization of deferred expenses and intangible costs | (24,274) | (7,770) | (32,044) |
| Net property operating income | \$107,497 | \$3,718 | \$111,215 |

Net property operating income for the year ended December 31, 2007

| (in thousands of dollars) | Canada | United States | Total |
|--|-----------------|----------------|------------------|
| Operating revenue | \$472,204 | \$111,065 | \$583,269 |
| Property operating costs | (168,880) | (16,629) | (185,509) |
| Mortgage and other interest expense | (122,297) | (52,934) | (175,231) |
| Depreciation of income properties | (61,892) | (25,961) | (87,853) |
| Amortization of deferred expenses and intangible costs | (24,490) | (7,978) | (32,468) |
| Net property operating income | \$94,645 | \$7,563 | \$102,208 |

Operating revenue from income properties in the United States has increased by \$5.7 million or 23% for the quarter ended December 31, 2008 compared to the same period in 2007 and by \$1.5 million or 1% for the year ended December 31, 2008 as compared to December 31, 2007. The increase quarter over quarter is due to a large fluctuation in the exchange rate. U.S. operating revenue for the three months ended December 31, 2008 was USD \$25.2 million as compared to December 31, 2007 of USD \$26.3 million, a 4% decrease and U.S. operating revenue was USD \$105.2 million for the year ended December 31, 2008 as compared to USD \$103.8 million for the year ended December 31, 2007, a 1% increase. The reason for the decrease quarter over quarter was due to no rent being received while mortgage interest still continues to accrue as a result of the Boscov's Department Store lease terminations.

Properties located in the United States comprise 30% of the REIT's book value of income properties at December 31, 2008 (December 31, 2007 – 25%). The net property operating income for properties located in the United States for the three months ended December 31, 2008 is income of \$0.4 million. There was \$1.9 million of mortgage interest accrued from the fourth quarter of 2008 for the Boscov's Department Stores mortgages. This also negatively affected the net property income from properties located in the United States for the year ended December 31, 2008.

ASSETS***Income Properties***

The following table lists the properties acquired by the REIT during the year ended December 31, 2008. These acquisitions less the mortgages assumed at closing were funded from the REIT's general operating facility and from the proceeds received from the securities offering that was completed by the REIT in June 2008.

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2008 Acquisitions:

| Property | Property Type | Date Acquired | Square Footage | Purchase Price (\$ Millions) | Contractual Mortgages Assumed on Closing (\$ Millions) | Ownership Interest Acquired |
|--|---------------|---------------|------------------|------------------------------|--|-----------------------------|
| 200 Monroeville Mall, Monroeville, PA | Retail | Feb 12, 08 | 263,700 | \$11.7 | \$8.7 * | 45% |
| 301 South Hills Village, Pittsburgh, PA | Retail | Feb 12, 08 | 264,855 | 11.5 | 8.6 * | 45% |
| 8220 Perry Hall Blvd., Nottingham, MD | Retail | Feb 12, 08 | 219,996 | 10.3 | 7.7 * | 45% |
| 10300 Mill Run Circle, Owings Mill, MD | Retail | Mar 24, 08 | 293,060 | 10.5 | 7.8 * | 45% |
| 7900 Richie Hwy., Glen Burnie, MD | Retail | Mar 24, 08 | 274,050 | 10.6 | 7.9 * | 45% |
| 500 Montgomery Mall, North Wales, PA | Retail | Mar 24, 08 | 182,541 | 9.3 | 6.9 * | 48% |
| 2300 East Lincoln Hwy., Langhorne, PA | Retail | Mar 24, 08 | 181,212 | 9.4 | 6.9 * | 48% |
| SE corner of Washington Rd., & Harrison Rd., Thompson, GA ⁽¹⁾ | Retail | Oct 16, 08 | 14,550 | 5.4 | - | 100% |
| Total | | | 1,693,964 | \$ 78.7 | \$54.5 | |

* Indicates non-recourse. Non-recourse mortgages are generally non-recourse to the REIT but have recourse to the specific property to which the mortgage applies

⁽¹⁾ upon the sale of a property in 2007, the mortgage on that property was not discharged. That mortgage was transferred to this property upon its purchase. The amount of the mortgage outstanding at the date of acquisition was \$2.9 million with an interest rate of 5.8%

2007 Acquisitions:

| Property | Property Type | Date Acquired | Square Footage | Purchase Price (\$ Millions) | Contractual Mortgages Assumed or Secured on Closing (\$ Millions) | Ownership Interest Acquired |
|---|---------------|---------------|------------------|------------------------------|---|-----------------------------|
| 10679 N. Michigan Rd., Zionsville, IN | Retail | Jan 26, 07 | 64,862 | \$15.2 | \$11.3 * | 100% |
| 51 Kelfield Dr., Toronto, ON | Industrial | Feb 14, 07 | 57,976 | 8.6 | 5.8 | 100% |
| 2089 W. Neways Dr., Springville, UT | Office | Feb 26, 07 | 84,511 | 9.6 | 7.4 * | 55% |
| 67 Thames St., Exeter, ON (land purchase) | Industrial | May 31, 07 | - | 0.3 | - | 100% |
| 2900 Veterans Hwy., Metairie, LA | Retail | Jul 10, 07 | 52,848 | 12.6 | 9.3 * | 100% |
| Atlas Portfolio, various provinces, CAN | Industrial | Sep 25, 07 | 1,733,002 | 214.6 | 160.9 | 100% |
| Total | | | 1,993,199 | \$260.9 | \$194.7 | |

* Indicates non-recourse. Non-recourse mortgages are generally non-recourse to the REIT but have recourse to the specific property to which the mortgage applies

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.

An amount of \$7.0 million (December 31, 2007 - \$3.4 million) was capitalized to the income properties acquired during the year ended December 31, 2008. Included in this amount is \$4.8 million of option fees

related to the acquisition of the seven properties which were previously classified as prepaid expenses and sundry assets, with the remainder being primarily acquisition costs.

Income properties increased by \$260.2 million which arose as a result of the U.S. dollar converting at \$1.22 Canadian at December 31, 2008 as compared to \$0.99 Canadian at December 31, 2007.

After accounting for the above acquisitions and the change in foreign exchange, the impairment of income properties and intangible assets and liabilities, the transfer of a \$140 million property from properties under development to income properties, the dispositions mentioned previously and for depreciation and amortization expensed, income properties increased by 2% to \$4.54 billion at December 31, 2008 (including income properties held for sale) from \$4.45 billion at December 31, 2007. The allocation of costs to income properties was done in accordance with the requirements of the Canadian Institute of Chartered Accountants ("CICA") EIC 140 "Accounting for Operating Leases Acquired in Either Asset Acquisition or Business Combination".

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 or renovated is 14.9 years at December 31, 2008 (December 31, 2007 - 14.3 years) and the split between type of asset by age of property is as follows:

| | December 31, 2008 (years) | December 31, 2007 (years) |
|--------------|--------------------------------------|------------------------------|
| Office | 18.1 | 17.1 |
| Industrial | 15.0 | 14.4 |
| Retail | 11.2 | 11.6 |
| Total | 14.9 | 14.3 |

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 REIT.

Legal title to each of the United States properties is held by a separate legal entity which is 100% owned, directly or indirectly, by U.S. Holdco, a subsidiary of the REIT. 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 U.S. Holdco. This structure does not prevent distributions to U.S. Holdco provided there are no conditions of default.

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

| Book Value by Type of Asset (millions) | December 31, 2008 | December 31, 2007 |
|---|--------------------------|-------------------|
| Office | \$1,502 | \$1,535 |
| Industrial | 1,665 | 1,517 |
| Retail | 1,369 | 1,401 |
| | \$4,536 | \$4,453 |

| Book Value by Region (millions) | December 31, 2008 | December 31, 2007 |
|--|--------------------------|-------------------|
| Ontario | \$1,865 | \$1,934 |
| Alberta | 608 | 622 |
| Other | 456 | 483 |
| Quebec | 244 | 294 |
| Canada | 3,173 | 3,333 |
| United States | 1,363 | 1,120 |
| Total | \$4,536 | \$4,453 |

Properties under development

The REIT entered into agreements to develop the Bow, a 2 million square foot head office complex in Calgary, Alberta for a budgeted cost of approximately \$1.5 billion. The budget includes capitalized interest on the REIT's equity investment and the 1,361 parking stalls on both the North and South Blocks. The previous budget of \$1.4 billion did not include any allocation of South Block costs. The REIT is expecting to incur approximately \$375 million of the Bow's development costs over the next twelve months. See Liquidity and Capital Resources for the budget breakdown and the anticipated sources of funds.

The building is fully pre-leased to EnCana Corporation for 25 years. EnCana Corporation will begin to occupy the building in tranches scheduled to commence in the second half of 2011 with the final tranche occurring in 2012. The total annualized year 1 projected income from the Project is expected to be \$94.3 million. Rent step ups will be 0.75% per annum on the EnCana lease and 1.5% per annum on the parking income for the full 25-year term. In certain circumstances, should the delivery of tranches of space within the project be delayed, the REIT will be liable to the tenant for certain delay costs which may be significant. During Q4 2008, the REIT incurred an additional \$49.1 million in this project to bring the REIT's total investment to \$402.0 million (December 31, 2007 - \$190.0 million). The steel is erected for the first tier (three floors) excluding the atrium. All three tower cranes are now erected and operational. The main ground floor slab has been poured and has opened to trucks for steel erection and other logistics. Steel fabrication is ongoing in many plants across Canada from Quebec through to BC.

On December 21, 2007, the REIT purchased a property under construction in Ajax, Ontario for \$109.6 million, which was the total cost expended by the vendor to date. The REIT was responsible for completing the construction of the 910,000 square foot state of the art distribution/warehouse/cold storage facility which had a final all-in cost of approximately \$140 million. As part of the transaction, the vendor granted the REIT a two-year second mortgage in the amount of \$27.8 million, at a 6% interest rate. The REIT obtained permanent financing for most of the balance of the purchase price. The building was pre-leased for a term of 20 years. During the year ended December 31, 2008, the vendor take back mortgage was increased by \$6.9 million to a total of \$34.7 million. This vendor takeback mortgage is due in November 2009. This property was transferred to income properties in Q2 2008 when the tenant commenced paying rent on May 1, 2008. The project was completed on schedule and at the budgeted cost of approximately \$140 million.

An investment of \$25.4 million was made in March 2006 (in which the REIT 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 upon completion. The REIT has granted a mortgage receivable to the joint venture for \$16 million in total. This is to replace the previous bank indebtedness associated with this land. See mortgages receivable for further information. This investment in properties under development increased by \$3.1 million to \$32.7 million at December 31, 2008 from \$29.6 million at December 31, 2007.

In August 2008, an investment of \$34.5 million was made to purchase 98.6 acres of development land located in Caledon, Ontario. The land forms part of the planned community of Mayfield West. The project is expected to produce 1,750,000 sq.ft. of industrial properties. As at December 31, 2008, this investment had increased to \$38.5 million.

During Q4 2007, the REIT exercised its purchase option and commenced construction of the 348,000 square foot Phase III expansion of Bell Canada's state-of-the-art office complex in Mississauga, Ontario. The project has an estimated construction cost of \$135 million and is expected to be substantially completed by the end of January 2009. As at December 31, 2008, the amount incurred on this development was \$117.0 million (December 31, 2007 - \$33.1 million). The tenant commences paying rent on January 1, 2009.

The transactions above have given rise to a total of \$590.2 million for properties under development at December 31, 2008 (December 31, 2007 - \$366.1 million).

Deferred Expenses

| (in thousands of dollars) | December 31, 2008 | December 31, 2007 |
|----------------------------------|--------------------------|-------------------|
| Deferred leasing | \$28,276 | \$26,925 |
| Deferred costs | 19,220 | 18,153 |
| | \$47,496 | \$45,078 |

Deferred leasing expenses relate to those expenditures incurred to re-lease premises once it becomes 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. After adjusting for amortization of \$5.1 million (including amortization included within discontinued operations) and the writing off of \$1.1 million due to the sale of properties, the total leasing costs incurred during the year ended December 31, 2008 was \$7.7 million (December 31, 2007 - \$3.6 million). Some of the larger costs during the year were incurred at the following properties:

- 26 Wellington St. E, Toronto, ON
- 160 Elgin St., Ottawa, ON
- 136 Charlotte St. Halifax, NS
- 69 Yonge St., Toronto, ON
- 55 West Dr., Brampton, ON
- 35 Alkenback St., Napanee, ON
- 475 Admiral Blvd., Mississauga, ON

Deferred costs represent those costs incurred under the REIT's capital improvement program which are deferred and amortized. Of the total of \$5.2 million incurred during the year ended December 31, 2008 (December 31, 2007 - \$6.4 million), the majority of these costs were incurred at the following properties:

- 25 Sheppard Ave. W, Toronto, ON
- 26 Wellington St. E, Toronto, ON
- 310-330 Front St., Toronto, ON
- 411-1st St., Calgary, AB
- 69 Yonge St., Toronto, ON
- 160 Elgin St., Ottawa, ON
- 7500 Lundy's Lane Blvd., Niagara Falls, ON

The REIT wrote off \$0.6 million of deferred costs due to the sale of properties during the year ended December 31, 2008.

The REIT expects to recover approximately 75% of these costs in accordance with the respective tenant leases.

Capital expenditure and non-recoverable costs required to maintain the REIT's portfolio had been relatively immaterial prior to 2004. However, the REIT 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. The majority of the program was aimed at the REIT's multi-tenant office portfolio which had experienced relative weakness over the last three years in terms of leasing demand and rental rates.

Total expenditures in 2006 and 2007 amounted to \$7.6 million and \$6.4 million, respectively. The budget for 2009 is \$7.8 million (of which the REIT expects to recover approximately 85% of these costs). The budget for 2010 is \$12.5 million (of which the REIT expects to recover approximately 85% of these costs). The REIT expects to be able to fund its capital expenditure program through excess cash generated by operations.

Accrued Rent Receivable

Certain leases call for rental payments that increase over the lease 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 17% or \$16.9 million from \$100.4 million at December 31, 2007 to \$117.3 million at December 31, 2008 with a corresponding increase to rentals from income properties. This increase was partially offset by the sale of assets and the writing off of the accrued rent receivable relating to Boscov's Department Stores of \$3.8 million during the year ended December 31, 2008.

The chart below lists some of the larger contractual rental step ups for the REIT occurring over the next 12 months.

| Property | Sq.ft. | Rent Increase (\$ psf) | Effective date of increase | Annualized Rental Increases (in thousands of dollars) |
|-------------------------------|---------|---------------------------|-------------------------------|--|
| 25 Sheppard, Ave., W | 82,506 | 6.00 | Jan 1, 09 | 495 |
| 1600 Lionel Boulet | 311,103 | 0.52 | Jan 1, 09 | 162 |
| 2300 Schenker Blvd. | 742,000 | 0.45 | Mar 1, 09 | 334 |
| 1880 Matheson Blvd, E | 216,439 | 1.22 | Mar 4, 09 | 264 |
| 100 Metropolitan Blvd. | 738,102 | 0.49 | Apr 29, 09 | 362 |
| 25 Sheppard Ave., W | 160,437 | 8.00 | Jul 1, 09 | 1,283 |
| 220 Chemin du Tremblay | 727,966 | 0.41 | Aug 11, 09 | 298 |
| 55 Yonge St. | 98,051 | 1.91 | Sep 1, 09 | 187 |
| Rona portfolio (9 properties) | 973,484 | 0.86 | Nov 2, 09 | 837 |

Cash and Cash Equivalents

Cash and cash equivalents decreased to \$22.2 million at December 31, 2008 from \$24.7 million at December 31, 2007. Included in the balance at December 31, 2008 is \$4.5 million (December 31, 2007 - \$12.2 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 and amounts held in escrow for the repayment of mortgages.

Mortgages and Amounts Receivable

In conjunction with the sale of ten income-producing properties, the purchaser agreed to assume an aggregate mortgage balance of \$82.6 million, and indemnify the REIT until such time that the lenders consent and release the REIT in respect of these mortgages. The REIT has been legally released from its obligation on eight properties. At December 31, 2008, the REIT has not been legally released from its mortgage obligation for the remaining two properties, resulting in an outstanding aggregate mortgage balance of \$10.5 million. As a result, the REIT recorded an amount receivable from the purchaser at fair value which is equivalent to the contractual mortgages payable balance outstanding as at December 31, 2008 and continues to record the aggregate mortgage payable balance as at December 31, 2008. The mortgage receivable balance is due on demand if: a) the lenders do not consent to the assumption of the

mortgages payable balances by the purchaser, resulting in the outstanding mortgages payable balances being due on demand by the lender; and b) the purchaser fails to fulfill the monthly contractual mortgage payments under the original debt agreements.

Upon the sale of 110 Bloor St. in December 2008, the REIT took back two mortgage receivables. The first is for \$58 million due December 1, 2010, bearing interest at 6% per annum with interest being payable monthly. Under GAAP, the REIT was required to perform a mark to market valuation on this mortgage to increase the interest rate to fair value as the mortgage is a secondary charge on the property. This reduced the gain by \$1.0 million and reduced the book value of the mortgage by \$1.0 million. The second vendor takeback mortgage is for \$3.0 million, bearing interest at 6% per annum, with interest only being due quarterly and maturing December 1, 2013. Both amounts may be prepaid at any time.

There was one property for which the REIT had provided a vendor take-back mortgage totalling \$16.4 million (December 31, 2007 - \$16.3 million) with an interest rate of 5.3% per annum, repayable on December 13, 2009.

During the twelve months ended December 31, 2008, the REIT granted a mortgage receivable to a joint venture in which the REIT has an 80% ownership interest. As a result, there is an additional \$3.2 million (December 31, 2007 – nil) which is currently outstanding from the joint venture partner. This mortgage receivable bears interest at a rate of prime plus 115 basis points and is repayable 60 days after demand but not earlier than July 28, 2009.

Other Assets

Tenant inducements represent those costs for which the REIT 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 for the year ended December 31, 2008 decreased by \$2.0 million to a balance of \$15.0 million (December 31, 2007 - \$17.0 million) due to amortization.

Prepaid expenses and sundry assets decreased from \$22.4 million at December 31, 2007 to \$13.8 million at December 31, 2008, a decrease of 38.4%. The decrease is primarily the result of the utilization of a \$10 million deposit for the purchase of additional lands for the Bow, which had previously been classified as a sundry asset.

Accounts receivable increased by \$1.3 million between December 31, 2007 and December 31, 2008. The increase is due to fluctuations arising during the normal course of business operations. Of the \$7.4 million of accounts receivable, tenant receivables account for \$4.7 million of this balance. Of this amount, 37% has been outstanding for less than 30 days, with an additional 34% being outstanding for 31-59 days. In addition, 26% represents loans outstanding to tenants for which there are fixed repayment schedules. The remaining receivables represent those amounts not yet billed for occupancy and taxes to tenants and work in progress.

LIABILITIES

The REIT's Declaration of Trust limits the indebtedness of the REIT (subject to certain exceptions) to a maximum of 65% of the gross book value ("GBV") of the REIT. The REIT's allocation of debt, including bank indebtedness, is as follows:

| | December 31, 2008 | December 31, 2007 |
|---|-------------------|-------------------|
| Total debt to GBV | 56.4% | 58.8% |
| Total debt to GBV per the Declaration of Trust ⁽¹⁾ | 54.7% | 58.8% |
| Non-recourse debt as a percentage of total debt | 51.4% | 49.5% |
| Floating rate debt as a percentage of total debt | 3.3% | 5.9% |

⁽¹⁾ Total debt per the Declaration of Trust excludes the convertible debentures and any debt secured by the Bow Project. The REIT's calculation of total debt to GBV is not recognized under GAAP and therefore does not have a standardized meaning prescribed by GAAP

The decrease in the debt to GBV ratio was as a result of the REIT issuing new units which were used to repay the existing bank indebtedness. The high percentage of non-recourse debt in the REIT's portfolio is a deliberate strategy adopted by the REIT to reduce risk within the property portfolio.

Mortgages Payable

Mortgages payable (including mortgages payable on income properties held for sale) increased 4% from the December 31, 2007 figure of \$3.02 billion to \$3.16 billion at December 31, 2008. Increases to the mortgages payable balance are due to the transactions described in detail in "Income Properties" and "Properties under Development" above, a mortgage secured on 500 Bayly for \$95 million as well as an increase of \$196.3 million due to the change in the U.S. forex rate. Upon the sale of properties, \$80.7 million of mortgages payable were assumed by the purchaser. Upon the sale of an additional property, \$20.1 million of mortgages payable were repaid upon closing. In addition to regular principal repayments, other decreases to the mortgages payable balance during the year include repayments on six mortgages totalling \$34.0 million.

The mortgages bear interest at the weighted average rate of 6.2% (December 31, 2007 – 6.3%) and mature between 2009 and 2035. The weighted average term to maturity of the REIT's mortgages is 9.3 years (December 31, 2007 – 10.2 years). Going forward, the REIT anticipates being able to refinance all its debt as it matures. Of the total mortgage balance, only 4.7% will mature in 2009. The mortgages coming due before the end of 2009 bear interest at a weighted average rate on maturity of 6.2%. For a further discussion of interest rate risk, please see "Risks and Uncertainties".

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

| (in thousands of dollars) | December 31, 2008 | December 31, 2007 |
|---------------------------|-------------------|-------------------|
| Canada | \$2,106,767 | \$2,185,966 |
| United States | 1,050,703 | 836,425 |
| Total | \$3,157,470 | \$3,022,391 |

Convertible Debentures

In June 2008, the REIT completed a public offering of \$115 million convertible unsecured subordinated debentures, bearing interest at the annual contractual rate of 6.65% and an effective interest rate of 9.10%. The debentures mature on June 30, 2013, and interest is payable semi-annually on June 30 and December

31. Each debenture is now convertible into freely tradeable units of the REIT at the holder's option at: (i) any time prior to the maturity date and (ii) the business day immediately preceding the date specified by the REIT for redemption of the debentures, at a conversion price of \$23.11 per unit, being a conversion rate of approximately 43.2713 units per \$1,000 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the Indenture governing the debentures.

As a result of the Plan of Arrangement, the REIT must deliver Stapled Units to the holders of the convertible debt if converted. The REIT has entered into a Support Agreement with Finance Trust whereby Finance Trust agreed to issue its units if the convertible debt holders convert. The conversion price per Stapled Unit will be calculated as the conversion price of \$23.11. Upon conversion, the REIT must purchase equivalent units of Finance Trust equal to the fair market value (as determined by Finance Trust in consultation with the REIT) of each such Finance Trust unit at the time of such conversion.

The principal and interest amount of the debentures is payable at the option of the REIT and can be satisfied through the issuance of units of the REIT by way of issuing a variable number of units equal to the principal and accrued interest divided by 95% of the then fair market value of the units. The debentures may not be redeemed by the REIT on or before June 30, 2011. Thereafter, but prior to June 30, 2012, the debentures may be redeemed, in whole or in part, only if the current market price of a unit is at least 125% of the conversion price. On or after June 30, 2012 and prior to the maturity date, the debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest.

The REIT accounts for convertible debentures by valuing the holders' option to convert units and classifying such value as equity. The remaining value of the convertible debentures is classified as debt. Interest expense is recorded as a charge to income and is calculated at an effective rate with the difference between the coupon rate and the effective rate being credited to the debt component of the convertible debentures such that, at maturity, the debt component is equal to the face value of the then outstanding convertible debentures.

On issuance, the REIT recorded a liability of \$103.7 million net of issue costs of \$4.2 million, and equity, which represents the holders' option to convert the debentures into Units, of \$6.8 million, net of issue costs of \$0.3 million. As at December 31, 2008, the REIT's liability has increased to \$104.8 million. The liability will continue to increase each quarter as the accretion amount increases quarterly over the life of the debentures.

Bank Indebtedness

The REIT has the following two facilities:

- (i) A general operating facility limited to \$286.6 million which is secured by a first charge over certain income properties, 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). 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 bears interest at LIBOR rates. At December 31, 2008 approximately \$125.5 million was still available under this line. This facility is due on August 15, 2009.

In January 2009, the total facility was increased to \$299.8 million. The amount available at December 31, 2008 would have been \$138.7 million had the new facility limit been in place at December 31, 2008.

The REIT may increase the general operating facility to a maximum amount of \$300 million, subject to providing further properties as security.

- (ii) A facility to finance and construct a distribution centre in Ajax, Ontario totalling \$3.7 million (December 31, 2007 - \$109.5 million). The amount available at December 31, 2008, after taking into account the bank indebtedness drawn of nil (December 31, 2007 – \$83.4 million) and the outstanding letters of credit, is nil (December 31, 2007 - \$22.4 million). The facility is due on demand.

Bank indebtedness decreased by \$78.2 million from \$191.1 million at December 31, 2007 to \$112.9 million at December 31, 2008. The change is primarily as a result of the issuing of \$172.5 million of units and \$115.0 million of convertible debentures, the repayment of the construction facility relating to the distribution centre in Ajax, Ontario, the sale of properties mentioned previously offset by the funding of properties under development and the properties acquired during the year ended December 31, 2008.

Intangible Liabilities

For all acquisitions subsequent to September 12, 2003, the acquisition cost is allocated to land, buildings, paving and equipment and intangible costs. The portion of the purchase price that is allocated to “below-market-value rents” is recorded as a liability on the REIT’s balance sheet and is amortized over the related lease. This amount has decreased to \$64.3 million at December 31, 2008 as compared to \$68.5 million as at December 31, 2007 due to the impairment of seven income properties as previously mentioned, the sale of properties and normal amortization incurred offset by new acquisitions during the year.

The change in this liability in the future will be dependent 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 \$39.7 million from \$91.8 million at December 31, 2007 to \$131.5 million at December 31, 2008. The change is partially due to an increase in accruals for the properties under development. These accruals at December 31, 2008 totalled \$48.8 million as compared to \$27.1 million at December 31, 2007. There was an increase of \$7.7 million of rents received in advance as compared to December 2007. Offsetting part of this increase at December 31, 2007, there was a payable for the forward contract for 500 Bayly of \$2.5 million. During the year ended December 31, 2008, this hedge was settled and the balance of \$2.5 million was reduced to nil. There is also a general increase in other payables and accruals relating to transactions occurring in the normal course of business operations.

Future Income Tax Liability

Due to the enactment of the SIFT rules on June 22, 2007, the REIT commenced recognizing future income tax assets and liabilities with respect to the temporary differences between the carrying amounts and tax basis of its assets and liabilities, including those related to its subsidiary trusts, that are expected to reverse in or after 2011. The SIFT rules are not expected to apply to the REIT until 2011 as it provides a transition period for publicly traded trusts that existed prior to November 1, 2006. In addition, the SIFT rules will not apply to an entity that qualifies for the real estate investment trust (“REIT”) exemption. The REIT does not currently meet certain technical requirements for the REIT exemption. Management is of the view that it can make changes that are within its control, and restructure its investment in HRLP, in order to qualify for the REIT exemption prior to 2011. As the REIT currently does not qualify, GAAP requires the REIT to prepare the REIT’s accounts on the basis that the new rules currently apply. Future income tax assets or liabilities are recorded using tax rates and laws expected to apply when the temporary differences are expected to reverse. The SIFT rules (as defined below under “Critical Accounting Estimates – Income Tax”) resulted in the REIT including a future income tax liability of \$133.3 million in the consolidated balance sheet at December 31, 2008, with a corresponding future income tax expense of \$15.6 million reflected as a charge to consolidated earnings for the year ended December 31, 2008 and a future income tax expense of \$0.6 million reflected as a charge to other comprehensive income. Temporary differences expected to reverse in or after 2011 have been measured using a tax rate of 29.5% in 2011 and 28% thereafter.

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 REIT acquired an initial 70% as part of its 1996 initial public offering the REIT issued 6,974,555 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 now exchangeable on a one for one basis for Stapled Units.

As clarified by EIC-151, since these Class B units can be transferred without requirement and can be exchanged for Stapled 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 Trusts financial statements until such time as these Class B units have been exchanged for Stapled Units. As Class B units are exchanged over time into Stapled Units, the conversion will result in a transfer to unitholders' equity and the non-controlling interest will be reduced accordingly. During the three and twelve months ended December 31, 2008, 1,536,990 Class B units were exchanged for Stapled Units. This resulted in a \$21.7 million decrease in non-controlling interest.

Non-controlling interest decreased from \$103.2 million at December 31, 2007 to \$75.8 million at December 31, 2008 due to the exchange of units as mentioned above and \$9.5 million of distributions attributable to the non-controlling interest. In addition, net income of \$3.8 million was attributable to non-controlling interest for both continuing and discontinued operations.

USE OF PROCEEDS FROM EQUITY/FINANCING ISSUED

| Financing | Disclosed Use of Proceeds | Actual Use of Proceeds |
|---|---|---|
| Public offering of \$172.5 million of REIT units completed on June 6, 2008. | To fund the acquisition of additional properties and properties under development. Proceeds intended to fund the acquisition of additional properties or fund properties under development and not initially used for such purposes were to be used to reduce the REIT's bank indebtedness. | The entire net proceeds were used to pay down the REIT's bank indebtedness on June 6, 2008. The equity component of acquisitions along with equity to fund properties development will continue to be obtained from the REIT's general operating facility as required until the REIT's overall percentage of indebtedness will be reached which will warrant a new public offering. |
| Public offering of \$115.0 million of REIT convertible debentures completed on June 6, 2008 | | |

EQUITY

Unitholders' Equity

Unitholders' equity increased by \$203.1 million between December 31, 2007 and December 31, 2008. The increase is due to the issue of 8.7 million Units which equates to \$172.5 million, the issue of 146 million stapled units equating to \$132.5 million, the net earnings for the period, proceeds received from the REIT's distribution reinvestment plan and direct unit purchase plan, the equity component of the convertible debentures, the change in accumulated other comprehensive loss and the exchange of non-controlling interest into equity, offset by the distributions paid to unitholders.

The majority of the accumulated other comprehensive loss is made up of the net adjustment to the equity invested in U.S.Holdco with the REIT's debt being held in U.S. dollars currently acting as a natural hedge against its total investment in U.S. dollars. In connection with the Plan of Arrangement that occurred on October 1, 2008, \$27.3 million of accumulated other comprehensive income was written off as a realized loss on foreign exchange. This loss represents the change in the foreign exchange rate from January 17, 2008 (the date of management's intention to repay USD \$125 million of its intercompany loan resulting in a reduction in its net investment in U.S. Holdco) to October 1, 2008. On October 1, 2008, upon the completion of the Plan of Arrangement, existing loans were repaid in full and the realized loss was recorded.

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 or cash provided by operations determined in accordance with GAAP as an indicator of the Trusts performance (see

also “Non-GAAP Financial Measures”). 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). The Trusts have calculated FFO in accordance with the recommendations of the Real Property Association of Canada which does not include any adjustment for realized or unrealized losses on foreign exchange. Nevertheless, the Trusts method of calculating FFO may differ from other issuers’ methods and accordingly may not be comparable to similar measures presented by other issuers.

The use of FFO, combined with the required GAAP presentations, has been presented for the purpose of improving the understanding of operating results of REITs by the investing public and in making comparisons of the Trusts operating results more comparable.

As FFO excludes depreciation, amortization, future income tax and gains and losses from property dispositions, it provides a performance measure that, when compared period over period, reflects the impact on operations of trends in occupancy levels, rental rates, operating costs and realty taxes, acquisition activities and interest costs, and provides a perspective on financial performance.

| Funds From Operations (in thousands of dollars except per unit amounts) | Three months ended December 31 | | Year ended December 31 | |
|--|-----------------------------------|----------|---------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Net earnings (loss) | \$45,984 | \$48,691 | \$98,530 | (\$2,193) |
| Add (deduct) | | | | |
| Depreciation of income properties | 24,497 | 22,177 | 95,871 | 87,853 |
| Amortization of deferred leasing expenses | 1,435 | 1,094 | 5,101 | 4,218 |
| Amortization of intangible assets on acquisitions | 4,550 | 6,208 | 23,523 | 25,183 |
| Impairment loss on income properties, intangible assets and intangible liabilities | 3,434 | - | 53,665 | - |
| Net earnings (loss) attributable to non-controlling interest | 1,074 | 2,765 | 3,829 | (123) |
| Gain on sale of income properties | (41,079) | (2,563) | (71,201) | (9,686) |
| Future income taxes | 4,940 | (20,515) | 15,628 | 115,635 |
| Operating income from discontinued operations | (1,156) | (3,197) | (8,418) | (10,051) |
| Funds from operations – continuing operations | \$43,679 | \$54,660 | \$216,528 | \$210,836 |
| Funds from operations – discontinued operations | 1,165 | 3,606 | 8,955 | 16,231 |
| Funds from operations | \$44,844 | \$58,266 | \$225,483 | \$227,067 |
| Funds from operations per unit (basic – adjusted for conversion of non-controlling interest) | \$0.306 | \$0.431 | \$1.592 | \$1.731 |
| Funds from operations per unit (diluted) | \$0.306 | \$0.429 | \$1.587 | \$1.720 |

The primary reason for the decrease in funds from operations per unit for the three months and year ended December 31, 2008 is due to the loss on foreign exchange of \$10.9 million for the three months and \$7.1 million for the year ended December 31, 2008. Under the definition of FFO, this item is not added back to the calculation of FFO. Interest expense was incurred on the mortgages on the Boscov Department Stores (without collection of rental income) of \$2.1 million for the three months and \$2.8 million for the year ended December 31, 2008. The last major item affecting FFO for both the three months and year ended December 31, 2008 is the \$1.6 million and the \$3.8 million respectively of trust expenses expensed in the last quarter of the year in accordance with the Plan of Arrangement.

If the loss on foreign exchange, the trust expenses relating to the Plan of Arrangement and the mortgage interest on Boscov’s Department Stores, which together total \$14.6 million were added back to the current

FFO calculation, this would result in basic FFO of \$0.406 per unit for the three months ended December 31, 2008. If the loss on foreign exchange, trust expenses relating to the Plan of Arrangement and Boscov's Department Stores mortgage interest, which together total \$13.7 million were added back to the current FFO calculation, FFO would have been \$1.688 per unit for the year ended December 31, 2008. For other items that affect FFO please see the items that affected DC.

The following is a reconciliation of the REIT's funds from operations to cash provided by operations.

| (in thousands of dollars) | Three months ended December 31 | | Year ended December 31 | |
|---|-----------------------------------|----------|---------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Funds from operations | \$44,844 | \$58,266 | \$225,483 | \$227,067 |
| Funds from operations – discontinued operations | (1,165) | (3,606) | (8,955) | (16,231) |
| Operating income from discontinued operations | 1,156 | 3,197 | 8,418 | 10,051 |
| Change in other non-cash operating items | 11,937 | 3,361 | (9,177) | (36,496) |
| Rent amortization | 3,830 | 80 | 4,813 | 1,059 |
| Other | 1,129 | 852 | 3,232 | 1,861 |
| Loss on foreign exchange | 11,166 | - | 7,341 | - |
| Amortization of deferred costs | 934 | 871 | 3,430 | 3,098 |
| Amortization of deferred leasing included within discontinued operations | - | 15 | 8 | 216 |
| Amortization of intangibles included within discontinued operations | - | 14 | - | 1,113 |
| Depreciation of income properties included within discontinued operations | 9 | 380 | 529 | 4,851 |
| Cash provided by operations | \$73,840 | \$63,430 | \$235,122 | \$196,589 |

All items which are included in the above reconciliation of the REIT's funds from operations to cash provided by operations are non-cash items which are included in the calculation of funds from operations but are not included in the determination of cash provided by operations.

Capital Resources

The cash provided by operations of \$73.8 million for the three months ended December 31, 2008 and \$235.1 million for the twelve month period represents the primary source of funds to pay cash distributions to unitholders totalling \$52.9 million for the three months ended December 31, 2008 and \$204.3 million for the year ended December 31, 2008.

In accordance with National Policy 41-201, the Trusts are required to provide the following additional disclosure relating to cash distributions.

H&R REIT and H&R FINANCE TRUST - MD&A – December 31, 2008

| (in thousands of dollars) | Three months ended December 31, 2008 | Year ended December 31, 2008 | Year ended December 31, 2007 | Year ended December 31, 2006 |
|---|--|------------------------------------|------------------------------------|------------------------------------|
| Cash provided by operating activities | \$73,840 | \$235,122 | \$196,589 | \$169,232 |
| Net earnings (loss) | 45,984 | 98,530 | (2,193) | 86,437 |
| Actual cash distributions paid or payable relating to the period | 52,739 | 204,108 | 179,980 | 155,374 |
| Distributions paid as a return of capital pursuant to the Plan of Arrangement | 132,500 | 132,500 | - | - |
| Total distributions paid | 185,239 | 336,608 | 179,980 | 155,374 |
| Excess of cash provided by operating activities over cash distributions paid | 21,101 | 31,014 | 16,609 | 13,858 |
| Shortfall of net earnings over cash distributions paid | (6,755) | (105,578) | (182,173) | (68,937) |

For the three months ended December 31, 2008 and years ended December 31, 2008, 2007 and 2006, cash provided by operating activities exceeded cash distributions. Management expects this trend to continue.

Cash distributions have exceeded net earnings due to non-cash items which are deducted in determining net earnings. Non-cash items such as impairment losses, future income taxes, depreciation and amortization, while deducted for net earnings have no impact on cash available to pay current distributions. Effective January 1, 2009, the distribution on the Stapled Units was reduced from \$1.44 to \$0.72 per unit annually.

Proceeds from the issuance of securities and debentures together with proceeds on disposition of income properties have been used to repay bank indebtedness and to fund acquisitions and capital expenditures of \$36.2 million and properties under development of \$336.7 million for the year ended December 31, 2008.

Subject to market conditions, management expects to be able to meet all of the Trusts ongoing obligations and to finance short term development commitments through the issue of new securities, as well as by using conventional real estate debt, selling or refinancing other assets, short-term financing from the bank and the Trusts cash flow from operations. The Trusts are not in default or arrears on any of its obligations including distribution payments, interest or principal payments on debt and any debt covenant with the exception of the non payment of principal and interest for the seven Boscov's Department Stores mortgages following the non receipt of rental revenue. The REIT has handed over control of the properties to the mortgage company and is waiting for them to legally release the REIT's subsidiaries from their debt obligations.

Short-term bank financing has been provided by the same chartered bank since the REIT's inception. This general operating facility is 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, 2008, approximately \$125.5 million was still available under this facility.

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

The REIT is currently not contemplating any acquisitions and expects total acquisitions to decrease on a dollar basis in 2009 as compared to 2008.

The following is a summary of material contractual obligations of the Trusts including payments due for the next 5 years and thereafter:

| Contractual Obligations (in thousands of dollars) | Payments Due by Period | | | | Total |
|--|------------------------|------------------|------------------|---------------------|--------------------|
| | 2009 | 2010-2011 | 2012-2013 | 2014 and thereafter | |
| Long-term debt ⁽¹⁾ | \$285,485 | \$297,992 | \$610,624 | \$1,955,362 | \$3,149,463 |
| Convertible debentures | - | - | 115,000 | - | 115,000 |
| Total Contractual Obligations | \$285,485 | \$297,992 | \$725,624 | \$1,955,362 | \$3,264,463 |

(1) Long-term debt excludes those mortgages on assets which have been sold. There are \$10.5 million of mortgages payable on assets sold which are not included above. See mortgages receivable for further information. However, it does include \$142.9 million of non-recourse mortgages whereby the REIT has handed over control of the income properties to the mortgage company and therefore expects to remove the accompanying liability from the balance sheet when the lender takes transfer of title to the properties.

The Trusts have no material capital or operating lease obligations.

Funding of Future Commitments

The REIT is currently undertaking significant development activities for the two million square foot office building in Calgary, Alberta ("the Bow"). The REIT has committed to incurring additional construction and development costs for this project of approximately \$1.1 billion (including capitalized interest of \$183 million) over a four year period of which approximately \$375 million is expected to be incurred during the next 12 months. The current difficult economic conditions have impacted the REIT's financing strategy. While the REIT is negotiating with lenders to obtain construction financing for the Bow and has entered into a conditional agreement for the issuance of \$200 million of debentures described below, at present there is no financing arrangement in place for the Bow.

In December 2008, the REIT entered into an agreement with Fairfax, whereby Fairfax has agreed to purchase on a private placement basis, \$200 million of 11.5% debentures due five years from issuance. The private placement is conditional upon the REIT obtaining construction financing for the Bow in the permanent amount of \$400 million and will terminate on April 23, 2009.

Subsequent to year end, the REIT has signed an engagement letter with RBC Capital Markets ("RBC") and TD Securities ("TD"), who will collectively act as co-lead arrangers and co-bookrunners to arrange a \$425 million construction facility for the REIT on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals for up to \$250 million of the Financing contingent upon securing the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway.

In addition to pursuing construction financing, the REIT has taken, or will consider taking, the following actions to partially fund its development commitment:

- (i) Reducing distributions - In December 2008, the REIT announced that it would decrease its cash distributions to unitholders to retain cash. If necessary, the REIT can further preserve cash flow from a further decrease in cash distributions;
- (ii) Utilizing the REIT's cash and unused operating line of credit as of December 31, 2008, which totals approximately \$148 million. The operating line of credit is due in August of 2009, and is secured by charges on 27 properties. While the REIT's operating line of credit has been renewed annually since the REIT's inception, in light of current market conditions, there is no certainty that the REIT will be successful in renewing the line of credit due in August of 2009. Should the operating line not be renewed, the REIT will attempt to replace the line through conventional first mortgages on the properties currently securing the line;

- (iii) Selling an interest in the Bow;
- (iv) Selling or refinancing other assets; and
- (v) Issuance of units – however, in light of current market conditions, there is no assurance that a significant amount of financing can be raised.

The combined financial statements have been prepared on a going concern basis in accordance with GAAP, which assumes that the REIT will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. The REIT's ability to obtain financing for its development commitments is a material uncertainty which may cast significant doubt on the ability of the REIT to continue as a going concern. The outcome is dependent on the successful completion of the actions taken or planned, some of which are described above, (which management believes will mitigate the adverse conditions and events) which may cast doubt about the validity of the going concern assumption.

The following table shows the budgeted costs for the Bow and actual costs to date. This budget is for the North Block Tower and parking on both the North and South Blocks. The previous budget of \$1.4 billion did not include any allocation of South Block costs.

| (in thousands of dollars) | Budget | Costs incurred to date | Remaining Costs |
|--|-------------|------------------------|-----------------|
| Land | \$58,380 | \$50,413 | \$7,967 |
| Financing costs | 54,250 | - | 54,250 |
| Capitalized interest on the REIT's costs incurred | 215,722 | 33,180 | 182,542 |
| Soft costs | 190,357 | 86,194 | 104,163 |
| Hard costs | 1,044,606 | 234,625 | 809,981 |
| Recoveries and other income | (113,165) | (2,381) | (110,784) |
| Contingency | 96,572 | - | 96,572 |
| Budget/ cost incurred to date | 1,546,722 | 402,031 | \$1,144,691 |
| Less capitalized interest on the REIT's costs incurred | (215,722) | (33,180) | (182,542) |
| Total budget/ costs incurred to date less capitalized interest | \$1,331,000 | \$368,851 | \$962,149 |

The chart below shows funds required and the projected source of funds for the 2009-2011 period.

| <u>Funds Required</u> | |
|-----------------------------------|----------------|
| (In millions of dollars) | |
| To complete the Bow as per above | \$962 |
| Mortgage and principal repayments | 335 |
| | \$1,297 |

| <u>Projected Source of Funds</u> | |
|---|----------------|
| (In millions of dollars) | |
| Construction facility | \$425 |
| Issuance of 11.5% debentures to Fairfax (see "Private Placement" below) | 200 |
| Cash retained from operations due to a reduction in distributions | 240 |
| Available cash and undrawn credit facilities | 160 |
| Bell Phase 3 mortgage payable and collection of mortgages receivables | 155 |
| Land and property sales | 185 |
| | \$1,365 |

While the REIT has identified projected sources of funds from which it expects to satisfy its anticipated cash flow requirements as described above, there is no assurance that such funds will be available to the REIT as the availability of any such funds will be subject to market conditions and other factors beyond the REIT's control. Please see "Forward-Looking Disclaimer" and "Risks and Uncertainties".

The total annualized projected year 1 income from the project is expected to be \$94.3 million. Rent will grow at 0.75% per annum and the parking revenue will grow by 1.5% per annum for the 25 year term.

The REIT's capacity (as determined in the manner below), to fund future acquisitions, capital expenditures and commitments was in excess of \$1,400 million as at December 31, 2008. This represented the amount that could be funded by the REIT from debt, subject to market availability before the REIT reached its maximum debt limitation of 65% of debt to its GBV of assets.

PRIVATE PLACEMENT

On December 23, 2008, the REIT entered into an agreement (the "Private Placement Agreement") with Fairfax, pursuant to which Fairfax has agreed to purchase, at par on a private placement basis, \$200 million of 11.5% debentures (the "Debentures") due on the fifth anniversary of the issue date with interest payable semi-annually. Completion of the private placement is subject to the satisfaction of certain conditions (see below).

The Debentures will be redeemable after the fourth anniversary of the issue date, at a redemption price equal to the principal amount thereof plus accrued and unpaid interest. The Debentures will require the REIT, at the holders' option, to effect repurchases upon a change of control at 101% of the principal amount plus accrued and unpaid interest, and will contain similar covenants, events of defaults and remedies as the REIT's outstanding convertible debentures. Furthermore, the Debentures will be unsecured and will rank equally with the REIT's current and future unsecured debt including the REIT's outstanding convertible debentures.

Contemporaneously with the issue of the Debentures, Fairfax will be granted warrants to purchase 28,571,429 Stapled Units at an exercise price of \$7.00 per Stapled Unit (or net proceeds of approximately \$200 million if exercised in full), which are exercisable for a period of 5 years from the date of grant.

The Private Placement Agreement is conditional upon, among other things, the occurrence of the following events by closing: (i) receipt by the REIT of construction financing commitments of no less than \$400 million for the development of “the Bow” in Calgary, (ii) monthly unitholder cash distributions per Stapled Unit being no greater than \$0.06 until closing; and (iii) TSX approval. Closing of the transactions contemplated in the Private Placement Agreement is expected to occur on the second business day following satisfaction of all conditions to the Private Placement Agreement and if conditions are not satisfied or waived within 120 days from the date the Private Placement Agreement was entered into, the Private Placement Agreement will be cancelled. As at December 31, 2008, these conditions have not been satisfied.

OFF-BALANCE SHEET ITEMS

The REIT has certain co-owners or partners in various projects. As a rule the REIT 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 REIT in the event of a default of the borrowers, in which case the REIT would have a claim against the underlying real estate investment. However, in certain circumstances, where absolutely required but subject to compliance with the REIT’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 REIT has provided guarantees, such guarantees will be provided.

At December 31, 2008, such guarantees amounted to \$51.3 million, expiring between 2011 and 2017 and no amount has been provided for in the consolidated financial statements for these items. These amounts arise where the REIT has guaranteed a co-owner’s share of the mortgage liability. The REIT, 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 has been determined by discounting the cash flows of these financial obligations using year-end market rents for debt of similar terms and credit risks. Based on these assumptions, the fair value of mortgages payable at December 31, 2008 has been estimated at \$2.935 billion (2007 - \$2.977 billion) compared with the carrying value of \$3.157 billion (2007 - \$3.022 billion).

The REIT had an electricity contract to swap floating for fixed price rates as a cash flow hedge of price volatility of the REIT’s electricity costs in Ontario, Canada for a monthly notional amount of approximately 4,000 MWh. This contract expired June 30, 2008. As a result, the fair value of this contract at December 31, 2008 was nil (December 31, 2007 – (\$0.03) million).

Where appropriate, the REIT also uses forward contracts to lock in lending rates on certain anticipated mortgages. This strategy provides certainty in the rate of interest on borrowings when the REIT is involved in transactions that close further into the future than during the normal timeframe of a transaction. At December 31, 2008, the REIT had no forward contracts in place.

SECTION IV

SUMMARY OF QUARTERLY RESULTS

| (unaudited) (in thousands of dollars except per unit amounts) | December 31, 2008 | September 30, 2008⁽¹⁾ | June 30, 2008⁽¹⁾ | March 31, 2008⁽¹⁾ |
|--|--------------------------|---|------------------------------------|-------------------------------------|
| Rentals from income properties | \$156,935 | \$151,855 | \$152,498 | \$147,426 |
| Mortgage interest and other income | 848 | 1,052 | 643 | 596 |
| Net property operating income | 27,431 | 27,296 | 28,367 | 28,121 |
| Net earnings (loss) from continuing operations | 5,629 | (26,702) | 20,740 | 22,986 |
| Net earnings (loss) per unit from continuing operations | | | | |
| (basic) | 0.03 | (0.19) | 0.16 | 0.18 |
| (diluted) | 0.03 | (0.19) | 0.16 | 0.18 |
| Net earnings (loss) | 45,984 | (20,158) | \$32,888 | \$39,816 |
| Net earnings (loss) per unit | | | | |
| (basic) | 0.32 | (0.15) | 0.25 | 0.31 |
| (diluted) | 0.32 | (0.15) | 0.25 | 0.31 |

| | December 31, 2007⁽¹⁾ | September 30, 2007⁽¹⁾ | June 30, 2007⁽¹⁾ | March 31, 2007⁽¹⁾ |
|---|--|---|------------------------------------|-------------------------------------|
| Rentals from income properties | \$149,728 | \$143,559 | \$142,896 | \$144,496 |
| Mortgage interest and other income | 554 | 770 | 891 | 375 |
| Net property operating income | 27,366 | 26,246 | 25,121 | 23,475 |
| Net earnings (loss) from continuing operations | 43,230 | 20,713 | (104,854) | 20,031 |
| Net earnings (loss) per unit from continuing operations | | | | |
| (basic) | 0.34 | 0.16 | (0.85) | 0.17 |
| (diluted) | 0.34 | 0.16 | (0.85) | 0.17 |
| Net earnings (loss) | \$48,691 | \$23,860 | (\$102,840) | \$28,096 |
| Net earnings (loss) per unit | | | | |
| (basic) | 0.38 | 0.19 | (0.83) | 0.24 |
| (diluted) | 0.38 | 0.19 | (0.83) | 0.23 |

⁽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, dispositions and income taxes.

SECTION V

CRITICAL ACCOUNTING ESTIMATES

The preparation of the Trusts financial statements requires management to make estimates and judgements that affect the reported amounts of assets and liabilities, 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 Trusts 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, 2008 audited combined financial statements of the Trusts.

Impairment of Assets

The REIT is required to write down to fair value any of its income properties that were 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 the third quarter of 2008, the REIT recognized an impairment of \$50.2 million with regard to Boscov's Department Stores. During the fourth quarter of 2008, the REIT recognized an impairment of \$3.0 million with regards to Boscov's Department Stores. This change was primarily due to an increase in foreign exchange rates for Q4 2008. In addition, upon the expiry of an option to purchase the remaining interest in the Neways office building, an additional \$0.4 million was written off. During the first six months and for the full 2007 year, no other impairments were recognized.

The REIT 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 2008 or 2007.

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 REIT 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 REIT 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 REIT'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 assumed 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.

Income Tax

On June 22, 2007, legislation relating to the federal income taxation of a SIFT, received royal assent (the "SIFT Rules"). A SIFT includes a publicly-listed or traded partnership and trust, such as an income trust and a REIT. The REIT meets the definition of a SIFT. Under the SIFT Rules, following a transition period for qualifying SIFTs, certain distributions from 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. Distributions paid by a SIFT as returns of capital will not be subject to the tax.

The REIT uses the asset and liability method of accounting for income taxes. Future income taxes are recognized for the temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases. Future income tax assets and liabilities are measured using enacted or substantively enacted tax rates and laws that are expected to apply to taxable income in the years in which those temporary differences are expected to be reversed or settled. The effect on future income tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the date of enactment or substantive enactment.

Pursuant to the terms of the Finance Trust Declaration of Trust, the only properties which Finance Trust is permitted to invest in are U.S. Holdco Notes, and certain cash and cash equivalents, none of which constitutes non-portfolio property for purposes of the Tax Act, provided Finance Trust does not at any time carry on a business in Canada. It follows that Finance Trust will not be a SIFT trust for purposes of the Tax Act and will not be subject to tax under the SIFT Rules.

Tax Consequences to U.S. Holders

Finance Trust qualifies as an investment trust that is classified as a grantor trust for U.S. federal income tax purposes under Treasury Regulation section 301.7701-4(c) (a "Fixed Investment Trust") and section 671 of the Code. In general, an investment trust will qualify as a Fixed Investment Trust if: (i) the trust has a single class of ownership interests, representing undivided beneficial interests in the assets of the trust; and (ii) there is no power under the trust agreement to vary the investment of the holders. If Finance Trust is a Fixed Investment Trust, then it will generally be disregarded for U.S. federal income tax purposes, with the result that the holders of Finance Trust units will be treated as owning directly their *pro rata* shares of all of the Finance Trust assets (i.e. primarily the U.S. Holdco Notes). Moreover, all payments made on the U.S. Holdco Notes will be treated as payments made directly to the holders of the Finance Trust units in proportion to their interest in Finance Trust.

Provided that Finance Trust qualifies as a Fixed Investment Trust and the U.S. Holdco Notes are respected as debt for U.S. federal income tax purposes, payments of principal and interest on the U.S. Holdco Notes that are attributable to U.S. holders will be treated as payments directly to the U.S. holders. Interest on the U.S. Holdco Notes will generally be taxable to U.S. holders as ordinary income at the time it is paid or accrued and will be subject to U.S. federal taxation at a maximum marginal rate of 35%. If the U.S. Holdco Notes were treated as equity rather than debt for U.S. federal income tax purposes, then the stated interest on the U.S. Holdco Notes would be treated as a distribution with respect to stock.

Additionally, there can be no assurance that the Internal Revenue Service will not challenge the determination that the interest rate on the U.S. Holdco Notes represents an arm's length rate.

CHANGES TO SIGNIFICANT ACCOUNTING POLICIES FOR 2008

The CICA released three new accounting standards that are effective for the Trust's fiscal year commencing January 1, 2008: Section 1535, "Capital Disclosures"; Section 3862, "Financial Instruments – Disclosures"; and Section 3863, "Financial Instruments – Presentation".

Section 1535 includes required disclosures of the Trust's objectives, policies and processes for managing capital, quantitative data about what the Trust regards as capital and whether the Trust has complied with any capital requirements.

Sections 3862 and 3863 replace the existing Section 3861, “Financial Instruments – Disclosure and Presentation”. These new sections revise and enhance disclosure requirements, and carry forward unchanged existing presentation requirements. These new sections place an increased emphasis on disclosures and presentation regarding the risks associated with both recognized and unrecognized financial instruments and how the Trusts manages those risks.

The results of adopting these new standards are discussed further in notes 21 and 22 of the financial statements.

FUTURE CHANGES TO SIGNIFICANT ACCOUNTING POLICIES

In February 2008, the CICA issued a new Handbook Section 3064 “Goodwill and Intangible Assets”. This new section replaces Section 3062 “Goodwill and other Intangible Assets” and establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets, and as a result, the basis of the deferral of maintenance capital expenditures recoverable from tenants will be impacted. The new and amended standards will be effective for the REIT’s 2009 fiscal year, and will be adopted on a retroactive basis with restatement of the prior years.

Commencing January 1, 2009, the REIT will no longer be able to defer capital cost expenditures recoverable from its tenants and record the depreciation of these deferred expenditures over the period which revenue is collected from tenants. This change requires the REIT to capitalize capital expenditures recoverable from its tenants and amortize it over the useful life of the asset. If the capitalization criteria is not met, the REIT must expense the full amount in the year incurred.

The adoption by the REIT of the new and amended standards will require it to restate its 2008 quarterly and annual consolidated financial statements on January 1, 2009. The following table outlines the estimated impact as of January 1, 2009:

| | |
|--------------------------------------|----------|
| Income properties will increase by | \$ 9,140 |
| Deferred costs will decrease by | 19,220 |
| Unitholders’ equity will decrease by | 10,080 |

ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (“IFRS”)

The Canadian Accounting Standards Board has confirmed that the use of IFRS, as issued by the International Accounting Standards Board (“IASB”), will replace Canadian Accounting Standards effective January 1, 2011. The Trusts are in the early stages of developing a conversion plan to transition financial reporting to IFRS as issued by the International Accounting Standards Board (“IFRS-IASB”). Accordingly, at this time, the Trust cannot quantify the impact that the adoption of IFRS will have on the classification or valuation of the Trusts consolidated financial statements.

The Canadian Securities Administrators issued Staff Notice 52-321, *Early Adoption of International Financial Reporting Standards*, which provides issuers with the option to early adopt IFRS effective January 1, 2009. It is not the Trusts intention to early adopt these standards on January 1, 2009.

Canadian GAAP will be fully converged with IFRS-IASB through a combination of two methods: first, as current joint-convergence projects of the United States’ Financial Accounting Standards Board and the International Accounting Standards Board are agreed upon, they will be adopted by Canada’s Accounting Standards Board and may be introduced in Canada before the publicly accountable enterprises’ transition date to IFRS-IASB; and secondly, standards not subject to a joint-convergence project will be exposed in an omnibus manner for introduction at the time of the publicly accountable enterprises’ transition date to IFRS-IASB. The IASB currently has projects underway that are expected to result in new pronouncements that continue to evolve.

Implementing IFRS will have an impact on accounting, financial reporting and supporting IT systems and processes. It may also have an impact on contractual commitments involving GAAP based clauses (including debt covenants), and performance metrics. Accordingly, the Trusts implementation plan will include measures to provide extensive training to key finance personnel, to review relevant contracts and agreements and to increase the level of awareness and knowledge amongst management, the Board of Trustees, the audit committee and investors.

The following provides a summary of the Trusts IFRS Implementation Plan and Status of our activities:

Initial Assessment Phase

This phase includes the identification of significant differences between existing Canadian GAAP and IFRS-IASB at a high level as relevant to the Trusts. Based upon the current state of IFRS-IASB, this phase identified a modest number of topics that may possibly impact the Trusts financial results and/or the necessary effort to make the transition to IFRS-IASB. Targeted training and communication activities, leveraging both internal and external resources, are occurring during this phase. The Trust's are currently finalizing its initial assessment phase, with activities in this phase planned for substantial completion by Q2 2009.

Detailed Assessment Phase

Building upon the assessment performed in the Initial Assessment Phase, this phase will include:

- identification, evaluation and selection of accounting policies necessary for the Trusts to change over to IFRS-IASB;
- identification of the business impacts resulting from the identified accounting differences. Business impacts to be considered in the Trusts project plan are: business units, control processes, information technology, unitholders, regulatory matters and others as identified during this phase;
- assessment of IFRS 1 elections. This aspect of the project plan will follow the detailed assessment of the financial statement items and will be revisited periodically throughout the project;
- an initial training analysis and information systems impact analysis are also components of this phase, and are currently being documented.

The detailed assessment phase will progress from Q2 2009 through to Q2 2010.

Design Phase

The Design Phase will integrate the recommendations from the Detailed Assessment Phase into our underlying financial systems and processes that are necessary for us to change over to IFRS-IASB. In addition, we will have designed business process changes and developed detailed training programs. The Design Phase is expected to wrap up during Q3 2010.

Testing & Implementation Phase

During 2010, we will be testing our IFRS-IASB systems, processes, financial statements, notes, policies, internal controls and internal reporting throughout the period in preparation of our conversion date of January 1, 2011.

Status of Convergence Plan

Currently, impact assessment and training activities are underway and progressing according to plan.

The Trusts combined financial performance and financial position as disclosed in our current GAAP financial statements may be significantly different when presented in accordance with IFRS.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

No changes were made to the design of our internal controls over financial reporting during the three months ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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

The Trusts management, including the CEO and CFO, does not expect that the Trusts 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 the Trust have been detected. The Trusts are continually evolving and enhancing its systems of controls and procedures.

SECTION VI

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, type of asset and tenant diversification in the REIT's portfolio. The major risk factors are outlined below, and in the REIT's Annual Information Form.

Unit Prices

Publicly traded trust units will not necessarily trade at values determined solely by reference to the underlying value of trust assets. Accordingly, the Stapled Units may trade at a premium or a discount to the underlying value of the assets of the REIT and Finance Trust. Investors in Stapled Units will be subject to all of the risks of an investment in units of Finance Trust and of an investment in units of the REIT. Holders of Stapled Units should consult the Management's Discussion and Analysis of Finance Trust and the REIT and specifically the risk factors therein. See also "Forward-Looking Disclaimer".

One of the factors that may influence the market price of the Stapled Units is the annual yield on the Stapled Units. Accordingly, an increase in market interest rates may lead investors in Stapled Units to demand a higher annual yield which could adversely affect the market price of Stapled Units. In addition, the market price for Stapled Units may be affected by changes in general market conditions, fluctuations in the markets for equity securities and numerous other factors beyond the control of the REIT and/or Finance Trust.

Availability of Cash for Distributions

The Trusts current distribution policy is to pay a monthly cash distribution such that the aggregate monthly distribution per Stapled Unit is 6 cents as of January 1, 2009. As the monthly cash distribution paid by Finance Trust fluctuates monthly, the monthly cash distribution paid by the REIT will also fluctuate in order to result in an aggregate monthly cash distribution of 6 cents per Stapled Unit. Although the Trusts intend to make distributions of its available cash to unitholders in accordance with its distribution policy, these cash distributions may be reduced or suspended. The actual amount distributed by the REIT will depend on numerous factors including monthly cash distributions paid by Finance Trust, capital market conditions, the financial performance of the properties, the REIT's debt covenants and obligations, its working capital requirements, its future capital requirements, its development commitments and fluctuations in interest rates. Distributable Cash may exceed actual cash available to the REIT from time to time because of items such as principal repayments on debt, tenant allowances, leasing commissions and capital expenditures. The Trusts may be required to use part of its debt capacity in order to accommodate any or all of the above items. The market value of Stapled Units may decline significantly if the REIT and/or Finance Trust suspend or reduce

distributions. The REIT may reduce distributions if its trustees anticipate a cash shortfall and determine that such a reduction would be in the best interests of the REIT.

Development and Financing Risk Relating to The Bow Development

The REIT entered into agreements to develop the Bow consisting of approximately 2.0 million square foot office and retail complex in Calgary. The north and south block development budgeted to cost approximately \$1.5 billion, are pre-leased to EnCana Corporation for an initial term of approximately 25 years. The previous budget of \$1.4 billion did not include any allocation for the South Block costs. Construction commenced during the spring of 2007 and is expected to be completed in 2012. The REIT is currently bearing the risk for construction overruns and project delays as the REIT does not have a fixed price contract for the entire project cost. The REIT 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. The REIT does not have any financing in place for this project and is at risk for securing financing to fund its development commitments.

While the REIT's operating line of credit has been renewed annually since the REIT's inception, in light of current market conditions, there is no certainty that the REIT will be successful in renewing the line of credit due in August of 2009 and in completing the above financing strategies. Should the operating line not be renewed, the REIT will attempt to replace the line through conventional first mortgages on the properties currently securing the line. If the REIT is unable to secure adequate funding from these strategies the REIT will be negatively impacted and will be forced to take actions to preserve cash generated from operations including decreasing cash distributions and issuing additional units or other securities of the REIT. See also Funding of Future Commitments.

Liquidity Risk

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

Credit Risk and Tenant Concentration

The REIT 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 REIT'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 REIT are Bell Canada, TransCanada PipeLines Limited, Telus Communications and Bell Mobility. Each of these companies that have a public debt rating is rated with at least a BBB rating by a recognized rating agency.

The following table illustrates the REIT's 25 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 January 1, 2009:

| | Tenant | % of rentals from income properties | Number of Locations | REIT owned sq.ft. (in 000's) | Lease term to maturity (years) |
|-----|----------------------------------|--|--------------------------------|---|---|
| 1. | Bell Canada | 8.6 | 3 | 1,397 | 15.8 |
| 2. | Bell Mobility | 7.7 | 3 | 1,123 | 17.9 |
| 3. | TransCanada Pipelines Limited | 6.6 | 2 | 950 | 12.2 |
| 4. | Telus Communications | 5.3 | 2 | 943 | 14.4 |
| 5. | Rona Inc. | 3.7 | 15 | 2,261 | 11.0 |
| 6. | Versacold Logistics Canada Inc. | 3.2 | 12 | 1,733 | 18.0 |
| 7. | Canadian Tire Corp. | 3.1 | 4 | 2,189 | 17.8 |
| 8. | Royal Bank of Canada | 3.0 | 4 | 476 | 3.7 |
| 9. | Lowes Companies Inc. | 2.2 | 11 | 1,435 | 10.3 |
| 10. | Nestle USA | 1.9 | 3 | 2,168 | 8.8 |
| 11. | Loblaw Companies Limited | 1.8 | 1 | 909 | 19.4 |
| 12. | Shell Oil Products | 1.7 | 18 | 249 | 13.7 |
| 13. | Purolator Courier Ltd. | 1.5 | 12 | 1,071 | 12.5 |
| 14. | Nestle Canada Inc. | 1.5 | 1 | 170 | 10.7 |
| 15. | Finning International Inc. | 1.5 | 16 | 893 | 13.4 |
| 16. | Marsh Supermarkets | 1.4 | 9 | 548 | 17.9 |
| 17. | Public Works of Canada | 1.3 | 3 | 238 | 7.8 |
| 18. | Hudson's Bay Company | 1.0 | 3 | 937 | 9.7 |
| 19. | Sobey's Inc. | 1.0 | 10 | 339 | 13.1 |
| 20. | BJ's Wholesale Club Inc. | 0.9 | 4 | 452 | 13.3 |
| 21. | Sony Pictures Entertainment Inc. | 0.8 | 1 | 172 | 15.5 |
| 22. | Harmony Logistics Canada Inc. | 0.8 | 1 | 716 | 14.1 |
| 23. | Gowling Lafleur Henderson LLP | 0.8 | 1 | 141 | 7.6 |
| 24. | Metro Inc. | 0.8 | 9 | 338 | 12.8 |
| 25. | Asea Brown Boveri Inc. | 0.7 | 3 | 484 | 4.4 |
| | Total | 62.8% | 151 | 22,332 | |

Interest Rate and Financing Risk

The REIT is exposed to financing risk on maturing mortgages, bank indebtedness and 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, 2008, the percentage of fixed rate debt to total debt was 96.7% (December 31, 2007 – 94.1%). In addition, the REIT 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, 2008, the weighted average term to maturity of the mortgages was 9.3 years (December 31, 2007 – 10.2 years) compared to the remaining average lease term of 11.5 years (December 31, 2007 – 12.1 years). Only 4.7% of total mortgage principal will mature before the end of 2009. The REIT also minimizes financing risk by restricting total debt (subject to certain exceptions) to 65% of aggregate assets as well as by obtaining non-recourse debt wherever possible. At December 31, 2008, the debt to GBV ratio (as per the Declaration of Trust) was 54.7% (December 31, 2007 – 58.8%) while the percentage of non-recourse debt to total debt was 51.4% (December 31, 2007 – 49.5%).

Tax Risk

The REIT currently qualifies as a mutual fund for Canadian Income Tax purposes. On June 22, 2007, the SIFT rules received royal assent. A SIFT includes a publicly-listed or traded partnership and trust, such as an income trust and a REIT. The REIT is a SIFT. Under the SIFT rules, following a transition period for qualifying SIFTs, certain distributions from 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. Distributions paid by a SIFT as returns of capital will not be subject to the tax.

Under the SIFT rules, the new taxation regime will not apply to a REIT that meets prescribed conditions relating to the nature of its income and investments. The REIT does not currently meet certain technical requirements for the REIT exemption and therefore is a SIFT. The REIT intends to restructure to qualify for the REIT exemption prior to 2011. However if the REIT is unable to restructure, commencing in 2011, the REIT will become subject to tax on distributions of certain income.

The REIT operates in the United States through U.S.Holdco which is capitalized with equity provided by the REIT and debt owed to Finance Trust. As at December 31, 2008, U.S. Holdco owed approximately USD \$125 million to Finance Trust which eliminates on the combined financial statements.

Prior to the Plan of Arrangement, the REIT provided debt financing to U.S. Holdco which paid interest of approximately USD \$16.3 million for the year ended December 31, 2008 (December 31, 2007 – USD \$21 million) on such debt. In determining income for U.S. tax purposes, U.S. Holdco was subject to possible limitations on the deductibility of interest paid to the REIT. Section 163(j) of the Internal Revenue Code (the "Code") applied to defer U.S. Holdings' deduction of interest paid on the debt to the REIT in years that (i) the debt to equity ratio of U.S. Holdings exceeded 1.5:1, and (ii) the net interest expense exceeds an amount equal to 50% of its "adjusted taxable income" (generally, earnings before interest, taxes, depreciation, and amortization). For the year ended December 31, 2008, USD \$12.5 million of the USD \$16.3 million interest expense (December 31, 2007 - U.S. \$14 million of the USD \$21 million interest expense) was disallowed by Section 163(j) of the Code, but such disallowance had no cash effect on U.S. Holdco. If this limitation applies to interest paid in a subsequent year, depending on the facts and circumstances and the availability of net operating losses to U.S. Holdco (which are subject to normal assessment by the Internal Revenue Service), the U.S. federal income tax liability of U.S. Holdings could increase. In such case, the amount of income available for distribution by the REIT to its unitholders could be reduced.

Ability to Access Capital Markets

As the Trusts distribute a substantial portion of their income to unitholders, the Trusts ability to access the capital markets through equity issues and forms of secured or unsecured debt financing will affect the operations of the Trusts. Such financing may be available only on disadvantageous terms, if at all. If financing is not available on acceptable terms, further acquisitions may be curtailed and cash available for distribution may be adversely affected.

Dilution

The number of units the Trusts is authorized to issue is unlimited. The Trustees have the discretion to issue additional Units in certain circumstances, including under the Unit Option Plan. Any issuance of Units may have a dilutive effect on the investors of Units.

Lease Rollover Risk

Lease rollover risk arises from the possibility that the REIT 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 creditworthy tenants to leases that are long-term in nature which assists in the REIT's attempt to fulfill its primary goal of maintaining a predictable cash flow. The REIT has relatively few short to medium term lease rollovers which is illustrated in the previously disclosed table showing that leases representing only 14.2% of the REIT's total square footage expires by the end of 2013.

Construction Risks

It is likely that, subject to compliance with its Declaration of Trust, the REIT will be involved in various development projects. The REIT's obligations in respect of properties under construction, or which are to be constructed, are subject to risks which include (i) the potential insolvency of a third party developer (where the REIT is not the developer); (ii) a third party developer's failure to use advanced funds in payment of construction costs; (iii) construction or other unforeseeable delays; (iv) cost overruns; (v) the failure of tenants to occupy and pay rent in accordance with existing lease agreements, some of which are conditional; (vi) the incurring of construction costs before ensuring rental revenues will be earned from the project; and (vii) increases in interest rates during the period of the development. See also the risk relating to the Bow Development above. Management strives 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.

Debentures

The likelihood that purchasers of the REIT's convertible debentures will receive payments owing to them under the terms of the debentures will depend on the financial health of the REIT and its creditworthiness. In addition, the debentures are unsecured obligations of the REIT and are subordinate in right of payment to all the REIT's existing and future senior indebtedness. Therefore, if the REIT becomes bankrupt, liquidates its assets, reorganizes or enters into certain other transactions, the REIT's assets will be available to pay its obligations with respect to the debentures only after it has paid all of its senior and secured indebtedness in full. There may be insufficient assets remaining following such payments to pay amounts due on any or all of the debentures then outstanding.

The debentures are also effectively subordinate to claims of creditors (including trade creditors) of the REIT's subsidiaries except to the extent the REIT is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors. The indenture governing such debentures does not prohibit or limit the ability of the REIT or its subsidiaries to incur additional debt or liabilities (including senior indebtedness) or to make distributions, except, in respect of distributions, where an event of default has occurred and such default has not been cured or waived. The indenture does not contain any provision specifically intended to protect holders of debentures in the event of a future leveraged transaction involving the REIT.

Mezzanine Financing Credit Risk

The REIT 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 REIT's investment guideline of only providing construction financing after 70% of the project has been pre-leased.

Currency Risk

The REIT is exposed to foreign exchange fluctuations as a result of ownership of assets in the United States and the rental income earned from these properties. In order to mitigate the risk, The REIT's debt on these properties is also held in U.S. dollars to act as a natural hedge.

Environmental Risk

The REIT is subject to various Canadian and U.S. laws, which could cause it, 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 REIT's ability to sell or finance the affected asset and could potentially also result in claims against the REIT.

The REIT has formal environmental policies in place to manage any exposure. The REIT'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 REIT carries appropriate insurance coverage to cover any environmental mishaps.

Redemption Right

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 REIT 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.

Unitholder Liability

The Declaration of Trust for both the Trusts provide that unitholders will have no personal liability for actions of the Trusts 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 Trusts. The Declarations of Trust further provide that this lack of unitholder liability, where possible, must be provided for in certain written instruments signed by the Trusts. In addition, legislation has been enacted in the Provinces of Ontario and certain other provinces that is intended to provide unitholders in those provinces with limited liability. However, there remains a risk, which the Trusts consider to be remote in the circumstances, that a unitholder could be held personally liable for the Trusts obligations to the extent that claims are not satisfied out of the Trusts assets. It is intended that the Trusts affairs will be conducted to seek to minimize such risk wherever possible.

RELATED PARTY TRANSACTIONS

H&R Property Management Ltd. (the "Property Manager"), a company owned by family members of the Chief Executive Officer, provides property management services for substantially all properties owned by the REIT, including leasing services, for a fee of 2% of gross revenue. The Property Manager also provides support services in connection with the acquisition, disposition and development activities of the REIT and is also entitled to an incentive fee. Acquisitions and development support services are provided for a fee of 2/3 of 1% of total acquisition and development costs, as defined in the agreement and effective January 1, 2007. Effective January 1, 2008, the support services relating to dispositions of income properties are provided for a fee of 10% of the gain on sale of income properties adjusted for the add back of accumulated depreciation and amortization. Prior to January 1, 2008, the disposition fee was 7.5% of the gain on sale of income properties without any adjustment for accumulated depreciation and amortization. This change had no impact for the three and twelve months ended December 31, 2008 as the disposition fee was nil. The current agreement expires on December 31, 2009 with two automatic five-year extensions.

During the three months ended December 31, 2008, the REIT recorded fees pursuant to this agreement of \$3.5 million (2007 - \$4.1 million), of which \$0.04 million (2007 - \$0.01 million) was capitalized to the cost of the income properties acquired, \$0.4 million (2007 - \$1.1 million) was capitalized to properties under development and \$0.2 million (2007 - \$0.2 million) was capitalized to deferred expenses. The REIT has also reimbursed the Property Manager for certain direct property operating costs and tenant construction costs.

For the three months ended December 31, 2008, a further amount of \$1.2 million (2007 - \$1.0 million) has been earned by the Property Manager pursuant to the above agreement, in accordance with the annual incentive fee payable to the Property Manager. Of this amount, \$1.2 million (2007 - nil) has been waived by the Property Manager and nil (2007 - \$1.0 million) has been expensed in the consolidated statement of earnings.

During the year ended December 31, 2008, the REIT recorded fees pursuant to this agreement of \$14.5 million (2007 - \$15.2 million), of which \$0.6 million (2007 - \$1.7 million) was capitalized to the cost of the income properties acquired, \$2.1 million (2007 - \$2.0 million) was capitalized to properties under

development and \$2.3 million (2007 - \$1.1 million) was capitalized to deferred expenses. The REIT has also reimbursed the Property Manager for certain direct property operating costs and tenant construction costs.

For the year ended December 31, 2008, a further amount of \$3.5 million (2007 - \$3.7 million) has been earned by the Property Manager, pursuant to the above agreement, in accordance with the annual incentive fee, payable to the Property Manager. Of this amount, \$1.5 million (2007 – nil) has been waived by the Property Manager and \$2.0 million (2007 - \$3.7 million) has been expensed in the consolidated statements of earnings. In addition, the Property manager has waived the 2009 annual incentive fee

Pursuant to the above agreements, as at December 31, 2008, \$1.0 million (2007 - \$3.3 million) was payable to the Property Manager.

The REIT leases space to companies affiliated with the Property Manager. The rental income earned for the three months ended December 31, 2008 is \$0.3 million (2007 - \$0.3 million) and for the year ended December 31, 2008 is \$1.2 million (2007 - \$1.1 million).

The REIT received interest from a related company of the Property Manager. The interest income earned for the three months ended December 31, 2008 is nil (2007 – nil) and for the year ended December 31, 2008 is nil (2007 - \$0.4 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 Trusts are represented by a single class of Stapled Units which are unlimited in number. Each unit carries a single vote at any meeting of unitholders. As at March 3, 2009, there were 147,475,442 trust units issued and outstanding.

A maximum of 5,800,000 units were authorized to be issued to the REIT's officers, employees and certain trustees. All such options had been issued prior to March 31, 2003. On September 19, 2008, an amendment to the unit option plan was approved increasing the maximum units authorized by 3,000,000 to a total of 8,800,000 as at December 31, 2008. As at March 3, 2009, there were 2,454,666 options to purchase units outstanding of which 1,854,666 are fully vested.

SECTION VII

OUTLOOK

The recent turmoil in the global markets has brought about a strong focus on liquidity as the capital markets have undergone dramatic change. Sources of funds are scarce and lenders have become more conservative with their loans. Fortunately for the REIT, it only has approximately \$49 million of mortgages maturing between January 1, 2009 and December 31, 2009. Also, given the REIT's quality of assets, the REIT does not anticipate any issues relating to refinancing existing mortgages that are maturing. On average, the mortgages which are maturing over the next five years have been outstanding for at least eight years and in addition to the value of the properties having increased in the last eight years, there has been a significant amount of principal repaid. On October 31, 2008, amidst the market chaos, the REIT renewed its general operating line of \$300 million with a single Canadian bank, testament to the fact that credit is available to large reputable entities with good portfolios of real estate producing sustainable cash flows over the long term. The most important issue now facing the REIT will be securing a construction facility for the Bow as discussed on pages 6 and 38.

Boscov's Department Stores filed for bankruptcy protection in August 2008 and terminated their leases. Management has handed over control of the seven income properties to the lender and therefore expects to be released from any further obligations under these non-recourse mortgages. From January 1, 2009 onwards, the annualized revenue lost from the seven Boscov's Department Stores properties will be \$15.1 million. In addition, property operating costs will be reduced by approximately \$1.8 million. Per Canadian GAAP mortgage interest will continue to accrue until such time as the lender releases the REIT's

subsidiaries from its debt obligations. Presently, the annual mortgage interest on the loans is \$9.2 million. The total DC lost from Boscov's Department Stores will be approximately \$13.3 million annually and will be \$5.6 million annually once the lender has released the REIT's subsidiaries from its debt obligations.

On November 10, 2008, Circuit City Stores filed for protection with a United States bankruptcy court. Circuit City occupies one of our properties for use as a distribution facility. To date, we have not been notified of their intent with regards to this property. The total annual rental rate on this 1,078,450 square foot property is \$3.22 per square foot. The property has a non-recourse mortgage of \$24.5 million as at December 31, 2008 bearing interest at 6.85% per annum. The REIT's total equity invested in this property is approximately \$8.7 million. The REIT did receive rental income for January 2009. Rent is due at the end of the month.

Government of Canada bond yields have experienced volatility during 2008 and commercial mortgage lenders have significantly widened their spreads. However, even with these wider spreads, the lowering of bond yields has resulted in mortgage interest rates for terms of 5 years and lower similar to the 6.2% weighted average interest of the REIT's mortgages.

The U.S. dollar although volatile, has strengthened considerably in the past few months. An increase in the U.S. dollar relative to the Canadian dollar will result in an increase to distributable cash. The REIT's distributable cash earned from properties in the United States, which are not under Chapter 11 protection, is approximately USD \$33 million per annum.

The major issue facing the REIT is securing the financing for the Bow. The REIT expects to obtain this financing by mid April although there is no assurance that this commitment will be secured.

SUBSEQUENT EVENTS

In February 2009, the REIT sold a 115,000 square foot retail building located in Austell, Georgia for gross proceeds of \$16.4 million.

The REIT has signed an engagement letter with RBC Capital Markets ("RBC") and TD Securities ("TD"), who will collectively act as co-lead arrangers and co-bookrunners to arrange a \$425 million construction facility for the REIT on a reasonable best efforts basis (the "Financing"). RBC and TD have received all necessary internal approvals for up to \$250 million of the Financing contingent upon securing the remainder of the Financing and certain other conditions. The marketing process for receiving commitments for the remainder of the Financing is currently underway.

ADDITIONAL INFORMATION

Additional information relating to the REIT and Finance Trust, including the REIT's Annual Information Form, is available on SEDAR at www.sedar.com.

H&R REIT- Supplemental Financial Information – December 31, 2008

The following are details of selected supplemental financial information as at December 31, 2008

| | 3 months ended December 31 | | | Year ended December 31 | | |
|---|----------------------------|---------|--------|------------------------|---------|--------|
| | 2008 | 2007 | Change | 2008 | 2007 | Change |
| | | | % | | | % |
| DISTRIBUTABLE CASH PER UNIT | \$0.381 | \$0.401 | (5) | \$1.565 | \$1.572 | n/a |
| CASH DISTRIBUTIONS PAID PER UNIT | \$0.360 | \$0.343 | (5) | \$1.440 | \$1.370 | 5 |
| PAYOUT RATIO | 94.5% | 85.5% | 11 | 92.0% | 87.2% | 6 |
| FUNDS FROM OPERATIONS PER UNIT | \$0.306 | \$0.431 | (29) | \$1.592 | \$1.731 | (8) |

| | December 31, 2008 | | | |
|--|-------------------|------------|---------|--------|
| Net Ownership Position | Office | Industrial | Retail | Total |
| Number of Properties | 34 | 124 | 122 | 280 |
| Total Leasable Area (square feet) | 7,983 | 25,259 | 8,012 | 41,254 |
| Occupancy | 98.9% | 98.6% | 99.9% | 98.9% |
| Average Rent per sq.ft. | \$19.12 | \$5.84 | \$13.19 | \$9.84 |
| Average Age of Buildings (years) | 18.1 | 15.0 | 11.2 | 14.9 |
| Average Interest Rate on Outstanding Mortgages | | | | 6.2% |

Diversification by Asset Class

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|------------------------------------|---------------------------------|---------------------------------|
| Property Operating Income * | | |
| Office | 46.2% | 48.7% |
| Industrial | 33.5% | 31.2% |
| Retail | 20.3% | 20.1% |

* (before interest, depreciation and amortization)

H&R REIT- Supplemental Financial Information – December 31, 2008

Income Properties

| Book Value by Type of Asset (millions) | December 31, 2008 | December 31, 2007 |
|---|--------------------------|-------------------|
| Office | \$1,502 | \$1,535 |
| Industrial | 1,665 | 1,517 |
| Retail | 1,369 | 1,401 |
| | \$4,536 | \$4,453 |

Diversification By Region

| Book Value by Region (millions) | December 31, 2008 | December 31, 2007 |
|--|--------------------------|-------------------|
| Ontario | \$1,865 | \$1,934 |
| Alberta | 608 | 622 |
| Other | 456 | 483 |
| Quebec | 244 | 294 |
| Canada | \$3,173 | \$3,333 |
| United States | 1,363 | 1,120 |
| Total | \$4,536 | \$4,453 |

H&R REIT- Supplemental Financial Information – December 31, 2008

TENANTS

| | Tenant | % of rentals from income properties | Number of Locations | REIT owned sq.ft. (in 000's) | Lease term to maturity (years) |
|-----|----------------------------------|---|------------------------|------------------------------------|--------------------------------------|
| 1. | Bell Canada | 8.6 | 3 | 1,397 | 15.8 |
| 2. | Bell Mobility | 7.7 | 3 | 1,123 | 17.9 |
| 3. | TransCanada Pipelines Limited | 6.6 | 2 | 950 | 12.2 |
| 4. | Telus Communications | 5.3 | 2 | 943 | 14.4 |
| 5. | Rona Inc. | 3.7 | 15 | 2,261 | 11.0 |
| 6. | Versacold Logistics Canada Inc. | 3.2 | 12 | 1,733 | 18.0 |
| 7. | Canadian Tire Corp. | 3.1 | 4 | 2,189 | 17.8 |
| 8. | Royal Bank of Canada | 3.0 | 4 | 476 | 3.7 |
| 9. | Lowes Companies Inc. | 2.2 | 11 | 1,435 | 10.3 |
| 10. | Nestle USA | 1.9 | 3 | 2,168 | 8.8 |
| 11. | Loblaw Companies Limited | 1.8 | 1 | 909 | 19.4 |
| 12. | Shell Oil Products | 1.7 | 18 | 249 | 13.7 |
| 13. | Purolator Courier Ltd. | 1.5 | 12 | 1,071 | 12.5 |
| 14. | Nestle Canada Inc. | 1.5 | 1 | 170 | 10.7 |
| 15. | Finning International Inc. | 1.5 | 16 | 893 | 13.4 |
| 16. | Marsh Supermarkets | 1.4 | 9 | 548 | 17.9 |
| 17. | Public Works of Canada | 1.3 | 3 | 238 | 7.8 |
| 18. | Hudson's Bay Company | 1.0 | 3 | 937 | 9.7 |
| 19. | Sobey's Inc. | 1.0 | 10 | 339 | 13.1 |
| 20. | BJ's Wholesale Club Inc. | 0.9 | 4 | 452 | 13.3 |
| 21. | Sony Pictures Entertainment Inc. | 0.8 | 1 | 172 | 15.5 |
| 22. | Harmony Logistics Canada Inc. | 0.8 | 1 | 716 | 14.1 |
| 23. | Gowling Lafleur Henderson LLP | 0.8 | 1 | 141 | 7.6 |
| 24. | Metro Inc. | 0.8 | 9 | 338 | 12.8 |
| 25. | Asea Brown Boveri Inc. | 0.7 | 3 | 484 | 4.4 |
| | Total | 62.8% | 151 | 22,332 | |

H&R REIT- Supplemental Financial Information – December 31, 2008

LEASE EXPIRIES

Percent of total expiring, and average net rent on expiry

| LEASE EXPIRIES | 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 |
| 2009 | 0.7 | 18.69 | 1.6 | 5.11 | 0.3 | 6.56 | 2.6 | 8.93 |
| 2010 | 0.6 | 19.70 | 2.3 | 6.22 | 0.3 | 25.06 | 3.2 | 10.51 |
| 2011 | 0.7 | 17.48 | 0.3 | 13.69 | 0.1 | 11.08 | 1.1 | 15.86 |
| 2012 | 0.7 | 17.66 | 2.0 | 5.13 | 0.1 | 21.74 | 2.8 | 8.86 |
| 2013 | 0.7 | 16.29 | 3.4 | 5.65 | 0.4 | 9.26 | 4.5 | 7.63 |
| | 3.4 | 17.91 | 9.6 | 5.84 | 1.2 | 13.73 | 14.2 | 9.40 |

| Rental expiry for 2009 | % of sq.ft. | Rent per sq.ft. on expiry | Expected Market Rent on Expiring Space |
|------------------------|-------------|---------------------------|--|
| Office | 0.7 | \$18.69 | \$20.01 |
| Industrial | 1.6 | 5.11 | 5.38 |
| Retail | 0.3 | 6.56 | 8.17 |
| | 2.6 | \$8.93 | \$9.65 |

OTHER STATISTICS

| | December 31, 2008 | December 31, 2007 |
|--|-------------------|-------------------|
| Mortgage term to maturity | 9.3 years | 10.2 years |
| Lease term to maturity | 11.5 years | 12.1 years |
| Tax deferred percentage of distributions | 46% | 47% |
| Payout ratio | 92.0% | 87.2% |

H&R REIT- Supplemental Financial Information – December 31, 2008

DEBT MATURITY

| MORTGAGES PAYABLE | Periodic Amortized Principal (\$000's) | Principal on Maturity (\$000's) | Total Principal (\$000's) | % of Total Principal | Weighted Average Interest Rate on Maturity |
|----------------------------------|--|---------------------------------|---------------------------|----------------------|--|
| Years | | | | | |
| 2009 | 93,554 | 49,010 | 142,564 | 4.7% | 6.2% |
| 2010 | 101,492 | 20,590 | 122,082 | 4.1% | 6.8% |
| 2011 | 105,664 | 70,246 | 175,910 | 5.9% | 6.5% |
| 2012 | 104,638 | 303,739 | 408,377 | 13.6% | 6.7% |
| 2013 | 99,935 | 102,312 | 202,247 | 6.7% | 7.5% |
| Thereafter | | | 1,955,362 | 65.0% | |
| | | | 3,006,542 | 100.0% | |
| Mortgages payable due on demand | | | 142,921 | | |
| Mortgages payable on assets sold | | | 10,461 | | |
| Mortgage premiums | | | 11,085 | | |
| Mortgage origination costs | | | (13,539) | | |
| Total | | | 3,157,470 | | |

Allocation of Debt (including bank indebtedness)

| | December 31, 2008 | December 31, 2007 |
|--|--------------------------|-------------------|
| Total debt to GBV | 56.4% | 58.8% |
| Total debt to GBV per the Declaration of Trust) ⁽¹⁾ | 54.7% | 58.8% |
| Non-recourse debt as a percentage of total debt | 51.4% | 49.5% |
| Floating rate debt as a percentage of total debt | 3.3% | 5.9% |

⁽¹⁾ Total debt per The Declaration of Trust excludes the convertible debentures and any debt secured by the Bow project.