



**H&R Real Estate Investment Trust
H&R Finance Trust**



2010 Annual Report

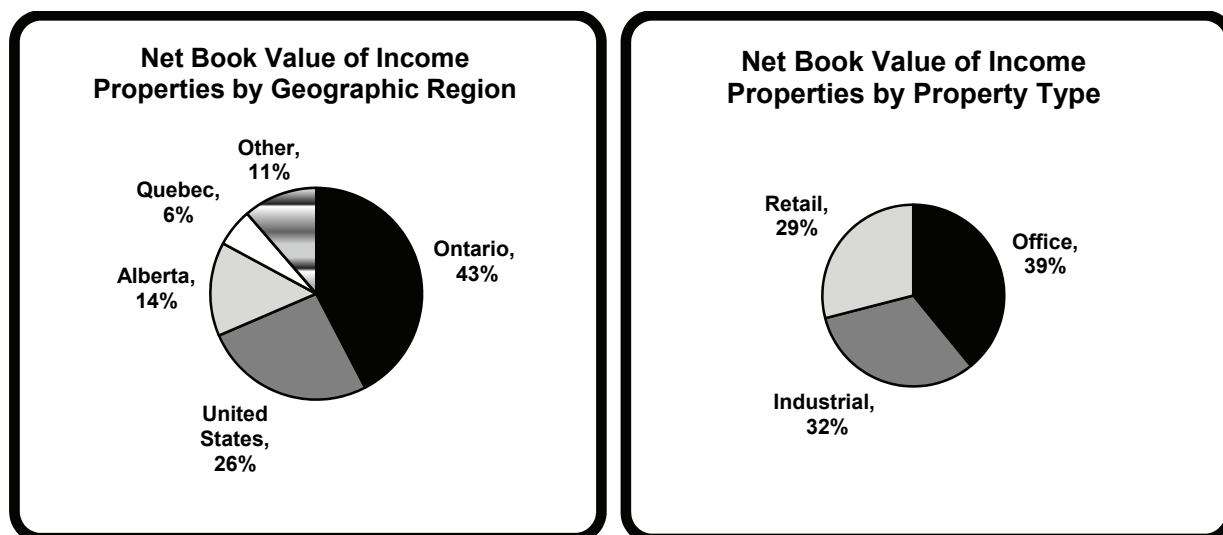
Including Combined MD&A and Financial Statements

H&R 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 282 office, industrial and retail properties comprising over 39 million square feet and three development projects, with an aggregate total net book value of \$5.3 billion as at December 31, 2010.

H&R Finance Trust is an unincorporated investment trust, which primarily invests in notes issued by a subsidiary of H&R REIT. 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”.

Additional information regarding H&R REIT and H&R Finance Trust is available at www.hr-reit.com and on www.sedar.com.



Primary Objectives

H&R strives to achieve two primary objectives: to provide unitholders with stable and growing cash distributions generated by revenues derived from a diversified portfolio of income properties, and to maximize the value of units through active management of H&R’s assets, acquisition of additional properties, and development of new projects. We are committed to maximizing returns to unitholders while maintaining prudent risk management and conservative use of financial leverage.

Stability Through Discipline

Since inception in 1996, H&R has executed a disciplined and proven strategy that has provided stable cash flow and adjusted funds from operations. We achieve our primary objectives and mitigate risks through long-term property leasing and financing, combined with conservative management of assets and liabilities.

Front and back cover images

Photos on the front and back covers are of *The Bow*, a two-million-square-foot office complex that H&R is developing in Calgary.

2010 Highlights

- Maintained portfolio occupancy rate at nearly 100% for the thirteenth consecutive year
- Net earnings increased by reversal of SIFT-related net future income tax liability of \$123 million
- FFO and AFFO reduced by one-time \$39-million charge for early \$200-million repayment of 11.5% debentures
- Invested \$474 million in properties under development, including construction of *The Bow* office complex in Calgary
- Invested \$80 million in property acquisitions, including 16 properties in the United States, with an initial levered return expected to be approximately 10.8%
- Raised \$477 million by issuing debentures (\$455 million) and selling non-strategic assets (\$22 million)

| | 2010 | 2009 |
|--|--------|--------|
| Average term to maturity of leases (years) | 10.2 | 10.5 |
| Average term to maturity of mortgages payable (years) | 8.0 | 8.3 |
| Portfolio occupancy rate | 98.9% | 99.0% |
| Rental income (millions) | \$616 | \$605 |
| Net earnings (millions) | \$172 | \$87 |
| Net earnings per Stapled Unit (basic) | \$1.19 | \$0.61 |
| Cash provided by operations (millions) | \$243 | \$239 |
| Funds from operations (millions) ⁽¹⁾ | \$192 | \$215 |
| FFO per Stapled Unit (basic) | \$1.28 | \$1.45 |
| Normalized funds from operations (millions) ⁽¹⁾⁽²⁾ | \$220 | \$236 |
| NFFO per Stapled Unit (basic) | \$1.47 | \$1.59 |
| Adjusted funds from operations (millions) ⁽¹⁾ | \$179 | \$223 |
| AFFO per Stapled Unit (basic) | \$1.19 | \$1.51 |
| Cash distributions paid (millions) | \$104 | \$98 |
| Distributions per Stapled Unit | \$0.79 | \$0.72 |
| Payout ratio per Stapled Unit (distributions/NFFO) | 54% | 45% |
| Assets (billions) | \$5.5 | \$5.4 |
| Unitholders' equity (billions) | \$1.6 | \$1.5 |
| Debt as percent of gross book value of assets ⁽³⁾ | 50% | 53% |
| <p>(1) H&R's MD&A includes the reconciliations of net earnings to FFO and NFFO, FFO to AFFO, and AFFO to cash provided by operations. As these are non-GAAP measures, readers are strongly encouraged to refer to H&R's MD&A for further discussion of such measures.</p> <p>(2) NFFO adjusts FFO for additional recoveries of capital expenditures in excess of items expensed in property operating costs, the net loss on derivative instruments and foreign exchange, the mortgage interest accruals on non-recourse mortgage defaults and other non-recurring items.</p> <p>(3) Calculated in accordance with the REIT's Declaration of Trust</p> | | |

First Quarter 2011 Highlights

- Closed \$180-million offering of 4.8% senior unsecured debentures, to fund property acquisitions and for general corporate purposes
- Entered into an agreement to acquire Atrium on Bay, a 1.1 million square foot office complex located in downtown Toronto for \$345 million
- Purchased two retail properties in the United States for USD\$32 million

President's Message to Unitholders

Financial Results

For fourteen years, we have executed a conservative strategy founded on **stability through discipline**. As the effects of the global financial crisis waned in Canada, we improved our financial results last year, and resumed our disciplined program of property acquisitions that are intended to be accretive. We also amended the terms of our construction loan for *The Bow* so as to reduce our interest costs and increase distributions to unitholders.

By year end, we had grown H&R's portfolio of high-quality properties and improved the capital structure of its balance sheet. Our Stapled Unit price closed at \$19.43, increasing 26% during the year, compared to 14% for the S&P/TSX Composite Index and 15% for the Capped Real Estate Index. Including this capital gain and distributions, the overall return on investment for our unitholders was 31% for 2010, and a compound average annual return of approximately 15% since inception in 1996.

Development of *The Bow*

We continue to build *The Bow* – our trophy office project in downtown Calgary, which at year end was 77% complete, comprising 58 storeys and two million square feet. The Class AAA office tower is expected to become the landmark in Calgary's downtown financial district and will be the keystone of our property portfolio. *The Bow* will be the largest Canadian office tower west of Toronto – its striking design crowning Calgary's skyline. The project will also feature three sky gardens and an energy-efficient design, and will be integrated with the city's rail and bus transit system and elevated pedestrian walkway.

EnCana Corporation – a leading North American natural gas producer and one of Canada's largest public companies with strong investment grade ratings – has preleased 100% of the skyscraper and all underground parking spaces on a triple-net basis for an initial term of 25 years. The \$1.5-billion complex will be occupied in tranches and will be fully occupied by the second quarter 2012, after which it will generate first year net rent of approximately \$94 million. Rent step-ups thereafter will be 0.75% per annum for the office space and 1.5% per annum for parking over the full term of the lease.

Adoption of International Financial Reporting Standards

As part of our transition to IFRS, we report the fair value of H&R REIT's investment properties as follows:

| | December 31, 2010 (billions) | January 1, 2010 (billions) |
|---|---------------------------------|-------------------------------|
| Net Book Value as reported under Canadian GAAP, including tenant inducements, deferred leasing costs and intangible liabilities | \$4.0 | \$4.1 |
| Increase in value of income-producing properties | 1.5 | \$0 |
| Fair value of investment properties to be reported under IFRS | \$5.5 | \$5.1 |

Outlook

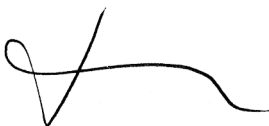
Equity and credit market conditions in Canada have improved over the past year, which has allowed the REIT to reduce financing costs and strengthen its balance sheet through a series of debenture offerings. More abundant and cheaper capital has increased demand for commercial properties, placing downward pressure on capitalization rates and thereby increasing the market value of our portfolio.

We expect to continue acquiring properties on a very selective and disciplined basis. In the United States, the recovery in commercial real estate and capital markets has been much slower, resulting in higher capitalization rates than for equivalent Canadian properties, and financing for high-quality properties is becoming increasingly available at attractive pricing.

The REIT's portfolio is performing well and we expect continued growth in profitability from our contracted rental escalations and accretive acquisitions. We remain very optimistic and excited about our opportunities for growth and ability to prosper in the coming year. Reflecting this positive outlook, H&R's trustees have updated our distribution policy, by increasing the annualized intended distribution per Stapled Unit and extending the policy for an additional two quarters to December 31, 2012, as shown below.

| Distribution Period | Updated Intended Annualized Distribution Per Stapled Unit | Previously Announced Intended Annualized Distribution Per Stapled Unit |
|--|---|--|
| Q1 2011 (January, February and March) | \$0.90 | \$0.90 |
| Q2 2011 (April, May and June) | \$0.95 | \$0.93 |
| Q3 2011 (July, August and September) | \$1.00 | \$0.96 |
| Q4 2011 (October, November and December) | \$1.05 | \$0.99 |
| Q1 2012 (January, February and March) | \$1.10 | \$1.02 |
| Q2 2012 (April, May and June) | \$1.15 | \$1.05 |
| Q3 2012 (July, August and September) | \$1.20 | \$ - |
| Q4 2012 (October, November and December) | \$1.25 | \$ - |

On behalf of H&R management, I wish to thank our investors, trustees and employees for their trust and commitments over the past year. With your support, we look forward to extending our legacy of ***stability through discipline.***



President and CEO

March 18, 2011

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

For the Year ended December 31, 2010

Dated: February 24, 2011

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SECTION I

FORWARD-LOOKING DISCLAIMER

Management's discussion and analysis ("MD&A") of the combined financial position and the combined 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") for the year ended December 31, 2010 should be read in conjunction with the Trusts' combined financial statements and the notes thereto for the years ended December 31, 2010 and 2009. 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 "Results of Operations", "Liquidity and Capital Resources", "Outlook" and "Risks and Uncertainties" 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 Trusts' expectation regarding future development 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; restrictions pursuant to the terms of indebtedness; 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; co-ownership interest in properties; competition for real property investments; environmental matters; reliance on one corporation for management of substantially all the REIT's properties; changes in legislation, indebtedness of the Trusts and the impact of adopting Internal Financial Reporting Standards ("IFRS"). 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 caution 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.

Readers are also urged to examine the REIT 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. 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. Neither the REIT nor any of its trustees or officers, assumes any responsibility for the completeness of the information contained in Finance Trust's materials filed with the Canadian securities regulatory authorities or for any failure of Finance Trust 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 February 24, 2011 and the Trusts, except as required by applicable law, assume 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, 2010 and 2009 is unaudited and has not been reviewed by an auditor.

NON-GAAP FINANCIAL MEASURES

Property operating income, same-asset property operating income, funds from operations ("FFO"), normalized funds from operations ("NFFO"), adjusted funds from operations ("AFFO") 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. Management believes that these non-GAAP financial measures are a meaningful measure of operating performance as they reject the assumption that the value of real estate investments diminishes predictably over time. 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. Unitholders are entitled to have their REIT 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 the 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 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 income producing properties in Canada and the United States occupied by creditworthy tenants on a long-term basis. The REIT does not have any specific allocation targets as to property type, but rather focuses on creditworthy tenants with long-term leases.

Currently, the REIT's main focus is on the construction of the Bow in Calgary, AB. The total budget for the project is \$1.5 billion net of rent received during the construction period. The Bow is a 2-million square foot head office complex pre-leased, on a triple net basis, to EnCana Corporation for a term of 25 years. EnCana Corporation is scheduled to begin occupancy in 2011. The project is currently on budget. The total annualized year one projected income from the Bow is expected to be approximately \$94 million. Rent step ups will be 0.75% per annum on the office space and 1.5% per annum on the parking income for the full 25-year term. See "Funding of Future Commitments" for further information.

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 is to hold debt issued by H&R REIT (U.S.) Holdings Inc. ("U.S. Holdco"), a wholly owned U.S. subsidiary of the REIT. As at December 31, 2010, Finance Trust holds U.S. \$126.4 million of aggregate principal amount of notes payable by U.S. Holdco ("U.S. Holdco Notes"). 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 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 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, Distribution Reinvestment Plan and Unit Purchase 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 or distributed to unitholders of Finance Trust.

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) (the “Tax Act”) 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.

FINANCIAL HIGHLIGHTS

| (in thousands of dollars except per unit amounts) | December 31, 2010 | December 31, 2009 |
|--|---|---|
| Total assets | \$5,531,534 | \$5,351,123 |
| Debt to gross book value of assets (per the REIT's Declaration of Trust) | 50.3% | 52.5% |
| Debt to gross book value of assets (per the combined financial statements) | 57.9% | 56.8% |
| Stapled Units outstanding | 146,121 | 143,825 |
| Class B units of H&R Limited Partnership outstanding | 5,438 | 5,438 |
| | Three months ended December 31, 2010 | Three months ended December 31, 2009 |
| Property rental revenue | \$160,262 | \$151,668 |
| Net property operating income | 29,632 | 21,606 |
| Normalized funds from operations ("NFFO") | 58,089 | 56,385 |
| Weighted average number of basic Stapled Units for NFFO | 150,624 | 148,501 |
| Normalized funds from operations per basic Stapled Unit | 0.39 | 0.38 |
| Distributions paid per Stapled Unit | 0.22 | 0.18 |
| Payout ratio per Stapled Unit as a % of basic NFFO | 56% | 47% |

Net earnings is reconciled to FFO which is reconciled to NFFO and AFFO. AFFO is reconciled to cash provided by operations, being the most comparable GAAP measures to these non-GAAP financial measures. See pages 24-29.

KEY PERFORMANCE DRIVERS

| OPERATIONS | | Office | Industrial | Retail | Total* |
|--|-------------|----------------|---------------|----------------|----------------|
| <i>Occupancy as at December 31⁽¹⁾</i> | 2010 | 99.2% | 98.3% | 100.0% | 98.9% |
| | 2009 | 98.4% | 98.9% | 99.9% | 99.0% |
| <i>Occupancy – same asset as at December 31⁽²⁾</i> | 2010 | 99.1% | 98.4% | 100.0% | 98.8% |
| | 2009 | 98.7% | 98.8% | 99.9% | 99.0% |
| <i>Average contractual rent per square foot for the three months ended December 31⁽³⁾</i> | 2010 | \$19.65 | \$5.76 | \$12.75 | \$10.19 |
| | 2009 | \$19.92 | \$5.86 | \$12.41 | \$10.10 |

* weighted average total

⁽¹⁾ Excluding those properties whose tenants who have filed for protection under Chapter 11 of the United States Bankruptcy Code.

⁽²⁾ Same asset refers to those properties owned by the REIT for the entire two-year period ended December 31, 2010 and excludes any assets classified as discontinued operations and those assets whose tenants terminated their leases due to U.S. bankruptcies.

⁽³⁾ For continuing operations only and excluding those properties whose tenants who have filed for protection under Chapter 11 of the United States Bankruptcy Code.

| | December 31, 2010 | December 31, 2009 |
|---|----------------------|----------------------|
| Average remaining term to maturity of leases (years) | 10.2 | 10.5 |
| Average remaining term to maturity of mortgages payable (years) | 8.0 | 8.3 |

PORTFOLIO OVERVIEW

The geographic diversification of the REIT's portfolio (excluding properties whose tenants have filed for Chapter 11 protection with a United States bankruptcy court) as at December 31, 2010 is outlined in the charts below:

| NUMBER OF PROPERTIES | Ontario | United States | Alberta | Quebec | Other | Total |
|-----------------------------|----------------|----------------------|----------------|---------------|--------------|--------------|
| Office | 22 | 4 | 4 | 1 | 4 | 35 |
| Industrial | 53 | 16 | 19 | 11 | 19 | 118 |
| Retail | 32 | 84 | 5 | 5 | 3 | 129 |
| Total | 107 | 104 | 28 | 17 | 26 | 282 |

| Square Feet (in thousands) | Ontario | United States | Alberta | Quebec | Other | Total |
|-----------------------------------|----------------|----------------------|----------------|---------------|--------------|---------------|
| Office | 5,208 | 430 | 1,406 | 452 | 884 | 8,380 |
| Industrial | 9,450 | 6,314 | 2,810 | 2,850 | 1,176 | 22,600 |
| Retail | 1,759 | 4,794 | 515 | 498 | 524 | 8,090 |
| Total | 16,417 | 11,538 | 4,731 | 3,800 | 2,584 | 39,070 |

PROPERTIES UNDER DEVELOPMENT
(in thousands of dollars)

| Project | Address | December 31, 2010 | December 31, 2009 |
|----------------|--|--------------------------|--------------------------|
| The Bow | 5 th Ave. at Centre Street, Calgary, AB | \$1,150,094 | \$719,173 |
| Heart Lake | Mayfield West Business Park, Caledon, ON | 80,195 | 39,809 |
| Airport Road | 7900 Airport Rd., Brampton, ON | 38,042 | 35,552 |
| | | \$1,268,331 | \$794,534 |

| 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 |
|---|---|--|----------------------------------|-----------------------------|---|
| 2011 | \$100,355 | \$70,246 | \$170,601 | 6.5% | 6.4% |
| 2012 | 99,911 | 263,881 | 363,792 | 13.8% | 6.7% |
| 2013 | 95,559 | 107,821 | 203,380 | 7.7% | 7.5% |
| 2014 | 96,129 | 182,632 | 278,761 | 10.6% | 6.2% |
| 2015 | 94,678 | 225,538 | 320,217 | 12.2% | 5.3% |
| Thereafter | | | 1,296,418 | 49.2% | |
| | | | 2,633,169 | 100% | |
| Mortgages payable due on demand ⁽¹⁾ | | | 77,365 | | |
| Financing cost and mark-to-market adjustment arising on acquisitions ⁽²⁾ | | | (3,827) | | |
| Total | | | \$2,706,707 | | |

⁽¹⁾ Relates to seven non-recourse mortgages to the REIT for income properties in which the tenants (Boscov's Department Stores, Bruno's Supermarkets LLC and Great Atlantic & Pacific Tea Company) have filed for protection under Chapter 11 of the United States Bankruptcy Code. The REIT has handed over control of three of these income properties to the lenders and expects to be released from any further obligations under these non-recourse mortgages upon the transfer of title to the lenders.

⁽²⁾ Mark-to-market adjustment represents the difference between the actual mortgages assumed on property acquisitions and the fair value of the mortgages at the date of purchase and is recognized in interest over the life of the applicable mortgage using the effective interest rate method. Deferred financing costs are deducted from the REIT's mortgages payable balances and are recognized in interest over the life of the applicable mortgage.

TOP TWENTY SOURCES OF REVENUE BY TENANT

| | Tenant | % of rentals from income properties⁽¹⁾ | Number of locations | REIT owned sq.ft. (in 000's) | Average lease term to maturity (in years) |
|-----|---------------------------------|--|----------------------------|-------------------------------------|--|
| 1. | Bell Canada | 12.4 | 4 | 1,734 | 14.8 |
| 2. | TransCanada Pipelines Limited | 7.4 | 2 | 950 | 10.2 |
| 3. | Telus Communications | 6.5 | 2 | 943 | 12.4 |
| 4. | Bell Mobility | 6.0 | 2 | 775 | 14.9 |
| 5. | Rona Inc. | 4.2 | 14 | 2,151 | 8.9 |
| 6. | Versacold Logistics Canada Inc. | 3.7 | 12 | 1,733 | 16.0 |
| 7. | Canadian Tire Corp. | 3.7 | 4 | 2,189 | 15.8 |
| 8. | Royal Bank of Canada | 3.4 | 4 | 467 | 5.7 |
| 9. | Lowes Companies Inc. | 2.4 | 11 | 1,435 | 8.2 |
| 10. | Nestle USA | 2.1 | 3 | 2,168 | 6.8 |
| 11. | Nestle Canada Inc. | 2.0 | 1 | 170 | 8.7 |
| 12. | Shell Oil Products | 1.9 | 18 | 249 | 11.6 |
| 13. | Purolator Courier | 1.9 | 12 | 1,071 | 10.4 |
| 14. | Finning International | 1.7 | 16 | 893 | 11.4 |
| 15. | Public Works of Canada | 1.7 | 3 | 277 | 6.3 |
| 16. | Marsh Supermarkets | 1.5 | 9 | 548 | 15.9 |
| 17. | Hudson's Bay Company | 1.2 | 3 | 937 | 8.2 |
| 18. | Sobey's Inc. | 1.2 | 10 | 347 | 11.1 |
| 19. | Loblaw Properties Limited | 1.0 | 1 | 716 | 12.1 |
| 20. | BJ's Wholesale Club Inc. | 1.0 | 4 | 452 | 11.3 |
| | Total | 66.9% | 135 | 20,205 | |

⁽¹⁾ The percentage of rentals from income properties is based on estimated annualized gross revenue excluding the straight lining of contractual rent and discontinued operations.

| | Office | | Industrial | | Retail | | Total | |
|-----------------------|--------------------|---------------------------------------|--------------------|---------------------------------------|--------------------|---------------------------------------|--------------------|---------------------------------------|
| LEASE EXPIRIES | % 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 |
| 2011 | 0.3 | 21.95 | 0.8 | 8.73 | 0.1 | 23.16 | 1.2 | 13.24 |
| 2012 | 0.8 | 18.04 | 1.9 | 5.32 | 0.1 | 20.56 | 2.8 | 9.50 |
| 2013 | 0.5 | 18.75 | 3.8 | 5.23 | 0.4 | 10.11 | 4.7 | 7.08 |
| 2014 | 1.4 | 16.16 | 3.5 | 4.47 | 0.4 | 6.66 | 5.3 | 7.72 |
| 2015 | 1.1 | 22.17 | 1.3 | 7.57 | 0.3 | 27.94 | 2.7 | 15.78 |
| | 4.1 | 18.88 | 11.3 | 5.53 | 1.3 | 14.97 | 16.7 | 9.54 |

OUTLOOK

Construction on the Bow is approximately 77% complete and currently on budget. The \$1.5-billion office development is being constructed by the REIT in downtown Calgary. The sole tenant at the building, EnCana, is scheduled to begin taking occupancy in 2011 with full occupancy of the 58-storey landmark tower during 2012, at which time the Bow is expected to emerge as one of the highest quality office towers in Canada and as the keystone of the REIT's portfolio of properties. See "Funding of Further Commitments" for further information.

Equity and credit market concerns have eased over the past year and continue to steadily improve which has allowed the REIT to reduce financing costs and strengthen its balance sheet. In February 2010, the REIT issued \$230 million of unsecured senior debentures at an average contractual interest rate of 5.55% for an average term of six years. The REIT subsequently issued \$100 million of convertible debentures in July 2010 for a 10-year term at a contractual interest rate of 5.90%, \$125 million of unsecured senior debentures in September 2010 at an interest rate of 5.00% for an eight-year term and a further \$180 million of unsecured senior debentures in January 2011 at an interest rate of 4.78% for a 5½ year term, all of which demonstrates the improving markets. More abundant and cheaper capital has increased demand for commercial properties, placing downward pressure on capitalization rates and thereby increasing the market value of our portfolio.

During the year ended December 31, 2010, the REIT acquired 16 properties in the United States for \$157.8 million. The REIT partially funded the acquisition of the above properties with mortgages payable totalling \$109.9 million at an average contractual interest rate of 6.06% for an average term of over 16 years. The REIT's initial levered return from these acquisitions is expected to be approximately 10.8%. The REIT expects to continue making acquisitions on a very select and disciplined basis. In the United States, the recovery in the commercial real estate markets and capital markets has been much slower, resulting in higher capitalization rates than equivalent Canadian properties with financing for high-quality properties becoming increasingly available at attractive pricing.

The REIT's portfolio is performing well and management expects continued growth from our contracted rental escalations and accretive acquisitions. In short, management remains very optimistic and excited about its ability to continue to grow and prosper in the coming year. Consistent with the REIT's positive outlook, the trustees have adopted an updated distribution policy to replace the distribution policy previously announced in May 2010, by increasing the annualized intended distribution per Stapled Unit and extending the policy for an additional two quarters until the quarterly period ended December 31, 2012. The updated distribution policy comparing the updated intended annualized distribution per Stapled Unit with the previously announced intended annualized distribution per Stapled Unit is set out in the table below:

| Distribution Period | Updated Intended Annualized Distribution Per Stapled Unit | Previously Announced Intended Distribution Per Stapled Unit |
|--|---|---|
| Q1 2011 (January, February and March) | \$0.90 | \$0.90 |
| Q2 2011 (April, May and June) | \$0.95 | \$0.93 |
| Q3 2011 (July, August and September) | \$1.00 | \$0.96 |
| Q4 2011 (October, November and December) | \$1.05 | \$0.99 |
| Q1 2012 (January, February and March) | \$1.10 | \$1.02 |
| Q2 2012 (April, May and June) | \$1.15 | \$1.05 |
| Q3 2012 (July, August and September) | \$1.20 | - |
| Q4 2012 (October, November and December) | \$1.25 | - |

The trustees retain the right to re-evaluate the distribution policy from time to time as they consider appropriate. As all distributions remain subject to approval and declaration by the Trusts' trustees, there is no assurance that the actual distributions declared will be as provided in the distribution policy.

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 2010 | Year Ended December 31 2009 ⁽¹⁾ | Year Ended December 31 2008 ⁽¹⁾ |
|--|-----------------------------------|--|--|
| Rentals from income properties | \$615,572 | \$605,165 | \$591,954 |
| Interest income | 2,589 | 6,222 | 3,294 |
| Net property operating income | 109,424 | 104,458 | 107,263 |
| Net earnings from continuing operations | 168,404 | 70,297 | 19,250 |
| Net earnings per Stapled Unit from continuing operations | | | |
| (basic) | 1.16 | 0.50 | 0.15 |
| (diluted) ⁽²⁾ | 1.16 | 0.46 | 0.14 |
| Net earnings | 172,348 | 86,525 | 97,706 |
| Net earnings per Stapled Unit | | | |
| (basic) | 1.19 | 0.61 | 0.73 |
| (diluted) ⁽²⁾ | 1.19 | 0.56 | 0.72 |
| Total assets | 5,531,534 | 5,351,123 | 5,442,074 |
| Mortgages payable ⁽³⁾ | 2,706,707 | 2,818,476 | 3,157,470 |
| Debentures payable | 822,340 | 565,758 | 104,820 |
| Cash distributions per Stapled Unit | \$0.79 | \$0.72 | \$1.44 |

Notes:

- ⁽¹⁾ Certain items have been reclassified to conform with the presentation adopted in the current year.
- ⁽²⁾ The calculation to determine "net earnings per unit from continuing operations (diluted)" and "net earnings per unit (diluted)" gives effect to the issue of Stapled Units pursuant to outstanding options and warrants where dilutive and non-controlling interest conversion to Stapled Units.
- ⁽³⁾ Including discontinued operations.

Over the last few years, total assets of the Trusts have remained relatively constant. Rentals from income properties and net property operating income have steadily increased despite property dispositions of approximately \$240 million over the past 2 years. This is due primarily to acquisitions and completed property developments and acquisitions.

RESULTS OF OPERATIONS

| (in thousands of dollars except per unit amounts) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|---------------|-------------|------------------------|---------------|-------------|
| | 2010 | 2009 | % Change | 2010 | 2009 | % Change |
| Operating revenue: | | | | | | |
| Rentals from income properties | \$160,262 | \$151,668 | 6 | \$615,572 | \$605,165 | 2 |
| Interest income | 265 | 1,621 | (84) | 2,589 | 6,222 | (58) |
| | 160,527 | 153,289 | 5 | 618,161 | 611,387 | 1 |
| Operating expenses: | | | | | | |
| Property operating costs | 55,680 | 50,535 | 10 | 204,084 | 195,615 | 4 |
| Interest | 44,263 | 46,284 | (4) | 179,519 | 182,671 | (2) |
| Depreciation and amortization | 30,952 | 34,864 | (11) | 125,134 | 128,643 | (3) |
| | 130,895 | 131,683 | (1) | 508,737 | 506,929 | - |
| Net property operating income | 29,632 | 21,606 | 37 | 109,424 | 104,458 | 5 |
| Net loss on foreign exchange | (4,453) | (2,125) | | (6,775) | (20,509) | |
| Impairment loss on income properties | (14,862) | (268) | | (14,862) | (14,764) | |
| Unrealized gain (loss) on derivative instruments | 2,648 | (1,213) | | (5,521) | 3,463 | |
| Loss on repayment of debentures | - | - | | (38,834) | - | |
| Gain (loss) on extinguishment of debt | (332) | - | | 17,296 | - | |
| Trust expenses | (1,792) | (2,600) | | (8,897) | (8,551) | |
| Net earnings before income taxes, non-controlling interest and discontinued operations | 10,841 | 15,400 | | 51,831 | 64,097 | |
| Income tax recovery (expense) | (45) | 17,395 | | 122,845 | 9,249 | |
| Net earnings before non-controlling interest and discontinued operations | 10,796 | 32,795 | | 174,676 | 73,346 | |
| Non-controlling interest | (588) | (1,307) | | (6,272) | (3,049) | |
| Net earnings from continuing operations | 10,208 | 31,488 | | 168,404 | 70,297 | |
| Net earnings (loss) from discontinued operations | 381 | (1,618) | | 3,944 | 16,228 | |
| Net earnings | \$10,589 | \$29,870 | | \$172,348 | \$86,525 | |
| Basic net earnings per Stapled Unit | | | | | | |
| Continuing operations | \$0.07 | \$0.22 | | \$1.16 | \$0.50 | |
| Discontinued operations | - | (0.01) | | 0.03 | 0.11 | |
| | \$0.07 | \$0.21 | | \$1.19 | \$0.61 | |
| Diluted net earnings per Stapled Unit | | | | | | |
| Continuing operations | \$0.07 | \$0.20 | | \$1.16 | \$0.46 | |
| Discontinued operations | - | (0.01) | | 0.03 | 0.10 | |
| | \$0.07 | \$0.19 | | \$1.19 | \$0.56 | |

The change in net earnings for both the three months and year ended December 31, 2010 as compared to the respective 2009 periods is mainly due to the income tax recovery, loss on repayment of debentures, change in impairment loss on income properties, gain on extinguishment of debt, net earnings from discontinued operations and the strengthening of the Canadian dollar as compared to the U.S. dollar.

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 held-for-sale criteria have been recorded under net earnings from discontinued operations during the year ended December 31, 2010 and 2009.

| Rentals from Income Properties (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|-----------|---------|------------------------|-----------|----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Same-asset – current rentals | \$153,503 | \$149,612 | \$3,891 | \$599,965 | \$592,299 | \$7,666 |
| Same-asset – straight-lining of contractual rent | 4,759 | 2,504 | 2,255 | 11,019 | 12,608 | (1,589) |
| Same-asset rent amortization | (890) | (1,064) | 174 | (4,037) | (3,796) | (241) |
| Acquisitions – current rentals, rent amortization and straight-lining of contractual rent | 2,808 | - | 2,808 | 6,396 | - | 6,396 |
| Terminated leases due to U.S. bankruptcies | 82 | 616 | (534) | 2,229 | 4,054 | (1,825) |
| Total rentals | \$160,262 | \$151,668 | \$8,594 | \$615,572 | \$605,165 | \$10,407 |

The increase in same-asset current rentals of \$3.9 million for Q4 2010 as compared to Q4 2009 is primarily due to the following items:

- an increase of \$2.3 million of additional rent recoverable from tenants in accordance with their leases for items which were capitalized to building improvements;
- an increase of \$0.2 million from rent escalations during the term of tenant leases;
- an increase of \$2.4 million in tenant recoveries due to higher regular property operating expenses; offset by
- same-asset current rentals from properties in the United States which have decreased by \$1.1 million primarily due to the weakening of the U.S. dollar when converted into Canadian dollars. The average exchange rate for the three months ended December 31, 2010 was \$1.00 Canadian for each \$1.00 U.S. (Q4 2009 - \$1.05).

The increase in same-asset current rentals of \$7.7 million for the year ended December 31, 2010 as compared to the same 2009 period is primarily due to the following items:

- an increase of \$8.8 million of additional rent recoverable from tenants in accordance with their leases for items which were capitalized to building improvements;
- an increase of \$4.0 million from rent escalations during the term of tenant leases;
- an increase of \$1.5 million in tenant recoveries due to higher regular property operating expenses;
- an increase of \$2.3 million due to lease terminations and higher recoveries in 2010 as compared to 2009 relating to the final reconciliation of tenant billings for the prior year; offset by
- same-asset current rentals from properties in the United States which have decreased by \$9.6 million primarily due to the weakening of the U.S. dollar when converted into Canadian dollars. The average exchange rate for the year ended December 31, 2010 was \$1.03 Canadian for each \$1.00 U.S. (December 31, 2009 - \$1.14).

The increase of \$2.3 million in the same-asset straight lining of contractual rent for the three months ended December 31, 2010 was due to a calculation correction of \$2.4 million. Without this one-time adjustment, straight lining of contractual rent for the three months and year ended December 31, 2010 would have been \$2.4 million and \$8.6 million, respectively.

Property Operating Costs

Property operating costs include costs relating to such items as cleaning, interior and exterior building repairs and maintenance, elevator, HVAC and insurance (collectively “building operating costs”); realty taxes, utilities and property management fees among other items. For Q4 2010, building operating costs, realty taxes, utilities and property management fees represented 26.0%, 46.9%, 11.3%, and 6.0%, respectively, of total property operating costs (Q4 2009 - 22.2%, 51.3%, 12.3% and 4.2%). For the year ended December 31, 2010, these costs represented 20.6%, 51.7%, 12.3% and 6.0%, respectively, of total property operating costs (December 31, 2009 - 19.6%, 54.2%, 11.8% and 4.5%).

| Property Operating Costs (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|----------|---------|------------------------|-----------|---------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Same-asset property operating costs | \$55,427 | \$50,303 | \$5,124 | \$201,812 | \$193,658 | \$8,154 |
| Acquisitions | 488 | - | 488 | 1,050 | - | 1,050 |
| Terminated leases due to U.S. bankruptcies | (235) | 232 | (467) | 1,222 | 1,957 | (735) |
| Total property operating costs | \$55,680 | \$50,535 | \$5,145 | \$204,084 | \$195,615 | \$8,469 |

The increase in same-asset property operating costs of \$5.1 million for Q4 2010 as compared to Q4 2009 is due primarily to the following reasons:

- higher regular property operating expenses of \$2.8 million;
- higher major repair expenditures of \$1.7 million;
- higher management fees of \$0.6 million due to an incentive fee of \$0.6 million (Q4 2009 - \$nil) payable to H&R Property Management Ltd. (the “Property Manager”). In 2009, the incentive fee was waived by the Property Manager; and
- lower expenses related to the REIT’s U.S. properties of \$0.2 million due primarily to the change in foreign exchange rates.

The increase in same-asset property operating costs of \$8.2 million for the year ended December 31, 2010 as compared to the year ended December 31, 2009 is due primarily to the following reasons:

- higher regular property operating expenses of \$1.8 million;
- higher major repair expenditures of \$5.3 million;
- higher management fees of \$2.5 million due to an incentive fee of \$2.5 million (December 31, 2009 - \$nil) payable to the Property Manager. In 2009, the incentive fee was waived by the Property Manager; and
- lower expenses related to the REIT’s U.S. properties of \$1.4 million due primarily to the change in foreign exchange rates.

| Same-Asset Property Operating Income* (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|-----------|-----------|------------------------|-----------|---------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Same-asset current rentals and straight-lining of contractual rent | \$158,262 | \$152,116 | \$6,146 | \$610,984 | \$604,907 | \$6,077 |
| Same-asset - property operating costs | 55,427 | 50,303 | 5,124 | 201,812 | 193,658 | 8,154 |
| Total same-asset - property operating income | 102,835 | 101,813 | 1,022 | 409,172 | 411,249 | (2,077) |
| Total same-asset – property operating income excluding straight-lining of contractual rent | \$98,076 | \$99,309 | (\$1,233) | \$398,153 | \$398,641 | (\$488) |

* Same-asset property operating income excludes the properties where the tenants have terminated their leases due to U.S. bankruptcies.

Total same-asset property operating income, excluding straight-lining of contractual rent, has decreased by \$1.2 million and \$0.5 million for the three months and for the year ended December 31, 2010, respectively, as compared to the respective 2009 periods. The net change in same-asset property operating income excluding straight-lining of contractual rent resulted from a decrease in Canada of \$0.4 million and an increase of \$7.2 million, respectively, which was offset by a corresponding decrease of \$0.8 million and \$7.7 million, respectively, in the United States, as shown below:

| | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------------|------------------|------------------------|------------------|----------------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Canada (in thousands of dollars) | | | | | | |
| Same-asset current rentals | \$131,534 | \$126,618 | \$4,916 | \$509,245 | \$492,544 | \$16,701 |
| Same-asset property operating costs | 51,977 | 46,641 | 5,336 | 186,874 | 177,352 | 9,522 |
| Same-asset property operating income excluding straight-lining of contractual rent | 79,557 | 79,977 | (420) | 322,371 | 315,192 | 7,179 |
| United States (in thousands of dollars) | | | | | | |
| Same-asset current rentals | 21,969 | 22,994 | (1,025) | 90,720 | 99,755 | (9,035) |
| Same-asset property operating costs | 3,450 | 3,662 | (212) | 14,938 | 16,306 | (1,368) |
| Same-asset property operating income excluding straight-lining of contractual rent | 18,519 | 19,332 | (813) | 75,782 | 83,449 | (7,667) |
| Total same-asset property operating income* | \$98,076 | \$99,309 | (\$1,233) | \$398,153 | \$398,641 | (\$488) |

* Same-asset property operating income excludes the properties where the tenants have terminated their leases due to U.S. bankruptcies.

Canadian same-asset property operating income decreased by \$0.4 million from the three months ended December 31, 2010 compared to the three months ended December 31, 2009.

The increase in the Canadian same-asset property operating income of \$7.2 million for the year ended December 31, 2010 as compared to the 2009 period is primarily due to increased recoverable amounts from tenants for major repair expenditures of \$8.8 million, increases in rent of \$4.0 million and lease terminations and prior year recoveries of \$2.3 million, offset by increased major repair and non-recoverable property operating costs of \$5.6 million and higher management fees of \$2.5 million as a result of management fees being waived by the Property Manager during 2009.

The decrease in the U.S. same-asset property operating income of \$0.8 million for Q4 2010 as compared to Q4 2009 and of \$7.7 million for the year ended December 31, 2010 as compared to the year ended December 31, 2009 is due primarily to the weakening of the U.S. dollar. The average exchange rate for the three months ended December 31, 2010 was \$1.00 Canadian for each \$1.00 U.S. (Q4 2009 - \$1.05). For the year ended December 31, 2010, the average exchange rate was \$1.03 (December 31, 2009 - \$1.14). Had the U.S. same-asset property operating income been reported in U.S. dollars, there would have been minimal changes between the respective 2010 and 2009 periods.

| Interest Income (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|---------|-----------|------------------------|---------|-----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Interest income | \$265 | \$1,621 | (\$1,356) | \$2,589 | \$6,222 | (\$3,633) |

Interest income decreased when comparing the three and twelve months ended December 31, 2010 as opposed to the respective 2009 periods. The decrease is primarily due to the collection of a \$16.5 million mortgage receivable in December 2009 and the collection of a \$58 million mortgage receivable in April 2010.

H&R REIT AND H&R FINANCE TRUST - MD&A - December 31, 2010

| Interest Expense (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|----------|-----------|------------------------|-----------|------------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Contractual interest on mortgages payable | \$41,532 | \$44,352 | (\$2,820) | \$170,293 | \$181,442 | (\$11,149) |
| Contractual interest on debentures payable | 13,326 | 10,334 | 2,992 | 46,400 | 27,884 | 18,516 |
| Effective interest rate accretion | 3,246 | 2,069 | 1,177 | 11,453 | 5,564 | 5,889 |
| Bank interest and charges | 1,721 | 190 | 1,531 | 3,573 | 2,193 | 1,380 |
| | 59,825 | 56,945 | 2,880 | 231,719 | 217,083 | 14,636 |
| Capitalized interest | (15,562) | (10,661) | (4,901) | (52,200) | (34,412) | (17,788) |
| Interest expense | \$44,263 | \$46,284 | (\$2,021) | \$179,519 | \$182,671 | (\$3,152) |

The decrease in contractual interest on mortgages payable for the three months and year ended December 31, 2010 compared to the respective 2009 periods is primarily due to a decrease in foreign exchange rates during the three months and year ended December 31, 2010. Included in mortgage interest for the three months ended December 31, 2010 is an accrual of \$1.2 million (Q4 2009 - \$2.4 million) and for the year ended December 31, 2010 is an accrual of \$6.8 million (December 31, 2009 - \$10.1 million) which relates to interest accrued on mortgages for properties where the tenant has filed for protection under Chapter 11 of the United States Bankruptcy Code. This accrual will be reversed into earnings when the lender accepts title to the properties and releases the REIT's subsidiaries from all obligations under these mortgages. As at both December 31, 2010 and 2009, the REIT's weighted average contractual mortgage rate was 6.2%.

Debenture interest increased for both the three and twelve month periods ended December 31, 2010 as compared to the respective 2009 periods as a result of twelve months' worth of interest being incurred in 2010 on debentures issued throughout 2009. In addition, in 2010, the REIT issued \$230 million of senior unsecured debentures (at an average contractual annual interest rate of 5.55%) in February, \$100 million of convertible debentures (at a contractual annual interest rate of 5.90%) in July and \$125 million of senior unsecured debentures (at a contractual annual interest rate of 5.00%) in September and repaid \$200 million of Non-Convertible Debentures in February.

Effective interest rate accretion is a non-cash item. This accretion increased by \$1.2 million between Q4 2009 and Q4 2010 and by \$5.9 million for the year ended December 31, 2010 as compared to the year ended December 31, 2009 due to the issuance of the above \$780 million of debentures between July 1, 2009 and December 31, 2010. These debentures have a weighted average contractual interest rate of 5.83% as compared to a weighted average effective interest rate of 7.78%.

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.

| Net Loss on Foreign Exchange (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|---------|-----------|------------------------|----------|------------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Net loss on foreign exchange | \$4,453 | \$2,125 | (\$2,328) | \$6,775 | \$20,509 | (\$13,734) |

The net loss on foreign exchange, which was recorded in the financial statements of Finance Trust, is due to a difference in exchange rates as the U.S. Holdco Notes receivable by Finance Trust are denominated in U.S. dollars while the financial statements of Finance Trust are expressed in Canadian dollars. The notes are eliminated upon combination however, the foreign exchange difference is not eliminated on combination as U.S. Holdco is a self-sustaining operation of the REIT.

| Impairment Loss on Income Properties (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|-------|----------|------------------------|----------|--------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Impairment loss on income properties | \$14,862 | \$268 | \$14,594 | \$14,862 | \$14,764 | \$98 |

During Q3 2010, The Great Atlantic & Pacific Tea Company ("A&P") had ceased rental payments on two of the REIT's properties resulting in the REIT recording a provision for bad debts of \$0.4 million. In December 2010, A&P filed for Chapter 11 protection with a United States bankruptcy court. The REIT has recorded an impairment loss of \$14.9 million in Q4 2010 to write down the value of

the properties to their estimated fair value of \$10.4 million. This represented the fair value of the properties as required under Canadian GAAP and is below the \$20.7 million of mortgages payable on the properties. As the mortgages on these properties are non-recourse, the REIT ceased making contractual mortgage payments. Once the lender has accepted title to the properties, the REIT is expecting to record a gain on extinguishment of debt of approximately \$10.3 million plus the amount of interest accrued. The net overall loss to the REIT is expected to be approximately \$4.6 million.

The \$14.8 million recorded in 2009 was due to Chapter 11 bankruptcy protection filing of Circuit City and Bruno's Supermarkets LLC, tenants at four of the REIT's properties. Pursuant to the terms of the bankruptcy filing with a United States bankruptcy court, Bruno's Supermarket LLC terminated its leases with the REIT.

Unrealized Gain (Loss) on Derivative Instruments

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|---------|------------------------|---------|-----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Unrealized gain (loss) on derivative instruments | \$2,648 | (\$1,213) | \$3,861 | (\$5,521) | \$3,463 | (\$8,984) |

The REIT has entered into an interest rate swap which has effectively locked the interest rate on the Bow construction facility at 4.65%. The interest expense on this facility is capitalized to properties under development during the eligible period. At the end of each reporting period, the interest rate swap is marked-to-market, resulting in an unrealized gain or loss recorded in net earnings. Upon completion of the development of the Bow and cessation of capitalizing interest, the difference between the hedged rate and the actual rate will be recorded as a realized gain or loss in net earnings.

In May 2010, the REIT entered into a foreign exchange forward contract with a Canadian chartered bank which effectively locked the REIT's rate to exchange U.S. \$2 million per month at 1.0402 for a two-year period in order to lock in a portion of the REIT's projected USD FFO and AFFO at a fixed Canadian dollar amount. The remaining foreign exchange forward contracts are marked-to-market through earnings each reporting period. As each month's contract is realized, any gain or loss is recorded into earnings at that time.

In June 2010, the REIT secured a floating rate mortgage on a U.S. property. In order to fix the interest rate, the REIT entered into an interest rate swap, which is marked-to-market through earnings each reporting period.

Loss on Repayment of Debentures

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---------------------------------|--------------------------------|------|--------|------------------------|------|----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Loss on repayment of debentures | - | - | - | \$38,834 | - | \$38,834 |

In February 2010, the REIT repaid the outstanding Non-Convertible Debentures having an aggregate face value of \$200 million for a total repurchase price of \$230 million. The repurchase price included accrued interest of approximately \$2 million. The REIT recognized a one-time non-recurring charge to net earnings of approximately \$39 million, representing the difference between the repurchase price, excluding accrued interest expense, and the carrying value of the Non-Convertible Debentures of \$189 million.

Gain (loss) on Extinguishment of Debt

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---------------------------------------|--------------------------------|------|---------|------------------------|------|----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Gain (loss) on extinguishment of debt | (\$332) | - | (\$332) | \$17,296 | - | \$17,296 |

In May and September 2010, the REIT was legally released from its mortgages on the Circuit City Distribution Warehouse and on four Boscov Department Stores upon the lender accepting title to the properties. As a result, the income properties, the mortgages and the accrued interest on the mortgages were all derecognized resulting in a gain (loss) on extinguishment of debt of (\$0.3 million) and \$17.3 million for the three months and for the year ended December 31, 2010, respectively.

Trust Expenses

| (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---------------------------|--------------------------------|---------|---------|------------------------|---------|--------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Trust expenses | \$1,792 | \$2,600 | (\$808) | \$8,897 | \$8,551 | \$346 |

These expenses are primarily comprised of salaries, professional fees, trustee fees and stock-based compensation expense. Trust expenses increased during the year ended December 31, 2010 over the respective 2009 period. The primary reasons for the

increase in 2010 as compared to 2009 are due to increased stock-based compensation expense and costs associated with the upcoming implementation of IFRS and the specified investment flow-through ("SIFT") restructuring.

| Income Tax Recovery (Expense) (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|----------|------------|------------------------|---------|-----------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Current income tax expense | (\$45) | (\$85) | 40 | (\$458) | (\$364) | (94) |
| Future income tax recovery | - | 17,480 | (17,480) | 123,303 | 9,613 | 113,690 |
| Total income tax recovery (expense) | (\$45) | \$17,395 | (\$17,440) | \$122,845 | \$9,249 | \$113,596 |

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.

During the second quarter of 2010, the REIT completed the necessary restructuring to qualify for the SIFT Exemption (as defined herein) under the SIFT rules commencing January 1, 2011. See the "Tax Risk" section for further discussion. Accordingly, the net future income tax liability has been reversed into earnings. This impact on earnings was \$nil for the three months ended December 31, 2010 and \$123.3 million for the year ended December 31, 2010.

Net Earnings (Loss) 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 combined statement of earnings in net earnings from discontinued operations as summarized below:

| Net Earnings (Loss) from Discontinued Operations (in thousands of dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|-----------|-----------|------------------------|----------|------------|
| | 2010 | 2009 | Change | 2010 | 2009 | Change |
| Net property operating income | \$436 | \$1,439 | (\$1,003) | \$517 | \$6,200 | (5,683) |
| Gain (loss) on sale of income properties | (40) | (3,118) | 3,078 | 3,576 | 10,649 | (7,073) |
| Non-controlling interest | (15) | 61 | (76) | (149) | (621) | 472 |
| Net earnings (loss) from discontinued operations | \$381 | (\$1,618) | \$1,999 | \$3,944 | \$16,228 | (\$12,284) |

During the three months ended December 31, 2010, the REIT sold no income properties (Q4 2009 - one) for gross proceeds of \$nil (Q4 2009 - \$140.0 million). For the year ended December 31, 2010, the REIT sold two income properties (December 31, 2009 - seven) for gross proceeds of \$23.3 million (December 31, 2009 - \$216.6 million). The net earnings from discontinued operations include the results from these properties. The REIT currently has no properties held for sale.

Dispositions from January 1, 2010 to December 31, 2010

| Property | Property Type | Date Sold | Square Footage | Gross Proceeds (\$ Millions) | Ownership Interest disposed |
|------------------------------------|---------------|--------------|----------------|------------------------------|-----------------------------|
| 2390 Argentia Rd., Mississauga, ON | Industrial | Jan 12, 2010 | 179,054 | \$12.3 | 100% |
| 110 Sheppard Ave., E., Toronto, ON | Office | Mar 1, 2010 | 154,022 | 11.0 | 50% |
| Total | | | 333,076 | \$23.3 | |

Dispositions from January 1, 2009 to December 31, 2009

| Property | Property Type | Date Sold | Square Footage | Gross Proceeds (\$ Millions) | Ownership Interest disposed |
|---------------------------------------|---------------|---------------|------------------|------------------------------|-----------------------------|
| 2435 EW Connector, Austell, GA | Retail | Feb 10, 2009 | 115,396 | \$16.4 | 100% |
| 97 Thames Rd., E. Exeter, ON | Industrial | Mar 16, 2009 | 84,000 | 4.4 | 100% |
| 1711 Springfield Rd., Kelowna, BC | Retail | June 3, 2009 | 110,178 | 18.4 | 100% |
| 6660 Financial Drive, Mississauga, ON | Industrial | July 16, 2009 | 164,236 | 11.8 | 100% |
| 2089 West Neways Dr., Springville, UT | Office | July 28, 2009 | 84,511 | 8.6 | 55% |
| 75 Frontenac Dr., Markham, ON | Industrial | Aug 4, 2009 | 243,614 | 17.0 | 100% |
| 500 Bayly St. E, Ajax, ON | Industrial | Dec 18, 2009 | 909,286 | 140.0 | 100% |
| Total | | | 1,711,221 | \$216.6 | |

SEGMENTED INFORMATION

The REIT invests in income producing properties in both Canada and the United States with tenants that are creditworthy and on long-term leases.

The REIT is not required to report in its financial statements on the performance of each class of assets 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 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 on a geographic basis as the property operations in the United States are considered to be a geographic segment. This segmented information on net property operating income is as follows:

Net property operating income for the three months ended December 31, 2010

| (in thousands of dollars) | Canada | United States | Total |
|--------------------------------------|------------------|-----------------|------------------|
| Operating revenue | \$132,495 | \$28,032 | \$160,527 |
| Property operating costs | (51,974) | (3,706) | (55,680) |
| Interest | (32,424) | (11,839) | (44,263) |
| Depreciation and amortization | (22,974) | (7,978) | (30,952) |
| Net property operating income | \$25,123 | \$4,509 | \$29,632 |

Net property operating income for the three months ended December 31, 2009

| (in thousands of dollars) | Canada | United States | Total |
|-------------------------------|-----------|---------------|-----------|
| Operating revenue | \$129,512 | \$23,777 | \$153,289 |
| Property operating costs | (46,640) | (3,895) | (50,535) |
| Interest | (33,291) | (12,993) | (46,284) |
| Depreciation and amortization | (23,028) | (11,836) | (34,864) |
| Net property operating income | \$26,553 | (\$4,947) | \$21,606 |

Net property operating income for the year ended December 31, 2010

| (in thousands of dollars) | Canada | United States | Total |
|--------------------------------------|------------------|----------------|------------------|
| Operating revenue | \$515,033 | \$103,128 | \$618,161 |
| Property operating costs | (186,875) | (17,209) | (204,084) |
| Interest | (129,893) | (49,626) | (179,519) |
| Depreciation and amortization | (92,111) | (33,023) | (125,134) |
| Net property operating income | \$106,154 | \$3,270 | \$109,424 |

Net property operating income for the year ended December 31, 2009

| (in thousands of dollars) | Canada | United States | Total |
|--------------------------------------|------------------|------------------|------------------|
| Operating revenue | \$506,679 | \$104,708 | \$611,387 |
| Property operating costs | (177,351) | (18,264) | (195,615) |
| Interest | (125,294) | (57,377) | (182,671) |
| Depreciation and amortization | (91,625) | (37,018) | (128,643) |
| Net property operating income | \$112,409 | (\$7,951) | \$104,458 |

The change in the Canadian net property operating income for the three months ended December 31, 2010 as compared to the respective 2009 period is (\$1.4 million). The change in the Canadian net property operating income of (\$6.3 million) for the year ended December 31, 2010 as compared to the prior year's period is primarily due to increased interest expense.

The change in U.S. net property income of \$9.5 million and \$11.2 million for the three months and year ended December 31, 2010, as compared to the respective prior periods, is primarily due to a change in foreign exchange rates, a one-time adjustment for straight lining of contractual rent, a decrease in mortgage interest expense, net property operating income generated from U.S. property acquisitions and decreased net property operating loss for those properties upon which the lender has taken back title for certain mortgages related to properties where the tenant has filed for protection under Chapter 11 of the United States Bankruptcy Code. Had the net property income for properties located in the United States been shown in U.S. dollars, and excluding the straight lining of contractual rent adjustment, the decrease in mortgage interest expense, the net property loss from those properties where the tenants have terminated their leases and the acquisitions during 2010, it would have shown income of \$2.5 million and \$7.9 million for the three months ended December 31, 2010 and the year ended December 31, 2010 as compared to income of \$2.0 million and \$7.4 million for the three months ended December 31, 2009 and the year ended December 31, 2009, respectively.

ASSETS

Income Properties

| | | |
|---|--------------|--------------------|
| Opening balance - December 31, 2009 | | \$4,124,856 |
| Acquisitions | | |
| Purchase price of acquisitions | 157,751 | |
| Transaction costs incurred | 2,787 | |
| Purchase price allocated to intangible liabilities based on EIC-140 calculation | 3,744 | |
| Mark-to-market adjustment of mortgages payable | <u>2,378</u> | 166,660 |
| Expenditures capitalized to building improvements | | 15,371 |
| Foreign exchange difference | | (71,146) |
| Depreciation and amortization | | (119,646) |
| Income derecognized upon lender accepting legal title to the properties | | (82,378) |
| Impairment loss | | (14,862) |
| Closing balance - December 31, 2010 | | \$4,018,855 |

The REIT acquired 16 properties during the year ended December 31, 2010. These acquisitions less mortgages assumed were funded from the REIT's general operating facility, funds from debenture issuances and proceeds received from the sale of properties. There were no properties acquired during the year ended December 31, 2009.

2010 Acquisitions:

| Property | Year Built | Property Type | Date Acquired | Square Footage | Purchase Price (\$ Millions) | Tenant Name | Remaining Lease Term (years) |
|---|------------|---------------|---------------|----------------|------------------------------|------------------------|------------------------------|
| 7919 Day Dr., Parma, OH | 2008 | Retail | Feb 26, 2010 | 92,634 | \$18.9 | Giant Eagle | 20 |
| 2951 SW Wanamaker Rd., Topeka, KS | 2008 | Retail | Mar 12, 2010 | 75,149 | 14.9 | Hy-Vee | 20 |
| 115-118 Wilmar Ave., Grand Island, NE | 2008 | Retail | Mar 12, 2010 | 83,331 | 13.2 | Hy-Vee | 20 |
| 9400 E. 350 Highway, Raytown, MO | 2009 | Retail | Mar 12, 2010 | 66,900 | 14.1 | Hy-Vee | 20 |
| 110 SSW Loop 323, Tyler, TX | 2008 | Retail | Aug 9, 2010 | 14,820 | 6.6 | Walgreens | 23 |
| 1510 South Main Ave., Taylor, PA | 2000 | Retail | Aug 11, 2010 | 68,622 | 7.9 | Price Chopper | 15 |
| 245 Wilkes Barre Township Blvd., Wilkes Barre, PA | 2008 | Retail | Aug 11, 2010 | 64,252 | 10.5 | Price Chopper | 23 |
| 400 E FM 2410 Rd., Harker Heights, TX | 2007 | Retail | Sep 30, 2010 | 14,731 | 3.9 | Walgreens | 21 |
| 4746 Twin City Hwy., Groves, TX | 2007 | Retail | Sep 30, 2010 | 14,538 | 4.8 | Walgreens | 22 |
| 3822 Old Spanish Tr., Houston, TX | 2007 | Retail | Sep 30, 2010 | 14,490 | 6.7 | Walgreens | 22 |
| 101 S Washington Ave., Cleveland, TX | 2008 | Retail | Sep 30, 2010 | 13,805 | 5.4 | Walgreens | 23 |
| 1790 Texas Ave., Bridge City, TX | 2008 | Retail | Sep 30, 2010 | 14,513 | 5.8 | Walgreens | 23 |
| 1220 W University Ave., Georgetown, TX | 2009 | Retail | Sep 30, 2010 | 14,545 | 6.0 | Walgreens | 23 |
| 50 Cambridge St., Worcester, MA | 2002 | Retail | Dec 21, 2010 | 69,020 | 14.8 | Price Chopper | 18 |
| 9229 Lyndon B. Johnson Freeway, Dallas, TX | 1978 | Office | Dec 30, 2010 | 79,049 | 11.4 | Texas Health Resources | 15 |
| 9330 Amberton Pkwy, Dallas, TX | 1978 | Office | Dec 30, 2010 | 92,694 | 12.9 | Texas Health Resources | 15 |
| Total | | | | 793,093 | \$157.8 | | |

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

The REIT partially funded the acquisition of the above properties with mortgages payable totalling \$109,856, bearing interest at an average contractual rate of 6.06% per annum. These mortgages payable have an average term of 16 years remaining and are non-recourse to the REIT but have recourse to the specific properties to which each mortgage applies. The REIT's initial levered return from these acquisitions is expected to be 10.8%.

The portfolio continues to remain in good condition. The average age of the total portfolio from the date built or renovated is 16.9 years at December 31, 2010 (December 31, 2009 - 16.3 years) and the average age of properties by type of asset is as follows:

| Average Age by Type of Asset | December 31, 2010 (years) | December 31, 2009 (years) |
|-------------------------------------|--------------------------------------|------------------------------|
| Office | 19.5 | 18.4 |
| Industrial | 17.6 | 16.9 |
| Retail | 12.1 | 12.1 |
| Total | 16.9 | 16.3 |

Legal title to each of the United States properties is held by a separate legal entity which is 100% owned, directly or indirectly, by H&R REIT (U.S.) Holdings Inc. ("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 net book value of income properties expressed by type of asset and by region is as follows:

| Net Book Value by Type of Asset (millions) | December 31, 2010 | December 31, 2009 |
|---|--------------------------|-------------------|
| Office | \$1,555 | \$1,565 |
| Industrial | 1,310 | 1,388 |
| Retail | 1,154 | 1,172 |
| | \$4,019 | \$4,125 |

| Net Book Value by Region (millions) | December 31, 2010 | December 31, 2009 |
|--|--------------------------|-------------------|
| Ontario | \$1,719 | \$1,763 |
| Alberta | 582 | 595 |
| Other | 420 | 433 |
| Quebec | 235 | 238 |
| Canada | 2,956 | 3,029 |
| United States | 1,063 | 1,096 |
| Total | \$4,019 | \$4,125 |

Significant costs associated with income properties are either capitalized and depreciated or expensed in the year incurred. As a result, the REIT expects to incur the following costs:

| Year | Total Amount Expected to be Incurred | Amount Expected to be Capitalized | Amount Expected to be Expensed to Property Operating Costs | Total Expected Recovery | Amount Expected to be Recovered in the Year Incurred | Amount Expected to be Recovered thereafter |
|------|--------------------------------------|-----------------------------------|--|-------------------------|--|--|
| 2011 | \$22 million | \$15 million | \$7 million | \$19 million | \$12 million | \$7 million |
| 2012 | \$16 million | \$10 million | \$6 million | \$13 million | \$10 million | \$3 million |

The information contained in the table above is based on current tenancies in place and management's estimates of these costs being recovered through tenant's leases.

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, including expected capitalized interest, and net of rent received during the construction period. The budget includes the cost to construct 1,360 parking stalls. The REIT has entered into fixed price contracts amounting to approximately 92% of the budgeted \$1.1 billion of hard construction costs. As a result, together with the costs incurred to date, the REIT has effectively locked in approximately 97% of the total budget before contingencies. See Section V for a discussion on development and financing risk relating to the Bow.

The building is fully pre-leased, on a triple net basis, to EnCana Corporation for 25 years. The total annualized year one projected income from the Bow is expected to be approximately \$94 million. Rent step ups will be 0.75% per annum on the office space and 1.5% per annum on the parking income for the full 25-year term. During the year ended December 31, 2010, the REIT incurred additional costs of \$430.9 million in this project to bring the REIT's total investment to \$1,150.1 million (December 31, 2009 - \$719.2 million). The erection of the main structure is substantially complete. The project is approximately 3 months behind schedule from the first contractual tranche delivery date. The potential cost expected to be incurred in the form of free rent for the late delivery of the tranches is approximately \$4.7 million and is included in the budgeted soft costs. The \$30.0 million contingency for the project would be available for any additional delay costs.

The REIT is expecting to incur approximately \$360.0 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.

Accrued Rent Receivable

Certain leases call for rental payments that increase over the lease term. To comply with Canadian GAAP, the rental revenue from these leases are recorded on a straight-line basis, resulting in accruals for rents that are not billable or due until future periods. Accrued rent receivable has increased by 9% or \$11.4 million from \$125.2 million at December 31, 2009 to \$136.6 million at December 31, 2010 with a corresponding increase to rentals.

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) |
|--|---------|---------------------------|-------------------------------|---|
| 88 McNabb St., Markham, ON | 74,592 | \$1.32 | Jan 2011 | \$98 |
| 649 N. Service Rd., Oakville, ON | 123,000 | \$1.60 | Mar 2011 | \$197 |
| 411-1 st St., S.E., Calgary, AB | 272,674 | \$2.00 | May 2011 | \$545 |
| 100 Wynford Dr., Toronto, ON | 459,171 | \$2.89 | May 2011 | \$1,327 |
| 200 Bouchard Boul, Dorval, QC | 451,899 | \$2.81 | May 2011 | \$1,270 |
| 450-1 st St., S.W., Calgary, AB | 931,187 | \$2.88 | May 2011 | \$2,682 |
| 2665- 32 nd St., Calgary, AB | 89,438 | \$1.06 | Jul 2011 | \$95 |
| 775 Panet Rd., Winnipeg, MB | 121,962 | \$1.08 | Jul 2011 | \$132 |
| 1333 Sargent Ave., Winnipeg, MB | 87,769 | \$1.26 | Jul 2011 | \$111 |
| 160 Elgin St., Ottawa, ON | 130,276 | \$2.00 | Aug 2011 | \$261 |
| 2140 E. 116 th St., Carmel, IN | 80,640 | \$1.06 | Dec 2011 | \$86 |

| Other Assets (in thousands of dollars) | December 31, 2010 | December 31, 2009 |
|---|--------------------------|--------------------------|
| Tenant inducements | \$33,209 | \$29,797 |
| Leasing expenses | 26,121 | 27,542 |
| Restricted cash | 19,106 | 20,001 |
| Accounts receivable | 7,420 | 6,543 |
| Prepaid expenses and sundry assets | 6,932 | 12,811 |
| Mortgages and amount receivable | 3,000 | 63,789 |
| Derivative instruments | 1,225 | 3,463 |
| Future income tax asset | - | 14,316 |
| Other Assets | \$97,013 | \$178,262 |

Tenant inducements increased by \$3.4 million in the year ended December 31, 2010 due primarily to one inducement for a tenant at 310-330 Front Street offset by normal periodic amortization.

Prepaid expenses and sundry assets have decreased from \$12.8 million at December 31, 2009 to \$6.9 million at December 31, 2010 primarily due to a deposit that was applied to the purchase of the Caledon lands.

Restricted cash decreased from \$20.0 million at December 31, 2009 to \$19.1 million at December 31, 2010 due primarily to a decrease in funds being held in escrow relating to costs to complete Bell Phase III.

Mortgages and amount receivable decreased from \$63.8 million to \$3.0 million from December 31, 2009 to December 31, 2010. The decrease of \$60.8 million is primarily due to the collection of a \$58 million mortgage receivable in April 2010 along with the collection of \$3.2 million of a mortgage receivable from the REIT's partner in the Airport Road lands during 2010.

Future income tax asset has decreased from \$14.3 million at December 31, 2009 to \$nil as at December 31, 2010 as the REIT has now completed the necessary restructuring to permit the REIT to qualify for the REIT Exemption beginning in 2011. Accordingly, this balance has been recognized in earnings.

Derivative instruments represented the fair value of the interest rate swap on the Bow construction facility at December 31, 2009. At December 31, 2010, the fair value of the interest rate swap on the Bow construction facility was a liability of \$2,897. In May 2010, the REIT entered into monthly future foreign exchange forward contracts which had a fair value of \$1,225 at December 31, 2010.

Cash and cash equivalents

Cash and cash equivalents decreased to \$10.7 million at December 31, 2010 from \$109.2 million at December 31, 2009 primarily due to the continued funding of properties under development and the purchase of income properties.

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.

| | December 31, 2010 | December 31, 2009 |
|---|-------------------|-------------------|
| Total debt to GBV (per the REIT's Declaration of Trust ⁽¹⁾) | 50.3% | 52.5% |
| Total debt to GBV of the combined financial statements | 57.9% | 56.8% |
| Non-recourse debt as a percentage of total debt | 39.9% | 44.9% |
| Floating rate debt as a percentage of total debt | 2.5% | 0.4% |
| Canadian properties total debt to GBV | 56.4% | 56.6% |
| U.S. properties total debt to GBV | 63.8% | 66.5% |

⁽¹⁾ Total debt per the REIT's Declaration of Trust is based on GBV of the REIT and excludes all convertible debentures and the U.S. Holdco Notes payable to Finance Trust. At the annual general meeting of the REIT in June 2010, the REIT's Declaration of Trust was amended to exclude certain guarantees provided by the REIT of debt assumed by purchasers, on a primary obligor basis, in connection with past dispositions of properties and for which the purchaser has provided the REIT an indemnity or similar arrangement from the REIT's calculation of debt to GBV as per the Declaration of Trust. In December 2010, the amount of these guarantees was \$116.4 million. 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.

There were no material changes in the debt ratios above. 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

| | |
|---|--------------------|
| Opening balance - December 31, 2009 | \$2,818,476 |
| Principal payments | (96,028) |
| Mortgage repaid upon maturity | (11,245) |
| New mortgages | 136,326 |
| Mortgages payable released upon lender taking title to properties | (89,484) |
| Foreign exchange difference | (51,338) |
| Closing balance - December 31, 2010 | \$2,706,707 |

The mortgages bear interest at a weighted average rate of 6.2% (December 31, 2009 – 6.2%) and mature between 2011 and 2035. The weighted average term to maturity of the REIT's mortgages is 8.2 years (December 31, 2009 - 8.3 years). Going forward, based on current market conditions and current lenders, the REIT anticipates being able to refinance all its debt as it matures. Notwithstanding this, the REIT may choose to repay some of its mortgages upon maturity. Of the total mortgages (excluding mortgages due on demand), 6.5% will mature in 2011 and 13.8% will mature in 2012. The mortgages coming due before the end of 2011 bear interest at a weighted average rate on maturity of 6.4% while mortgages coming due during 2012 bear interest at a weighted average rate on maturity of 6.7%. For a further discussion of interest rate risk, please see "Risks and Uncertainties".

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.

Segmented disclosure by geographic location is provided as follows:

| (in thousands of dollars) | December 31, 2010 | December 31, 2009 |
|-----------------------------------|--------------------------|-------------------|
| Mortgages payable - Canada | \$1,890,881 | \$1,950,224 |
| Mortgages payable - United States | 815,826 | 868,252 |
| Total | \$2,706,707 | \$2,818,476 |

Debentures Payable

| | Maturity Date | Contractual Interest Rate | Effective Interest Rate | Conversion Price | Face Value (in millions) | Carrying Value December 31, 2010 (in millions) | Carrying Value December 31, 2009 (in millions) |
|-----------------------------------|------------------|---------------------------------|-------------------------------|---------------------|--------------------------------|--|--|
| 2013 6.65% Convertible Debentures | Jun 30, 2013 | 6.65% | 9.10% | \$23.11 | \$115.0 | \$108.8 | \$106.7 |
| 2014 6.75% Convertible Debentures | Dec 31, 2014 | 6.75% | 12.30% | 14.00 | 145.0 | 120.2 | 119.4 |
| 2017 6.00% Convertible Debentures | Jun 30, 2017 | 6.00% | 8.60% | 19.00 | 175.0 | 153.3 | 150.8 |
| 2020 5.90% Convertible Debentures | Jun 30, 2020 | 5.90% | 7.53% | 23.50 | 100.0 | 89.2 | - |
| Series A Senior Debentures | Feb 3, 2015 | 5.20% | 5.40% | n/a | 115.0 | 114.1 | - |
| Series B Senior Debentures | Feb 3, 2017 | 5.90% | 6.06% | n/a | 115.0 | 114.1 | - |
| Series C Senior Debentures | Dec 1, 2018 | 5.00% | 5.30% | n/a | 125.0 | 122.6 | - |
| Non-Convertible Debentures | - | 11.50% | 12.90% | n/a | - | - | 188.8 |
| | | | | | \$890.0 | \$822.3 | \$565.7 |

Debentures payable increased by \$256.6 million to \$822.3 million at December 31, 2010 from \$565.7 million at December 31, 2009. During the year ended December 31, 2010, the REIT issued Series A, Series B and Series C Senior Debentures with a carrying value of \$350.8 million in aggregate, issued 2020 Convertible Debentures with a carrying value of \$89.2 million, and repaid in full the Non-Convertible Debentures which had a carrying value of \$188.8 million at December 31, 2009. See the consolidated financial statements of the REIT for detailed information regarding the various debentures payable.

In February 2010, the REIT repaid the outstanding Non-Convertible Debentures having an aggregate face value of \$200 million for a total repurchase price of \$230 million. The repurchase price included accrued interest of approximately \$2 million. The REIT recognized a one-time non-recurring charge to the combined statement of earnings of approximately \$39 million, representing the difference between the repurchase price, excluding accrued interest expense, and the carrying value of the Non-Convertible Debentures of \$189 million.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities increased by \$3.5 million from \$167.0 million at December 31, 2009 to \$170.5 million at December 31, 2010. Other payables and accruals increased as a result of transactions occurring in the normal course of business operations including an increase of \$5.7 million due to increased interest accrued on all of the debentures. Also included in accrued liabilities is the total interest accrued to date on the non-recourse mortgages under default of \$8.1 million (December 31, 2009 - \$11.7 million). This amount has decreased \$3.6 million as the lenders have now taken title to five properties.

Future Income Tax Liability

As at December 31, 2010, the REIT did not exceed the normal growth guidelines at any time prior to 2011 and has qualified for the REIT Exemption beginning in 2011. Accordingly, the REIT and holders of REIT units will not become subject to the SIFT Rules (as defined herein) and the REIT will not be liable to pay tax, provided that the REIT continues to qualify for the REIT Exemption at all times after 2010. As a result, the future income tax liability of \$138.1 million recorded as at December 31, 2009 has been recognized into income.

USE OF PROCEEDS FROM FINANCING ISSUED DURING 2010

| Financing | Disclosed Use of Proceeds | Actual Use of Proceeds |
|--|--|---|
| Public offering of \$230 million of unsecured senior debentures on February 3, 2010. | To fund the repurchase of the Non-Convertible Debentures. | The entire net proceeds were used to fund the repurchase of the Non-Convertible Debentures. |
| Public offering of \$100 million of convertible debentures completed on July 27, 2010. | Proceeds intended to repay debt (including debt incurred to finance acquisitions and development of properties) for potential acquisitions and for general trust purposes. | The entire net proceeds were used to fund the Bow. |
| Public offering of \$125 million of unsecured senior debentures completed on September 14, 2010. | Proceeds intended to repay indebtedness, fund future acquisitions and development of the Bow and for general trust purposes. | The entire net proceeds were used to fund the Bow and for general trust purposes. |

EQUITY***Unitholders' Equity***

Unitholders' equity increased by \$93.0 million between December 31, 2009 and December 31, 2010. \$29.1 million was from proceeds received from the issuance of Stapled Units and the balance of the increase is due primarily to net earnings 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.

LIQUIDITY AND CAPITAL RESOURCES***Funds from Operations, Normalized Funds from Operations and Adjusted Funds from Operations***

Funds from operations ("FFO"), normalized funds from operations ("NFFO") and adjusted funds from operations ("AFFO") are not measures recognized under GAAP and do not have standardized meanings prescribed by GAAP. FFO, NFFO and AFFO should not be construed as alternatives 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 and AFFO are operating performance measures which are 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 or derivative instruments in the calculation of FFO. The Trusts' method of calculating FFO, NFFO and AFFO may differ from other issuers' methods and accordingly may not be comparable to similar measures presented by other issuers.

The use of FFO, NFFO and AFFO, combined with the required GAAP presentations, have been presented for the purpose of improving the understanding of operating results of the Trusts by the investing public.

FUNDS FROM OPERATIONS AND NORMALIZED FUNDS FROM OPERATIONS

| (in thousands of dollars except per unit amounts) | Three months ended December 31 | | Year ended December 31 | |
|--|--------------------------------|----------|------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Net earnings | \$10,589 | \$29,870 | \$172,348 | \$86,525 |
| Add (deduct) | | | | |
| Depreciation and amortization | 30,952 | 34,864 | 125,134 | 128,643 |
| Impairment loss on income properties | 14,862 | 268 | 14,862 | 14,764 |
| (Gain) loss on sale of income properties | 40 | 3,118 | (3,576) | (10,649) |
| Future income tax recovery | - | (17,480) | (123,303) | (9,613) |
| Net earnings attributable to non-controlling interest | 603 | 1,246 | 6,421 | 3,670 |
| Operating loss from discontinued operations | (436) | (1,439) | (517) | (6,200) |
| Funds from operations – continuing operations | 56,610 | 50,447 | 191,369 | 207,140 |
| Funds from operations – discontinued operations | 436 | 1,585 | 558 | 7,966 |
| Funds from operations (“FFO”) | \$57,046 | \$52,032 | \$191,927 | \$215,106 |
| Add (deduct) | | | | |
| Net loss on derivative instruments and foreign exchange | 1,805 | 3,338 | 12,296 | 17,046 |
| Mortgage interest accruals on non-recourse mortgage defaults | 1,191 | 2,425 | 6,783 | 10,058 |
| Additional recoveries for capital expenditures in excess of items expensed in property operating costs | (2,285) | (1,410) | (9,898) | (6,313) |
| (Gain) loss on extinguishment of debt | 332 | - | (17,296) | - |
| Lease terminations and other non-recurring items | - | - | (2,311) | - |
| Loss on repayment of debentures | - | - | 38,834 | - |
| Normalized funds from operations (“NFFO”) | \$58,089 | \$56,385 | \$220,335 | \$235,897 |
| Weighted average number of Stapled Units (in thousands of Stapled Units adjusted for conversion of non-controlling interest) | 150,624 | 148,501 | 149,786 | 147,946 |
| Diluted weighted average number of Stapled Units (in thousands of Stapled Units) for the calculation of FFO ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾⁽⁵⁾ | 171,164 | 173,105 | 150,422 | 164,863 |
| Funds from operations per Stapled Unit (basic – adjusted for conversion of non-controlling interest) | \$0.38 | \$0.35 | \$1.28 | \$1.45 |
| Funds from operations per Stapled Unit (diluted) | 0.38 | 0.32 | 1.28 | 1.34 |
| Diluted weighted average number of Stapled Units (in thousands of Stapled Units) for the calculation of NFFO ⁽¹⁾⁽²⁾⁽⁶⁾⁽⁷⁾ | 171,164 | 173,305 | 170,294 | 164,863 |
| Normalized funds from operations per Stapled Unit (basic - adjusted for conversion of non-controlling interest) | \$0.39 | \$0.38 | \$1.47 | \$1.59 |
| Normalized funds from operations per Stapled Unit (diluted) | 0.38 | 0.35 | 1.46 | 1.47 |
| Distributions per Stapled Unit | \$0.22 | \$0.18 | \$0.79 | \$0.72 |
| Payout ratio (as a percentage of NFFO) | 56% | 47% | 54% | 45% |

(1) Although the warrants issued to Fairfax Financial Holdings Limited or its affiliates (the “Fairfax Warrants”) were redeemed on December 29, 2009, they are included in the denominator of diluted FFO and NFFO per Stapled Unit for the period for which they were outstanding (for the three months and year ended December 31, 2009, 13,646,056 Stapled Units and 12,231,559 Stapled Units, respectively).

(2) For the three months ended December 31, 2010 and 2009, 804,513 and 244,139 Stapled Units, respectively, are included in the determination of diluted FFO and NFFO with respect to the unit option plan. For the years ended December 31, 2010 and 2009, 636,044 and 84,765 Stapled Units, respectively, are included in the determination of diluted FFO and NFFO with respect to Unit Option Plan.

- (3) The 2014 and 2017 Convertible Debentures are dilutive for the three months ended December 31, 2010. Debenture interest of \$7.2 million is added to FFO for the three months ended December 31, 2010 and 19,735,888 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for that period.
- (4) The 2014 Convertible Debentures are dilutive for the three months ended December 31, 2009. Debenture interest of \$3.7 million is added to FFO and 10,714,286 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for that period.
- (5) The 2014 and 2017 Convertible Debentures are dilutive for the year ended December 31, 2009. Debenture interest of \$6.2 million is added to FFO and 4,600,371 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for that period.
- (6) The 2014 and 2017 Convertible Debentures are dilutive for the three months and year ended December 31, 2010. Debenture interest of \$7.2 million and \$27.9 million, respectively, is added to NFFO and 19,735,888 and 19,871,740 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for the respective periods.
- (7) The 2014 and 2017 Convertible Debentures are dilutive for the three months and year ended December 31, 2009. Debenture interest of \$3.7 million and \$6.2 million is added to NFFO and 10,914,515 Stapled Units and 4,600,371 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for the respective periods.

NFFO adjusts FFO for: the net gain or loss on derivative instruments and foreign exchange as these are non-cash items which will vary from quarter to quarter; the additional recoveries for capital expenditures in excess of items expensed in property operating costs as these also vary from quarter to quarter and in the view of the Trusts' management, this volatility is not indicative of the Trusts' performance, and the loss on repayment of debentures is a one-time, non-recurring item and as such is not in the normal course of operations. In addition, the Trusts have adjusted its NFFO for mortgage interest accruals on non-recourse mortgage defaults, the gain on extinguishment of debt along with other non-recurring items such as lease termination fees. FFO is reconciled to AFFO which is reconciled to cash provided by operations.

The primary reasons for the increase of \$1.7 million in NFFO between Q4 2009 and Q4 2010 are:

- An increase of \$2.3 million in property operating income due to acquisitions during 2010;
- An increase of \$0.8 million due to lower interest expense;
- An increase of \$2.0 million in straight lining of contractual rent;
- A decrease of \$0.9 million in property operating income primarily due to the average U.S./Canadian dollar foreign exchange rate of \$1.00 for Q4 2010 as compared to \$1.05 during Q4 2009;
- A decrease of \$0.9 million in property operating income from properties sold between October 1, 2009 and December 31, 2010;
- A decrease of \$0.4 million due to an increase in non-recoverable property operating costs;
- A decrease of \$0.5 million due to lower interest income, lower trust expenses and lower current income taxes; and
- A decrease of \$0.6 million due to higher property management fees.

The primary reasons for the decrease of \$15.6 million in NFFO between the year ended December 31, 2010 as compared to the same period in 2009 are:

- A decrease of \$8.2 million in property operating income primarily due to the average U.S./Canadian dollar foreign exchange rate of \$1.03 as compared to \$1.14 for the year ended December 31, 2009;
- A decrease of \$6.1 million in property operating income from properties sold between January 1, 2009 and December 31, 2010;
- A decrease of \$4.0 million due to lower interest income, higher trust expenses and higher current income taxes;
- A decrease of \$2.5 million due to higher property management fees;
- A decrease of \$1.1 million in property operating income due to tenants who filed for protection under Chapter 11 of the United States Bankruptcy Code and subsequently terminated their leases; and

- An increase of \$5.3 million in property operating income due to acquisitions during 2010.

ADJUSTED FUNDS FROM OPERATIONS

| (in thousands of dollars except per unit amounts) | Three months ended December 31 | | Year ended December 31 | |
|---|--------------------------------|----------|------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Funds from operations | \$57,046 | \$52,032 | \$191,927 | \$215,106 |
| Add (deduct) | | | | |
| Straight-lining of contractual rent | (4,742) | (2,797) | (10,899) | (12,990) |
| Rent amortization | 848 | 1,051 | 3,912 | 3,931 |
| Effective interest rate accretion | 3,246 | 2,386 | 11,453 | 5,844 |
| Mortgage interest accruals on non-recourse mortgage defaults | 1,191 | 2,425 | 6,783 | 10,058 |
| (Gain) loss on extinguishment of debt | 332 | - | (17,296) | - |
| Additions to tenant expenditures | (1,247) | (2,119) | (5,517) | (6,044) |
| Capital expenditures | (3,428) | (5,399) | (15,371) | (10,090) |
| Net loss on derivative instruments and foreign exchange | 1,805 | 3,338 | 12,296 | 17,046 |
| Unit-based compensation | 310 | 177 | 1,225 | 535 |
| Adjusted funds from operations ("AFFO") | \$55,361 | \$51,094 | \$178,513 | \$223,396 |
| Weighted average number of Stapled Units (in thousands of Stapled Units adjusted for conversion of non-controlling interest) | 150,624 | 148,501 | 149,786 | 147,946 |
| Diluted weighted average number of Stapled Units (in thousands of Stapled Units) for the calculation of AFFO ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾⁽⁵⁾ | 175,420 | 173,305 | 170,294 | 164,863 |
| Adjusted funds from operations per Stapled Unit (basic - adjusted for conversion of non-controlling interest) | \$0.37 | \$0.34 | \$1.19 | \$1.51 |
| Adjusted funds from operations per Stapled Unit (diluted) | \$0.35 | \$0.31 | \$1.17 | \$1.38 |

(1) Although the Fairfax Warrants were redeemed on December 29, 2009, they are included in the denominator of diluted AFFO per Stapled Unit for the period for which they were outstanding (for the three months and year ended December 31, 2009, 13,646,056 Stapled Units and 12,231,559 Stapled Units, respectively).

(2) For the three months ended December 31, 2010 and 2009, 804,513 Stapled Units and 244,139 Stapled Units, respectively, are included in the determination of diluted AFFO with respect to the Unit Option Plan. For the year ended December 31, 2010 and 2009, 636,044 Stapled Units and 84,765 Stapled Units, respectively, are included in the determination of diluted AFFO with respect to the Unit Option Plan.

(3) The 2014, 2017 and 2020 Convertible Debentures are dilutive for the three months ended December 31, 2010. Contractual interest for the three months ended December 31, 2010 of \$6.7 million is added to AFFO and 23,991,207 Stapled Units and are included in the diluted weighted average number of Stapled Units for that period.

(4) The 2014 and 2017 Convertible Debentures are dilutive for the year ended December 31, 2010. Contractual interest for the year ended December 31, 2010 of \$20.6 million is added to AFFO and 19,871,740 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for that period.

(5) The 2014 and 2017 Convertible Debentures are dilutive for the three months and year ended December 31, 2009. Contractual interest for the three months of \$2.6 million and \$4.4 million for the year ended December 31, 2009, respectively, is added to AFFO and 10,914,515 Stapled Units and 4,600,371 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for each respective period.

Excluding the non-recurring charge of \$38.8 million to redeem the Non-Convertible Debentures, basic AFFO would have been \$217.3 million for the year ended December 31, 2010 (\$1.45 per Stapled Unit).

The primary reasons for the increase of \$4.3 million in AFFO for the three months ended December 31, 2010 as compared to the same period last year are:

- An increase of \$0.9 million in additional rent recoverable from tenants in accordance with their leases for items which were capitalized to building improvements net of items which were expensed in property operating costs;
- An increase of \$2.0 million due to lower interest expense;
- An increase of \$2.3 million in property operating income due to acquisitions during 2010;
- An increase of \$2.8 million due to lower capital and tenant expenditures;
- A decrease of \$0.9 million in property operating income primarily due to the average U.S./Canadian dollar foreign exchange rate of \$1.00 for Q4 2010 as compared to \$1.05 during Q4 2009;
- A decrease of \$1.2 million in property operating income from properties sold between October 1, 2009 and December 31, 2010;
- An decrease of \$0.5 million due to lower interest income, lower trust expenses and lower current income taxes; and
- A decrease of \$0.6 million due to higher property management fees.

The primary reasons for the decrease of \$44.9 million in AFFO for the year ended December 31, 2010 as compared to the same period last year are:

- A decrease of \$38.8 million due to the one-time loss on the repayment of the Non-Convertible Debentures;
- A decrease of \$4.8 million due to higher capital and tenant expenditures;
- A decrease of \$8.2 million in property operating income primarily due to the average U.S./Canadian dollar foreign exchange rate of \$1.03 for the year ended December 31, 2010 as compared to \$1.14 during the year ended December 31, 2009;
- A decrease of \$6.4 million in property operating income from properties sold between January 1, 2009 and December 31, 2010;
- A decrease of \$1.1 million in property operating income due to tenants who filed for protection under Chapter 11 of the United States Bankruptcy Code and subsequently terminated their leases;
- A decrease of \$4.0 million due to lower interest income, higher trust expenses and higher current income taxes;
- A decrease of \$2.5 million due to higher property management fees;
- An increase of \$4.0 million due to rent step ups throughout the portfolio;
- An increase of \$2.3 million due to lease terminations and other non-recurring items;
- An increase of \$5.8 million due to lower interest expense;
- An increase of \$3.6 million in additional rent recoverable from tenants in accordance with their leases for items which were capitalized to building improvements net of items which were expensed in property operating costs; and
- An increase of \$5.3 million in property operating income due to acquisitions during 2010.

The following is a reconciliation of the Trusts' AFFO to cash provided by operations:

| (in thousands of dollars) | Three months ended December 31 | | Year ended December 31 | |
|--|--------------------------------|----------|------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Adjusted funds from operations | \$55,361 | \$51,094 | \$178,513 | \$223,396 |
| Straight-lining of contractual rent | 4,742 | 2,797 | 10,899 | 12,990 |
| Additions to tenant expenditures | 1,247 | 2,119 | 5,517 | 6,044 |
| Capital expenditures | 3,428 | 5,399 | 15,371 | 10,090 |
| Change in other non-cash operating items | 16,116 | 7,612 | 822 | (3,499) |
| Mortgage interest accruals on non-recourse mortgage defaults | (1,191) | (2,425) | (6,783) | (10,058) |
| Loss on repayment of debentures | - | - | 38,834 | - |
| Realized gain (loss) on foreign exchange | 6 | - | 4 | (22) |
| Cash provided by operations | \$79,709 | \$66,596 | \$243,177 | \$238,941 |

Capital Resources

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

| (in thousands of dollars) | Three months ended December 31, 2010 | Year ended December 31, 2010 | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|--|------------------------------------|------------------------------------|------------------------------------|
| Cash provided by operating activities | \$79,709 | \$243,177 | \$238,941 | \$233,200 |
| Net earnings | 10,589 | 172,348 | 86,525 | 97,706 |
| Actual cash distributions paid or payable relating to the period | 28,475 | 103,708 | 97,726 | 161,839 |
| Excess of cash provided by operating activities over cash distributions paid | 51,234 | 139,469 | 141,215 | 71,361 |
| Excess (shortfall) of net earnings over cash distributions paid | (17,886) | 68,640 | (11,201) | (64,133) |

For the three months ended December 31, 2010, and years ended December 31, 2010, December 31, 2009 and 2008, cash provided by operating activities exceeded cash distributions. Management expects this trend to continue.

Cash distributions exceeded net earnings for the three months ended December 31, 2010 due to the impairment loss on income properties and other non-cash items which are deducted or added in determining net earnings. Net earnings exceed cash distributions paid for the year ended December 31, 2010 and the year ended December 31, 2009. Non-cash items such as impairment losses, gain on extinguishment of debt, future income tax recoveries, unrealized gains or losses, depreciation and amortization, while deducted from or added to net earnings have no impact on cash available to pay current distributions.

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. As at December 31, 2010, the REIT is 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 three Boscov's Department Store, the two Bruno's Supermarkets LLC and the two A&P mortgages following the Chapter 11 filings of those tenants. The REIT has handed over control of three of the properties to the respective mortgage companies and is waiting for those companies to legally release the REIT's subsidiaries from their debt obligations.

The REIT's general operating facility has been provided by the same chartered bank since the REIT's inception. This general operating facility expires on December 31, 2012 and is secured by certain income properties. At December 31, 2010, approximately \$188.1 million was still available under this facility.

Other than the Bow development which is described in greater detail under "Funding of Future Commitments", the following is a summary of material contractual obligations of the REIT (excluding mortgages related to discontinued operations and mortgages payable on demand) including payments due as at December 31, 2010 for the next 5 years and thereafter as of December 31, 2010:

| Contractual Obligations (in thousands of dollars) | Payments Due by Period | | | | Total |
|--|------------------------|------------------|------------------|------------------------|--------------------|
| | 2011 | 2012- 2013 | 2014- 2015 | 2016 and thereafter | |
| Mortgages payable | \$170,601 | \$567,172 | \$598,978 | \$1,296,418 | \$2,633,169 |
| 2013 Convertible debentures | - | 115,000 | - | - | 115,000 |
| 2014 Convertible debentures | - | - | 145,027 | - | 145,027 |
| 2017 Convertible debentures | - | - | - | 175,000 | 175,000 |
| 2020 Convertible debentures | - | - | - | 100,000 | 100,000 |
| Series A Senior Debentures | - | - | 115,000 | - | 115,000 |
| Series B Senior Debentures | - | - | - | 115,000 | 115,000 |
| Series C Senior Debentures | - | - | - | 125,000 | 125,000 |
| Bank indebtedness | - | 89,045 | - | - | 89,045 |
| Property acquisitions ⁽¹⁾ | 180,400 | - | - | - | 180,400 |
| Total Contractual Obligations | \$351,001 | \$771,217 | \$859,005 | \$1,811,418 | \$3,792,641 |

(1) The total purchase price is approximately \$376.8 million less the mortgage assumptions of \$196.4 million.

DBRS Limited ("DBRS") provides credit ratings of debt securities for commercial entities. A credit rating generally provides an indication of the risk that the borrower will not fulfill its obligations in a timely manner with respect to both interest and principal commitments. Rating categories range from highest credit quality (generally AAA) to default payment (generally D).

DBRS has confirmed that the REIT has a credit rating of BBB with a Stable trend as at December 31, 2010. A credit rating of BBB by DBRS is generally an indication of adequate credit quality, where protection of interest and principal is considered acceptable. A credit rating of BBB or higher is an investment grade rating. There can be no assurance that any rating will remain in effect for any given period of time or that any rating will not be withdrawn or revised by DBRS at any time. The credit rating is reviewed periodically by DBRS.

The REIT has no material capital or operating lease obligations.

Funding of Future Commitments

The following table shows the budgeted costs for the Bow and actual costs to date:

| (in thousands of dollars) | Costs incurred to date | Remaining Costs | Budget |
|---|------------------------|------------------|--------------------|
| Land | \$60,804 | \$ - | \$60,804 |
| Financing costs | 21,893 | 19,315 | 41,208 |
| Capitalized interest on the REIT's costs as incurred | 121,979 | 93,743 | 215,722 |
| Soft costs | 134,168 | 50,769 | 184,937 |
| Hard costs | 855,593 | 259,844 | 1,115,437 |
| Recoveries and other income | (44,343) | (56,995) | (101,338) |
| Contingency | - | 29,952 | 29,952 |
| Cost incurred to date/remaining costs/budget | 1,150,094 | 396,628 | 1,546,722 |
| Less capitalized interest on the REIT's costs incurred | (121,979) | (93,743) | (215,722) |
| Total costs incurred to date/ remaining costs/budget less capitalized interest | \$1,028,115 | \$302,885 | \$1,331,000 |

Both the REIT and the lenders' project consultant believe the remaining contingencies to be sufficient at this stage of the project. Based on the current anticipated tranche completion dates, it is expected that there will be an approximate one to three month delay in delivery for each tranche. This potential cost based on the expected delay, would be approximately \$4.7 million and is included in

the budgeted soft costs. In light of the expected delay, certain subcontractors may look for additional billings for cost overruns, which should be covered by the contingency.

The REIT believes that as at December 31, 2010, through the amount undrawn under the construction facility of \$398.6 million and the available cash and undrawn credit facility of \$188.1 million, it has enough funds to complete the Bow. However, 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 REIT's capacity to fund future acquisitions, capital expenditures and commitments was in excess of \$2.6 billion as at December 31, 2010. This represents the amount by which the REIT can increase its debt, subject to market availability, before the REIT reaches its maximum debt limitation of 65% of debt to its GBV of assets under the Declaration of Trust.

The following summarizes term debt maturities for existing mortgages:

| Year | Mortgage Debt due on Maturity (\$000's) | Number of Properties | 2011 Estimated Property Operating Income (\$000's) ⁽¹⁾ | Loan to Value ⁽²⁾ |
|------|---|----------------------|---|------------------------------|
| 2011 | 70,246 | 11 | 17,368 | 29% |
| 2012 | 263,881 | 21 | 48,132 | 40% |
| 2013 | 107,821 | 10 | 23,163 | 34% |
| 2014 | 182,632 | 8 | 26,892 | 49% |
| 2015 | 207,538 ⁽³⁾ | 18 | 27,413 | 55% |
| | \$832,118 | 68 | \$142,968 | 42% |

⁽¹⁾ Converting U.S. dollars to Canadian dollars at an exchange rate of 0.99.

⁽²⁾ Using a 7.25% capitalization rate

⁽³⁾ Excludes \$18 million vendor takeback mortgage on land held for development.

Based on the low percentage of the projected loan to values of the maturing mortgages, the REIT is confident it will be able to replace these mortgages as they mature.

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, 2010, such guarantees amounted to \$41.3 million (December 31, 2009 - \$43.3 million), expiring between 2011 and 2016 and no amount has been provided for in the combined financial statements of the Trusts 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.

In addition, the REIT continued to guarantee certain debt assumed by purchasers in connection with past dispositions of properties, and will remain liable thereunder until such debts are extinguished or the lenders agree to release the REIT's covenants. At December 31, 2010, the estimated amount of debt subject to such guarantees, and therefore the maximum exposure to credit risk is approximately \$116.4 million (December 31, 2009 - \$119.2 million) with expiries between 2013 and 2018. There have been no defaults by the primary obligor for debts on which the REIT has provided its guarantees, and as a result, no contingent loss on these guarantees has been recognized in the financial statements.

FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS

Where appropriate, the REIT uses forward contracts to lock in lending rates on certain anticipated mortgages. This strategy provides certainty to 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, 2010, the REIT had no forward contracts in place.

Where appropriate, the REIT uses forward exchange contracts to lock in foreign exchange rates. This strategy provides certainty in the foreign exchange rates on transactions that will occur in the future. The REIT has entered into a forward exchange forward contract with a Canadian chartered bank, which effectively locks in the REIT's rate to exchange, U.S.\$2 million per month at a rate of \$1.0402. This forward exchange contract expires in April 2012.

The REIT has entered into interest rate swaps on the Bow credit facility and on one U.S. mortgage which effectively locked the interest rate at 4.65% and 5.25%, respectively. At the end of each reporting period, the interest rate swaps are marked-to-market resulting in an unrealized gain or loss recorded in net earnings.

SECTION III

SUMMARY OF QUARTERLY RESULTS

| (unaudited) (in thousands of dollars except per unit amounts) | December 31, 2010 | September 30, 2010 | June 30, 2010 | March 31, 2010 |
|--|-------------------------------------|--------------------------------------|---------------------------------|----------------------------------|
| Rentals from income properties | \$160,262 | \$152,743 | \$151,344 | \$151,223 |
| Mortgage interest and other income | 265 | 248 | 802 | 1,274 |
| Net property operating income | 29,632 | 26,705 | 28,122 | 24,965 |
| Net earnings (loss) from continuing operations | 10,208 | 34,201 | 144,655 | (20,660) |
| Net earnings (loss) per Stapled Unit from continuing operations | | | | |
| (basic) | 0.07 | 0.24 | 1.00 | (0.14) |
| (diluted) | 0.07 | 0.24 | 0.91 | (0.14) |
| Net earnings (loss) | \$10,589 | \$34,354 | \$144,665 | (\$17,260) |
| Net earnings (loss) per Stapled Unit | | | | |
| (basic) | 0.07 | 0.24 | 1.00 | (0.12) |
| (diluted) | 0.07 | 0.24 | 0.91 | (0.12) |
| | December 31, 2009 ⁽¹⁾ | September 30, 2009 ⁽¹⁾ | June 30, 2009 ⁽¹⁾ | March 31, 2009 ⁽¹⁾ |
| Rentals from income properties | \$151,668 | \$148,206 | \$148,999 | \$156,292 |
| Mortgage interest and other income | 1,621 | 1,602 | 1,504 | 1,495 |
| Net property operating income | 21,606 | 23,896 | 28,415 | 30,540 |
| Net earnings (loss) from continuing operations | 31,488 | 7,641 | 10,754 | 20,413 |
| Net earnings (loss) per Stapled Unit from continuing operations | | | | |
| (basic) | 0.22 | 0.05 | 0.07 | 0.15 |
| (diluted) | 0.20 | 0.05 | 0.07 | 0.14 |
| Net earnings | \$29,870 | \$15,656 | \$18,901 | \$22,098 |
| Net earnings per Stapled Unit | | | | |
| (basic) | 0.21 | 0.11 | 0.13 | 0.16 |
| (diluted) | 0.19 | 0.10 | 0.13 | 0.15 |

⁽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. Revenues may have significant fluctuations due to recoveries from tenants for changes to property operating costs depending on when major maintenance projects are incurred.

SECTION IV

CRITICAL ACCOUNTING ESTIMATES

The preparation of the Trusts' combined 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' combined financial statements have been prepared in accordance with Canadian 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, 2010 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 undiscounted 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 2010, the REIT recorded an impairment loss of \$14.9 million relating to two properties formerly tenanted by A&P. During 2009, the REIT recorded an impairment loss of \$14.8 million relating to four properties formerly tenanted by Circuit City and Bruno's Supermarkets LLC.

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 2010 or 2009.

Depreciation of Income Properties

Upon 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 and building improvements 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

During the second quarter of 2010, the REIT completed necessary restructuring to qualify for the REIT Exemption commencing January 1, 2011. The REIT will not be subject to the SIFT Rules provided that the REIT qualifies for the REIT Exemption at all times after 2010. See the "Tax Risk" section for further discussion. Accordingly, the net future income tax liability of \$125.3 million recorded as at March 31, 2010, was reversed into net earnings as at June 30, 2010.

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 intended 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.

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.

ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

The discussion in this section should be read in conjunction with the Trusts' annual MD&A for the years ended December 31, 2009 and 2008, and contains an update as at the reporting date.

The Canadian Accounting Standards Board ("AcSB") has mandated the adoption of IFRS effective for 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 2010 fiscal year will also have to be reported. These new standards will be effective for the Trusts during the first quarter of 2011. The Trusts' combined financial performance and financial position as disclosed in the current GAAP financial statements may be significantly different when presented in accordance with IFRS.

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 has included 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 Boards of Trustees and the audit committees of both Trusts.

The following provides a summary of the Trusts' IFRS Implementation Plan and status of the Trusts' activities:

Status of Convergence Plan

An analysis of the impact of the majority of IFRS standards has been assessed and recommendations on policy choices, where applicable, have been approved by the Boards of Trustees of both Trusts. As such, action plans have been created to implement these policy choices. These plans detail what is required to implement each standard and the information and related systems requirements to gather and track data for the extensive accounting and disclosure requirements under the transition to IFRS and on a continual basis once the adoption of these new standards has been completed.

Where significant impacts of the transition were identified, work commenced on solutions which required a significant amount of time to resolve. These issues include but may not be limited to, the identification of proposed information technology initiatives and components of debt covenants which need to be addressed to ensure they are completed on time. As the review of accounting policies is completed, appropriate changes to ensure the integrity of internal controls over financial reporting and disclosure controls and procedures has been made. For example, changes in accounting policies could result in changes to controls or procedures to address reporting of first time adoption as well as ongoing IFRS reporting requirements. The Trusts have held IFRS information sessions with members of the Boards of Trustees of both Trusts and separately with Audit Committee members of both Trusts. During these sessions, management and external consultants provided both Boards of Trustees with a review of the timeline for implementation, the implications of IFRS standards to the business and an overview of the impact to the financial statements (as experienced in Europe by comparable companies). Both Audit Committees continue to receive quarterly updates from management.

Significant elements of the Trusts' IFRS conversion plan include:

| Area | Key Activities | Progress to Date |
|--|---|---|
| Financial Statement Presentation and Disclosure | Identification of differences between IFRS and Canadian GAAP | Complete |
| | Assess and select accounting policy choices | Complete |
| | Quantify the effects of the difference based on accounting policies selected | Complete |
| | Prepare opening and quarterly financial statements and related note disclosures | In progress |
| Business Impacts | Identify required resources - valuation and accounting - for technical analysis and implementation during the transition | Complete |
| | Develop a real estate valuation strategy | Complete |
| | Complete real estate valuation for the opening balance sheet as at January 1, 2010 | Complete |
| | Identify impact on contractual agreements and financial covenants | Complete |
| | Where required, make amendments to agreements | Complete |
| Processes and Systems | Identify changes required to current financial reporting systems | Complete |
| | Identify data collection requirements and implement process to collect data | Complete |
| | Evaluate and select methods to address the need for dual record keeping during 2010 | Complete |
| Internal Control over Financial Reporting and Disclosure | Ensure documentation of processes and systems are in place | In progress |
| | Ensure appropriate changes to internal controls to address existing accounting policies and requirement for dual record keeping during 2010 | Complete |
| | Assess effectiveness of controls | Ongoing |
| Training | Technical training of accounting staff | Ongoing |
| | Educate Boards of Trustees, Audit Committees and Senior Management on the effects of IFRS | Senior management is updated regularly. Boards of Trustees and Audit Committees are updated quarterly |
| | Communication to all other internal and external stakeholders | Ongoing quarterly external communication through MD&A |

The significant IFRS differences that will potentially have an impact on the Trusts' financial statements include the following:

- 1) Under Canadian GAAP, issued units of the Trusts are presented as equity in the combined balance sheet. A Trust unit is a financial instrument for both Canadian GAAP and IFRS purposes. Under IFRS if there is a mandatory requirement to distribute taxable income or distributable cash (a "contractual requirement to deliver cash"), this would result in Trust units being considered as a liability. At the June 2010 annual meeting of unitholders of the REIT, an amendment was made to the Declaration of Trust whereby distributions are no longer mandatory, rather they are now to be made at the discretion of the trustees, thereby eliminating this potential issue under IFRS. Finance Trust is still reviewing this issue.
- 2) IFRS defines investment property as property held by the REIT to earn rental income, capital appreciation or both. Assets classified as income properties on the balance sheet of the REIT qualify as investment property under IFRS.

Under IFRS, the REIT has a choice of measuring an investment property using the historical cost model or the fair value model. The cost model is generally consistent with Canadian GAAP and would require that the fair value be disclosed in the notes to the financial statements. Under the fair value model, investment property is measured at fair value, and changes in fair value are recorded through earnings each reporting period, which could lead to income statement volatility in future periods. Under the fair value model there are no charges for depreciation as there are under the cost model.

The REIT has completed its analysis and has elected to use the cost model to account for its investment property. In addition, the REIT will also elect under IFRS 1 to use the fair value as the deemed cost for 13 of its income properties upon the initial implementation of IFRS. At conversion, the adjustment resulting from this election which is expected to be approximately \$531 million, net of impairments, will be recorded directly to income properties and unitholders' equity.

The REIT will disclose the fair value of its investment properties at January 1, 2010 and December 31, 2010 in the notes to the financial statements as follows:

| | December 31, 2010 (billions) | January 1, 2010 (billions) |
|--|---------------------------------|-------------------------------|
| Net Book Value of income-producing properties as reported under Canadian GAAP ⁽¹⁾ | \$4.0 | \$4.1 |
| Increase in value of income-producing properties | 1.5 | 1.0 |
| Fair value of investment properties to be reported under IFRS | \$5.5 | \$5.1 |
| Fair value of Canadian - investment properties | \$4.3 | \$4.0 |
| Fair value of United States - investment properties | 1.2 | 1.1 |
| Fair value of investment properties to be reported under IFRS | \$5.5 | \$5.1 |
| Externally prepared appraisals | \$1.1 | \$4.9 |
| Internally prepared appraisals | 4.4 | 0.2 |
| Fair value of investment properties to be reported under IFRS | \$5.5 | \$5.1 |

⁽¹⁾ These amounts include tenant inducements, deferred leasing costs and intangible liabilities.

For subsequent reporting of the fair value of income properties, the REIT will prepare most of these valuations internally after taking into account any changes to the property status, condition, tenants, leases, net operating income and changes to discount and capitalization rates as well as market rental rates. The REIT will use market data provided by valuation firms.

This change is not expected to require any major change to the REIT's information technology ("IT") systems. The controls and procedures to ensure accurate reporting are almost complete.

The REIT is required to meet financial covenants included in its Declaration of Trust and in banking and debenture agreements. Within each of the previously mentioned documents, the REIT's debt cannot exceed 65% of the GBV.

- 3) Canadian GAAP generally uses a two-step approach to impairment testing: first comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists, and then measuring impairment by comparing asset carrying values to their fair value (which is calculated using discounted cash flows). IAS 36 Impairment of Assets (IAS 36) uses a one-step approach for testing and measuring impairment, with asset carrying values compared directly with the higher of fair value less costs to sell and value in use (which uses discounted cash flows). This may potentially result in write-downs where the carrying value of assets were previously supported under Canadian GAAP on an undiscounted cash flow basis, but could not be supported on a discounted cash flow basis. Unlike Canadian GAAP, which does not permit reversals, IFRS requires the reversal of an impairment loss when the recoverable amount is higher than the carrying value (to no more than what the depreciated amount of the asset would have been had the impairment not occurred). These differences could lead to earnings statement and earnings volatility in future periods. There is no change expected to the REIT's current IT systems for this accounting change but the REIT is in the process of designing controls and procedures for this change. The REIT is currently finalizing its assessment of potential impairments.
- 4) Under Canadian GAAP, upon the purchase of a property, all transaction costs (i.e. commissions, land transfer tax, appraisals, etc.) associated with the purchase are capitalized to the cost of the property. Under IFRS, these costs must be expensed as part of operations. This may have a material impact on the REIT's net earnings and could lead to earnings statement and earnings volatility in future periods.

- 5) Certain leases call for rental payments that increase over their term. Under Canadian GAAP, rental revenue is recognized on a straight-line basis over the term of the lease, resulting in accruals for rents that are not billable or due until future years. Under Canadian GAAP, this accounting policy change came into effect on January 1, 2004, as a prospective change. Only lease information from this time forward was applicable for this standard. Under IFRS, the accrued rent receivable amount is determined from the latter of inception of each lease or the date the REIT assumed the lease rather than from January 1, 2004.

The REIT has already made the necessary changes to its IT system and has completed the testing of these modifications. The December 31, 2009 accrued rent receivable balance of \$125.2 million is expected to change to approximately \$147 million once IFRS is adopted. There will not be any changes to disclosure or internal controls as the existing controls have been deemed to be appropriate by the REIT.

- 6) The Trusts will be required under IAS 32, Financial Instruments: Presentation, to present the Class B units of H&R Portfolio Limited Partnership ("HRLP") as a liability upon initial adoption of IFRS. This presentation will result in a reduction of non-controlling interest of approximately \$77.3 million (based on December 31, 2010 figures) and a corresponding liability being recorded. Distributions on the Class B units of HRLP will then be reflected as a component of interest expense in earnings.
- 7) Included in the budget for the Bow is approximately \$37 million of rental income expected to be received from EnCana Corporation prior to substantial completion of the building which is currently recorded in the current budget in the line item "recoveries and other income". Under IFRS, income earned during the construction of the property will not reduce the cost to construct the Bow, but will rather be included in rentals from income properties which will cause a corresponding increase to the cost of the project. These figures assume all occupancies occur on time.

First Time Adoption of IFRS

Upon adoption of IFRS, the Trusts are required to apply IFRS 1, which provides guidance for the initial adoption of IFRS. Included in IFRS 1 are certain optional exemptions from full retrospective applications of IFRS. The optional exemptions expected to be applied are described below:

- a) Deemed Fair Value

As discussed under the "Status of Convergence Plan", under IFRS 1 the REIT will choose to adopt the fair value model for certain income properties prospectively. At conversion the resulting adjustment of approximately \$531 million net of impairments of this election is recorded directly to income properties and retained earnings.

The REIT is required to meet financial covenants included in its Declaration of Trust and in banking and debenture agreements. Within each of the previously mentioned documents, the REIT's debt cannot exceed 65% of the GBV. As at January 1, 2010, the debt to GBV ratio in accordance with the Declaration of Trust is 52.5%. Given the change for the increase in income properties as mentioned above, the debt to GBV ratio decreases to 49.5%.

- b) Business Combinations

The REIT expects to apply the business combination exemption offered in IFRS 1 to not apply IFRS 3 Business Combinations retrospectively to past business combinations. Accordingly, the REIT will not restate business combinations that took place prior to the January 1, 2010 transition date. There is no change expected to the REIT's current IT systems or controls and procedures for this election.

- c) Cumulative Translation Difference

The REIT expects to elect this exemption to set the previous foreign exchange cumulative translation balance to zero at January 1, 2010, with the balance reclassified to retained earnings. The only effect of this will be a restatement within the accounts of the unitholders' equity. The effect at this time would be to reduce the accumulated other comprehensive loss by \$27.5 million and to reduce retained earnings by a similar amount. There is no change expected to the REIT's IT systems or controls and procedures for this election.

d) Borrowing Costs

The REIT has concluded that it will elect to capitalize amounts on qualifying assets which had not been previously capitalized using the provisions of IAS 23. The effect of capitalizing amounts not previously capitalized would be an increase to the cost of properties developed and an increase to retained earnings of approximately \$11 million as at January 1, 2010 with no impact for the year ended December 31, 2010. This adjustment may change depending on which income properties are deemed fair value on initial adoption.

The reader should be cautioned that these optional exemptions are considered forward looking information and certain project activities and choices may change. The process is on-going as new standards and recommendations are issued by the IASB.

Testing & Implementation Phase

The Trusts will be completing and testing its IFRS-IASB systems, processes, financial statements, notes, policies, internal controls and internal reporting in preparation for the REIT's first IFRS reporting period. Training of accounting and operational staff is well underway.

INTERNAL CONTROL OVER FINANCIAL REPORTING

No changes were made to the design of the Trusts' internal control over financial reporting during the three months ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, the Trusts' internal control over financial reporting. The financial statements and MD&A were reviewed by the respective audit committees and the Boards 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 Trusts have been detected. The Trusts are continually evolving and enhancing its systems of controls and procedures.

The Trusts have also established adequate disclosure controls and procedures and internal control over financial reporting to provide reasonable assurance regarding their responsibility of the Trusts' financial reporting and the preparation of the financial statements for external purposes in accordance with GAAP. The Trusts' CEO and CFO assessed, or caused an assessment under their direct supervision, of the effectiveness of the REIT's disclosure controls and procedures and internal control over financial reporting (as defined in *National Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings*) as at December 31, 2010. Based on this assessment, it was determined that the Trusts' disclosure controls and procedures and internal control over financial reporting were effective as at December 31, 2010.

SECTION V

RISKS AND UNCERTAINTIES

All income property investments are subject to a degree of risk and uncertainty. They are affected by various factors including general market conditions and local market circumstances. An example of general market conditions would be the availability of long-term mortgage financing whereas local conditions would relate to factors affecting specific properties such as an oversupply 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 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 proposed distribution policy is outlined under "Outlook". 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 as previously outlined. Although the REIT intends 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. Cash available to the REIT for distributions may be reduced from time to time because of items such as principal repayments on debt, tenant allowances, leasing commissions and capital expenditures. The REIT 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 suspends or reduces distributions. The REIT trustees retain the right to re-evaluate the distribution policy from time to time as they consider appropriate.

Development and Financing Risk Relating to the Bow Development

The REIT entered into agreements to develop the Bow an approximately 2.0 million square foot office and retail complex in Calgary. The Bow, budgeted to cost approximately \$1.5 billion (including capitalized interest), is pre-leased, on a triple net basis, to EnCana Corporation for an initial term of approximately 25 years. 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. To mitigate this, the REIT has entered into fixed price contracts amounting to approximately 92% of the hard cost budget. Together with costs incurred to date, the REIT has effectively locked in approximately 97% of the total budget before contingencies. The REIT is also at risk for interest rate fluctuations on this project during the construction period. To mitigate this risk, the REIT entered into an interest rate swap which is intended to limit the interest rate to an effective annual rate of 4.65%.

The REIT secured a \$425 million construction facility during April 2009. There were amendments to the construction facility during 2010. The initial maturity date of the facility is October 22, 2012. The agreements and indentures governing indebtedness of this construction facility contain certain covenants and conditions applicable to the REIT, including without limitation, those requiring the REIT to maintain, at all times on a combined basis with Finance Trust, the following financial ratios (i) indebtedness to gross asset value of not greater than 0.65:1.0; (ii) debt service coverage of not less than 1.25:1.0 and (iii) unitholders' equity of not less than the sum of \$1.35 billion plus 75% of net cash proceeds received in connection with any equity offering after April 24, 2009. In addition, the REIT is required to have not less than \$906 million of cash equity being invested by the REIT and to have in place a committed revolving credit facility of not less than \$300 million (subject to reduction to \$200 million in certain circumstances) with a maturity date of not less than 11 months from the date of the initial borrowing under the facility. The REIT met these conditions during the three months ended December 31, 2010. The construction facility imposes certain restrictions on the REIT including without limitation regarding: the disposition of the Bow project; lands related to the Bow; the creation of liens or granting of negative pledges; the entering into of any merger or similar transaction with any person; changes of a fundamental nature (including senior management, business objectives, purposes or operations, capital structure and constating documents; the cancellation or waiver of material contracts; and changes to the Bow project budget. As a result, the REIT is limited by such covenants and restrictions. As at December 31, 2010, \$26.4 million has been drawn on this facility. Please see note 9 and 25 of the December 31, 2010 audited combined financial statements for further information.

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 individually 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 an A low rating by a recognized rating agency. Once the Bow is completed, EnCana Corporation is also expected to account for more than 5% of the rentals from income properties. EnCana Corporation's current public debt rating is A low.

Interest Rate and Financing Risk

The REIT is exposed to interest rate risk on its notes payable due to the volatility of variable interest rates. The interest rate on the U.S. Holdco Notes is adjusted monthly and is equal to the then-prevailing ten-year U.S. Treasury note rate plus 8% per annum. The floor interest rate of 8% mitigates the effect of a change in short-term market interest rates while the floating component linked to the ten-year U.S. Treasury rate results in decreased earnings when the short-term market interest rate increases.

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, 2010, the percentage of fixed rate debt to total debt was 97.5% (December 31, 2009 - 99.6%). 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, 2010, the weighted average term to maturity of the mortgages was 8 years (December 31, 2009 - 8.3 years) compared to the remaining average lease term of 10.2 years (December 31, 2009 - 10.5 years). Only 6.5% of total mortgage principal will mature before the end of 2011 and 13.8% of total mortgage principal will mature before the end of 2012. 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, 2010 the debt to GBV ratio (as per the REIT's Declaration of Trust) was 50.3% (December 31, 2009 - 52.5%) while the percentage of non-recourse debt to total debt was 39.9% (December 31, 2009 - 44.9%).

Liquidity Risk

Real estate investments tend to be relatively illiquid, with the degree of liquidity generally fluctuating in relationship with demand for and the perceived desirability of such investments. Such illiquidity 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.

Tax Risk

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 SIFT, received royal assent (the "SIFT Rules"). A SIFT includes certain publicly listed or traded partnerships and trusts and generally includes an income trust. The REIT is a SIFT until December 31, 2010, as discussed below.

Under the SIFT Rules, following a transition period for qualifying SIFTs, certain distributions from a SIFT will no longer be deductible in computing the SIFT's taxable income, and the SIFT will be subject to tax on an amount equal to the amount of 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 such 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 throughout the taxation year (the "REIT Exemption").

During the second quarter of 2010, the REIT completed necessary restructuring to qualify for the REIT Exemption commencing January 1, 2011. Accordingly, management believes the REIT will not be subject to the SIFT Rules provided that the REIT qualifies for the REIT Exemption at all times after 2010.

Management of the REIT intends to conduct the affairs of the REIT so that it qualifies for the REIT Exemption at all times after 2010; however, as the requirements of the REIT Exemption include complex revenue and asset tests, no assurances can be provided that the REIT will in fact so qualify at any time.

The REIT operates in the United States through U.S. Holdco which is capitalized with equity provided by the REIT and debt in the form of U.S. Holdco Notes owed to Finance Trust and HRLP. As at December 31, 2010, U.S. Holdco owed \$126.5 million to Finance Trust and HRLP which is eliminated on the combined financial statements.

U.S. Holdco intends to treat the U.S. Holdco Notes as indebtedness for U.S. federal income tax purposes. If the Internal Revenue Service ("IRS") or a court were to determine that the U.S. Holdco Notes should be treated for U.S. federal income tax purposes as equity rather than debt, the interest on the notes could be treated as a dividend, and interest on the notes would not be deductible for U.S. federal income tax purposes. In addition, if the IRS were to determine that the interest rate on the U.S. Holdco Notes did not represent an arm's length rate, any excess amount over arm's length would not be deductible and could be recharacterized as a dividend payment instead of an interest payment. This would significantly increase the U.S. federal income tax liability of U.S. Holdco, potentially including the tax liability for prior years in which U.S. Holdco has claimed a deduction for interest paid on the U.S. Holdco Notes. In addition, U.S. Holdco could be subject to penalties. The increase in tax liability could materially adversely affect U.S. Holdco's ability to make interest payments on the U.S. Holdco Notes or the REIT's ability to make distribution on its units. Additionally, payments of interest on the U.S. Holdco Notes to non-U.S. holders of Stapled Units could be subject to withholding taxes.

To the extent that the REIT or a related party provided debt financing to U.S. Holdco (e.g., by acquiring U.S. Holdco Notes), in determining income for U.S. tax purposes, U.S. Holdco is subject to possible limitations on the deductibility of interest, if any, paid to the REIT. Section 163(j) of the Internal Revenue Code (the "Code") applies to defer U.S. Holdings' deduction of interest paid on 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). The REIT intends to take the position that, due to the treatment of the Finance Trust as a grantor trust that is disregarded for U.S. federal tax purposes, the interest paid to Finance Trust is treated as having been paid to the holders of the Finance Trust units and is therefore not subject to section 163(j). If section 163(j) applied to interest paid to the Finance Trust, 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 IRS), 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.

A foreign corporation will be classified as a passive foreign investment company ("PFIC") for United States federal income tax purposes if either (i) 75% or more of its gross income is passive income or (ii) on average for the taxable year, 50% or more of its assets (by value) produce or are held for the production of passive income. The properties of the REIT are managed by a third party rather than directly by its own employees. Although the REIT's officers and employees oversee the activities of the manager, it is likely that the REIT will be characterized as a PFIC for U.S. federal income tax purposes, though this conclusion is uncertain. In the absence of certain elections being made by a U.S. holder of REIT Units, any distributions in respect of the REIT Units which exceed 125% of the average amount of distributions in respect of such REIT Units during the preceding three years, or, if shorter, during the preceding years in the U.S. holder's holding period ("excess distributions") and any gain on a sale or other disposition of the REIT units will be treated as ordinary income and will be subject to special tax rules, including an interest charge. U.S. holders should consult with their own tax advisors regarding the implications of these rules and the advisability of making one of the applicable PFIC elections, taking into account their particular circumstances.

In compliance with U.S. Treasury Department Circular 230, which provides rules governing certain conduct of U.S. tax advisors giving advice with respect to U.S. tax matters, please be aware that: (i) any U.S. federal tax advice contained herein is not intended to be used and cannot be used by the reader for the purpose of avoiding penalties that may be imposed under the Code; (ii) such advice was prepared in the expectation that it may be used in connection with the promotion or marketing (within the meaning of U.S. Treasury Department Circular 230) of Stapled Units; and (iii) prospective investors should seek advice based on their particular circumstances from an independent tax advisor.

Ability to Access Capital Markets

As the Trusts distribute a substantial portion of its income to unitholders, the Trusts may need to obtain additional capital through capital markets and the Trusts' ability to access the capital markets through equity issues and forms of secured or unsecured debt financing may affect the operations of the Trusts as such financing may be available only on disadvantageous terms, if at all. If financing is not available on acceptable terms, further acquisitions or ongoing development projects may be curtailed and cash available for distributions or to fund future commitments may be adversely affected.

Dilution

The number of Stapled Units the Trusts are authorized to issue is unlimited. The trustees have the discretion to issue additional Stapled Units in certain circumstances, including under the REIT's Unit Option Plan. Any issuance of Stapled Units may have a dilutive effect on the investors of Stapled 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 under the heading "Overview" showing that leases representing only 16.4% of the REIT's total square footage expires by the end of 2015.

Construction Risks

It is likely that, subject to compliance with the REIT's 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 "Development and Financing 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 to the extent possible, on a bonded basis) and by attempting to obtain long-term financing as early as possible during construction.

Debentures

The likelihood that purchasers of the 2013 Convertible Debentures, the 2014 Convertible Debentures, the 2017 Convertible Debentures, the 2020 Convertible Debentures and the Series A, B and C senior debentures will receive payments owing to them under the terms of such debentures will depend on the financial health of the REIT and its creditworthiness. In addition, such debentures are unsecured obligations of the REIT and are subordinate in right of payment to all the REIT's existing and future senior indebtedness as defined in each such respective trust indenture. 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 such debentures only after it has paid all of its senior 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. Finance Trust is a creditor of U.S. Holdco, a subsidiary of the REIT. A parent entity is entitled only to the residual equity of its subsidiaries after all debt obligations of its subsidiaries are discharged. In the event of bankruptcy, liquidation or reorganization of the REIT, holders of indebtedness of the REIT (including holders of the 2013 Convertible Debentures, the 2014 Convertible Debentures, the 2017 Convertible Debentures and the 2020 Convertible Debentures) may become subordinate to lenders to the subsidiaries of the REIT. The indentures governing such debentures do not prohibit or limit the ability of the REIT or its subsidiaries to incur additional debt or liabilities (including senior indebtedness), to amend and modify the ranking of any 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 indentures do not contain any provision specifically intended to protect holders of debentures in the event of a future leveraged transaction involving the REIT.

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 the REIT, 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 investment 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 Stapled 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 Trusts is subject to limitations. In certain circumstances, the REIT's Declaration of Trust provides for the *in specie* distributions of notes of H&R Portfolio LP Trust in the event of redemption of REIT units that are part of Stapled Units. 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 Trusts' Declarations of 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 Trusts 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.

Impact of Adoption of IFRS

IFRS will replace current Canadian GAAP for publicly accountable enterprises beginning in 2011. For the Trusts, IFRS will be effective for interim and annual periods commencing January 1, 2011, including the preparation and reporting of comparative figures for 2010. The impact of IFRS on the Trusts' consolidated financial results at the time of transition is dependent upon prevailing business circumstances, market factors and economic conditions at that time, as well as the accounting elections made. As a result, any transition impact disclosed by the Trusts are subject to change.

RELATED PARTY TRANSACTIONS

The Property Manager, a company partially owned by family members of the Chief Executive Officer, provides property management services, pursuant to a property management agreement, 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. In addition, the support services relating to dispositions of income properties provides for a fee of 10% of the gain on sale of income properties adjusted for the add back of accumulated depreciation and amortization. The current agreement expires on January 1, 2015 and will automatically be renewed for an additional five-year term.

During the three months ended December 31, 2010, the REIT recorded fees pursuant to this agreement of \$3.7 million (2009 - \$3.5 million), of which \$0.3 million (2009 - \$nil) was capitalized to the cost of the income properties acquired, \$0.4 million (2009 - \$0.5 million) was capitalized to properties under development and \$0.3 million (2009 - \$0.8 million) was capitalized to leasing 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, 2010, a further amount of \$0.6 million (2009 - \$0.9 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. In 2009, the Property Manager waived payment of the annual incentive fee.

During the year ended December 31, 2010, the REIT recorded fees pursuant to this agreement of \$14.7 million (2009 - \$13.8 million), of which \$1.1 million (2009 - \$nil) was capitalized to the cost of the income properties acquired, \$2.2 million (2009 - \$2.1 million) was capitalized to properties under development and \$1.8 million (2009 - \$2.8 million) was capitalized to leasing 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, 2010, a further amount of \$2.5 million (2009 - \$3.6 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. In 2009, the Property Manager waived payment of the annual incentive fee.

Pursuant to the above agreements, as at December 31, 2010, \$1.7 million (2009 - \$0.9 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, 2010 is \$0.3 million (2009 - \$0.3 million) and for the year ended December 31, 2010 is \$ 1.3 million (2009 - \$1.3 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 February 22, 2011, there were 146,292,321 Stapled Units issued and outstanding.

As at December 31, 2010, the maximum number of Stapled Units authorized to be granted under the REIT's Unit Option Plan was 8,800,000. Of this amount, 7,600,000 had been granted and 6,039,667 had been exercised. As at February 24, 2011, there were 2,093,666 options to purchase Stapled Units outstanding of which 585,333 are fully vested.

The following table lists the principal outstanding balance of the REIT's convertible debentures as at February 22, 2011 and the number of Stapled Units required to convert the convertible debentures to equity:

| Convertible Debentures | Principal outstanding as at February 22, 2011 | Maximum number of Stapled Units issuable |
|------------------------|--|---|
| 2013 6.65% Debentures | \$115.0 million | 4,976,201 |
| 2014 6.75% Debentures | 144.2 million | 10,303,143 |
| 2017 6.00% Debentures | 175.0 million | 9,210,526 |
| 2020 5.90% Debentures | 100.0 million | 4,255,319 |

SUBSEQUENT EVENTS

- (a) In January 2011, the REIT has entered into an agreement to purchase 595 Bay Street, 20 & 40 Dundas Street West and 306 York Street, which are collectively known as the "Atrium on Bay" in Toronto, Ontario for gross proceeds of \$344.8 million. The REIT will assume a 7-year non-recourse mortgage of \$190 million. The acquisition is conditional upon the vendor meeting certain conditions. It is anticipated that the acquisition will close by April 2011 upon satisfaction of such conditions.
- (b) In January 2011, the REIT completed the acquisition of the remaining 20% beneficial interest not already owned by the REIT of a property under development located at 7900 Airport Road for an aggregate cash purchase price of approximately \$11 million. The REIT now owns 100% of approximately 81 acres of land located in Brampton, Ontario (known as Airport Road).
- (c) In January 2011, the REIT completed a public offering of 4.778% Series D senior debentures of \$180 million due July 27, 2016.
- (d) In February 2011, the REIT purchased a 42,000 square foot retail property in Teaneck, New Jersey for a purchase price of U.S. \$10.3 million. A mortgage payable of U.S. \$6.4 million was assumed on closing.
- (e) In February 2011, the REIT purchased a 116,000 square foot retail property in Columbus, Ohio for a purchase price of U.S. \$21.7 million.

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.

Combined Financial Statements of

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

Years ended December 31, 2010 and 2009



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INDEPENDENT AUDITORS' REPORT

To the Unitholders of H&R Real Estate Investment Trust
and H&R Finance Trust

We have audited the accompanying combined financial statements of H&R Real Estate Investment Trust and H&R Finance Trust, which comprise the combined balance sheets as at December 31, 2010 and 2009, the combined statements of earnings, unitholders' equity and comprehensive income and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Combined Financial Statements

Management is responsible for the preparation and fair presentation of these combined financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of combined financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these combined financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the combined financial statements present fairly, in all material respects, the financial position of H&R Real Estate Investment Trust and H&R Finance Trust as at December 31, 2010 and 2009, 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

February 24, 2011
Toronto, Canada

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Balance Sheets
(In thousands of dollars)
December 31, 2010 and 2009

| | 2010 | 2009 |
|--|---------------------|--------------|
| Assets | | |
| Income properties (note 3) | \$ 4,018,855 | \$ 4,124,856 |
| Properties under development (note 4) | 1,268,331 | 794,534 |
| Accrued rent receivable | 136,605 | 125,212 |
| Other assets (note 5) | 97,013 | 178,262 |
| Cash and cash equivalents (note 6) | 10,730 | 109,224 |
| Assets held for sale and discontinued operations (note 24) | - | 19,035 |
| | \$ 5,531,534 | \$ 5,351,123 |

Liabilities and Unitholders' Equity

Liabilities:

| | | |
|--|---------------------|--------------|
| Mortgages payable (note 7) | \$ 2,706,707 | \$ 2,818,476 |
| Debentures payable (note 8) | 822,340 | 565,758 |
| Accounts payable and accrued liabilities | 170,544 | 166,971 |
| Future income tax liability (note 23) | - | 138,122 |
| Bank indebtedness (notes 9(a) and 9(b)) | 89,045 | 13,556 |
| Intangible liabilities | 55,668 | 57,237 |
| Derivative instruments (notes 7 and 9(b)) | 3,317 | - |
| Liabilities related to discontinued operations (note 24) | - | 2,215 |
| | 3,847,621 | 3,762,335 |
| Non-controlling interest (note 10) | 77,261 | 75,122 |
| Unitholders' equity (notes 11 and 12) | 1,606,652 | 1,513,666 |
| Commitments and contingencies (note 25) | | |
| Subsequent events (note 27) | | |
| | \$ 5,531,534 | \$ 5,351,123 |

See accompanying notes to combined financial statements.

Approved by the Trustees:

"Robert Dickson" _____ Trustee

"Thomas J. Hofstedter" _____ Trustee

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Earnings
(In thousands of dollars, except per unit amounts)
Years ended December 31, 2010 and 2009

| | 2010 | 2009 |
|--|-------------------|------------|
| Operating revenue: | | |
| Rentals from income properties (note 13) | \$ 615,572 | \$ 605,165 |
| Interest income | 2,589 | 6,222 |
| | 618,161 | 611,387 |
| Operating expenses: | | |
| Property operating costs | 204,084 | 195,615 |
| Interest (note 14) | 179,519 | 182,671 |
| Depreciation and amortization (note 15) | 125,134 | 128,643 |
| | 508,737 | 506,929 |
| Net property operating income (note 22) | 109,424 | 104,458 |
| Net loss on foreign exchange | (6,775) | (20,509) |
| Impairment loss on income properties (note 3) | (14,862) | (14,764) |
| Unrealized gain (loss) on derivative instruments (notes 7, 9(b) and 19(c)) | (5,521) | 3,463 |
| Loss on repayment of debentures (note 8(f)) | (38,834) | - |
| Gain on extinguishment of debt (note 3) | 17,296 | - |
| Trust expenses | (8,897) | (8,551) |
| Net earnings before income taxes, non-controlling interest and discontinued operations | 51,831 | 64,097 |
| Income tax recovery (note 23) | 122,845 | 9,249 |
| Net earnings before non-controlling interest and discontinued operations | 174,676 | 73,346 |
| Non-controlling interest (note 10) | (6,272) | (3,049) |
| Net earnings from continuing operations | 168,404 | 70,297 |
| Net earnings from discontinued operations (note 24) | 3,944 | 16,228 |
| Net earnings | \$ 172,348 | \$ 86,525 |
| Basic net earnings per Stapled Unit (note 16): | | |
| Continuing operations | \$ 1.16 | \$ 0.50 |
| Discontinued operations | 0.03 | 0.11 |
| | \$ 1.19 | \$ 0.61 |
| Diluted net earnings per Stapled Unit (note 16): | | |
| Continuing operations | \$ 1.16 | \$ 0.46 |
| Discontinued operations | 0.03 | 0.10 |
| | \$ 1.19 | \$ 0.56 |

See accompanying notes to combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Unitholders' Equity and Comprehensive Income
(In thousands of dollars)
Years ended December 31, 2010 and 2009

| UNITHOLDERS' EQUITY | Value of units | Accumulated net earnings | Accumulated distributions | Contributed surplus | Equity component of warrants and debentures | Accumulated other comprehensive loss (note 12) | Total |
|--|---------------------|-----------------------------|------------------------------|------------------------|--|---|---------------------|
| Unitholders' equity, December 31, 2008 | \$ 2,188,052 | \$ 744,777 | \$(1,268,723) | \$ - | \$ 6,767 | \$ (19,205) | \$ 1,651,668 |
| Proceeds from issuance of units | 23,441 | - | - | - | - | - | 23,441 |
| Issue costs | (866) | - | - | - | - | - | (866) |
| Issuance of warrants, net of costs | - | - | - | - | 8,533 | - | 8,533 |
| Equity component from issuance of convertible debentures, net of costs (notes 8(b) and 8(c)) | - | - | - | - | 43,326 | - | 43,326 |
| Net earnings | - | 86,525 | - | - | - | - | 86,525 |
| Distributions to unitholders (note 11(b)) | - | - | (102,605) | - | - | - | (102,605) |
| Redemption of units (note 10) | (28,873) | - | - | 28,873 | - | - | - |
| Redemption of warrants (note 8(f)) | - | (148,308) | - | (28,873) | (8,533) | - | (185,714) |
| Unit-based compensation (note 11(a)) | 535 | - | - | - | - | - | 535 |
| Other comprehensive loss | - | - | - | - | - | (11,177) | (11,177) |
| Unitholders' equity, December 31, 2009 | 2,182,289 | 682,994 | (1,371,328) | - | 50,093 | (30,382) | 1,513,666 |
| Proceeds from issuance of units | 29,099 | - | - | - | - | - | 29,099 |
| Equity component from issuance of convertible debentures, net of costs (note 8(d)) | - | - | - | - | 6,572 | - | 6,572 |
| Net earnings | - | 172,348 | - | - | - | - | 172,348 |
| Distributions to unitholders (note 11(b)) | - | - | (113,696) | - | - | - | (113,696) |
| Redemption of convertible debentures (note 8(b)) | 4,973 | - | - | - | (908) | - | 4,065 |
| Unit-based compensation (note 11(a)) | - | - | - | 1,225 | - | - | 1,225 |
| Other comprehensive income | - | - | - | - | - | (6,627) | (6,627) |
| Unitholders' equity, December 31, 2010 | \$ 2,216,361 | \$ 855,342 | \$ (1,485,024) | \$ 1,225 | \$ 55,757 | \$ (37,009) | \$ 1,606,652 |

| COMPREHENSIVE INCOME | 2010 | 2009 |
|--|-------------------|------------------|
| Net earnings | \$ 172,348 | \$ 86,525 |
| Unrealized loss on translation of self-sustaining foreign operations | (7,502) | (16,605) |
| Transfer of realized loss on cash flow hedges to net earnings | 372 | 4,444 |
| Future income taxes (note 23) | 503 | 984 |
| Other comprehensive loss | (6,627) | (11,177) |
| Comprehensive income | \$ 165,721 | \$ 75,348 |

See accompanying notes to combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Cash Flows

(In thousands of dollars)

Years ended December 31, 2010 and 2009

| | 2010 | 2009 |
|--|------------------|-------------------|
| Cash provided by (used in): | | |
| Operations: | | |
| Net earnings | \$ 172,348 | \$ 86,525 |
| Items not affecting cash: | | |
| Rent amortization (notes 13 and 24) | 3,912 | 3,931 |
| Depreciation and amortization (notes 15 and 24) | 125,175 | 130,409 |
| Gain on sale of income properties (note 24) | (3,576) | (10,649) |
| Gain on extinguishment of debt (note 3) | (17,296) | - |
| Impairment loss on income properties (note 3) | 14,862 | 14,764 |
| Future income tax recovery (note 23) | (123,303) | (9,613) |
| Unrealized (gain) loss on derivative instruments (notes 7, 9(b) and 19(c)) | 5,521 | (3,463) |
| Loss on repayment of debentures (note 8(f)) | 38,834 | - |
| Effective interest rate accretion (notes 14 and 24) | 11,453 | 5,844 |
| Unrealized loss on foreign exchange | 6,779 | 20,487 |
| Unit-based compensation (note 11(a)) | 1,225 | 535 |
| Net earnings attributable to non-controlling interest (note 10) | 6,421 | 3,670 |
| Change in other non-cash operating items (note 17) | 822 | (3,499) |
| | 243,177 | 238,941 |
| Financing: | | |
| Bank indebtedness | 75,485 | (99,374) |
| Mortgages payable: | | |
| New mortgages payable | 35,831 | 82,134 |
| Principal repayments | (107,273) | (143,553) |
| Proceeds from issuance of debentures payable (notes 8(d) and 8(e)) | 445,924 | 510,352 |
| Redemption of warrants (note 8(f)) | - | (185,714) |
| Repayment of debentures payable (note 8(f)) | (227,752) | - |
| Proceeds from issuance of units, net | 14,829 | 13,781 |
| Distributions to unitholders (note 11(b)) | (99,426) | (93,811) |
| Distributions to non-controlling interest (note 10) | (4,282) | (3,915) |
| | 133,336 | 79,900 |
| Investments: | | |
| Properties under development | (463,362) | (313,511) |
| Income properties: | | |
| Net proceeds on disposition of income properties | 22,183 | 96,258 |
| Acquisitions (note 3) | (80,422) | - |
| Capital expenditures | (15,371) | (10,090) |
| Mortgages and amounts receivable | 60,789 | 15,821 |
| Restricted cash (note 5) | 895 | (15,497) |
| | (475,288) | (227,019) |
| Increase (decrease) in cash and cash equivalents | (98,775) | 91,822 |
| Cash and cash equivalents, beginning of year (notes 6 and 24) | 109,505 | 17,683 |
| Cash and cash equivalents, end of year (notes 6 and 24) | \$ 10,730 | \$ 109,505 |

Supplemental cash flow information (note 17)

See accompanying notes to combined financial statements.

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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 (note 11). 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 are 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 Trusts' 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 Trusts may only be transferred together as Stapled Units unless an event of "uncoupling" has occurred.

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

- The units of the Trusts are stapled (as noted above), resulting in the two Trusts being under common ownership;
- A support agreement between the Trusts 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 H&R REIT (U.S.) Holdings Inc. ("U.S. Holdco"), a wholly owned U.S. subsidiary of the REIT; and
- 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.

On November 30, 2009, the Trusts completed a reorganization (the "2009 Reorganization") as part of the steps required to enable the REIT to qualify for the REIT exemption under certain provisions in the Income Tax Act (Canada) applicable to publicly traded trusts and partnerships. The 2009 Reorganization involved, among other things, a redemption of 5,437,565 Stapled Units of the Trusts held by H&R Portfolio Limited Partnership ("HRLP"), a subsidiary partnership of the REIT. In accordance with the respective Declarations of Trust for the REIT and Finance Trust and upon the exercise of discretion by the trustees of the REIT, as provided for in the Declaration of Trust of the REIT, the redemption price for the REIT units was paid in cash, while Finance Trust delivered notes receivable from U.S. Holdco in payment of the redemption price for the Finance Trust units redeemed.

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1. Significant accounting policies:

These combined financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and reflect the following policies:

(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 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.

The combination of the Trusts does not result in the elimination of the equity of Finance Trust as neither of the Trusts hold any interest in the other. The equity of the Trusts 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.

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1. Significant accounting policies (continued):

Buildings are depreciated on a straight-line basis over their useful lives for a period of approximately 40 years. Building improvements are amortized over their useful lives, which typically vary between 5 and 20 years. Improvements that do not meet the capitalization criteria are expensed in full in the period incurred. Paving and equipment are depreciated on a straight-line basis over their useful lives 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.

(d) *Leasing 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.

(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 of the REIT intend to distribute 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 23).

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.

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1. Significant accounting policies (continued):

(g) *Unit option plan:*

The REIT has a unit option plan available for officers, employees and certain trustees as disclosed in note 11(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) *Restricted cash:*

Restricted cash includes tenant rent deposits and amounts held in reserve by lenders to fund repairs and capital expenditures or to cover property tax payments as required by either a mortgage or under the terms of a purchase and sale agreement.

(j) *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 in accumulated other comprehensive income 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 accumulated unrealized gains or losses arising from the translation of this obligation are recorded as a foreign currency translation adjustment in accumulated other comprehensive income.

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

(k) *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 sheets. The effective portion of the hedge is recorded in other comprehensive income and the ineffective portion is recognized in net earnings.

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1. Significant accounting policies (continued):

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 loss and recognized as an adjustment to interest expense over the term of the related mortgage.

(l) *Financial instruments:*

The Trusts have designated their cash and cash equivalents, restricted cash and swap derivatives as held-for-trading, which are measured at fair value. Accounts receivable and mortgages and amount receivable are classified as loans and receivables, which are measured at amortized cost. Mortgages payable, debentures payable, accounts payable and accrued liabilities and bank indebtedness 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 years ended December 31, 2010 and 2009.

(m) *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 revenues and expenses during the period of development. The amount of interest cost capitalized for a qualifying asset project is that portion of the interest cost incurred during the assets' development periods that theoretically could have been avoided if expenditures for the development had not been made in addition to interest costs specific to the qualifying asset.

(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. Estimates are used when accounting for items such as embedded prepayment and extension options, notes payable and acquisitions. 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.

2. Future changes in accounting policies:

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 current Canadian 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.

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3. Income properties:

| December 31, 2010 | Cost | Accumulated depreciation and amortization | Net book value |
|-----------------------|--------------|---|-------------------|
| Land | \$ 878,625 | \$ - | \$ 878,625 |
| Buildings | 3,251,583 | (508,622) | 2,742,961 |
| Building improvements | 38,637 | (8,812) | 29,825 |
| Paving and equipment | 120,129 | (59,609) | 60,520 |
| | 4,288,974 | (577,043) | 3,711,931 |
| Intangible assets | 442,183 | (135,259) | 306,924 |
| | \$ 4,731,157 | \$ (712,302) | \$ 4,018,855 |

| December 31, 2009 | Cost | Accumulated depreciation and amortization | Net book value |
|-----------------------|--------------|---|-------------------|
| Land | \$ 877,530 | \$ - | \$ 877,530 |
| Buildings | 3,282,641 | (444,212) | 2,838,429 |
| Building improvements | 23,260 | (5,997) | 17,263 |
| Paving and equipment | 128,820 | (56,156) | 72,664 |
| | 4,312,251 | (506,365) | 3,805,886 |
| Intangible assets | 442,708 | (123,738) | 318,970 |
| | \$ 4,754,959 | \$ (630,103) | \$ 4,124,856 |

During the year ended December 31, 2010, the REIT recorded an impairment charge of \$14,862 on two of its U.S. income properties (2009 - \$14,764 on four of its U.S. income properties). Each impairment was triggered by the tenant vacating the premises following their bankruptcy announcement.

During the year ended December 31, 2010, the lenders accepted title to five U.S. income properties, one previously occupied by Circuit City and four previously occupied by Boscov's Department Stores, thereby releasing the REIT from any further obligation with respect to the mortgages on such properties. The REIT recorded a gain on the extinguishment of this debt of \$17,296 for the year ended December 31, 2010 (2009 - \$nil).

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. 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.

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3. Income properties (continued):

Acquisitions:

During the year ended December 31, 2010, the REIT acquired 16 income properties. These acquisitions have been recorded by the purchase method with the results of operations included in these combined financial statements from the date of acquisition. There were no acquisitions during the year ended December 31, 2009. The following table summarizes the acquired net assets at fair value on their respective dates of acquisition:

| | 2010 |
|--|------------------|
| Assets | |
| Land | \$ 35,308 |
| Building | 100,801 |
| Paving and equipment | 4,173 |
| Intangible in-place lease costs | 16,253 |
| Above-market leases | 8,485 |
| Customer relationship value | 1,640 |
| | 166,660 |
| Liabilities | |
| Mortgages payable, net of mark to market adjustments | 82,495 |
| Intangible below-market leases | 3,743 |
| Net assets acquired and settled by cash | \$ 80,422 |

4. Properties under development:

| Project | Address | 2010 | 2009 |
|----------------------|--|---------------------|-------------------|
| The Bow (note 25(a)) | 5th Ave. at Centre Street, Calgary, AB | \$ 1,150,094 | \$ 719,173 |
| Heart Lake | Mayfield West Business Park, Caledon, ON | 80,195 | 39,809 |
| Airport Road | 7900 Airport Road, Brampton, ON | 38,042 | 35,552 |
| | | \$ 1,268,331 | \$ 794,534 |

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5. Other assets:

| | 2010 | 2009 |
|---|------------------|-------------------|
| Tenant inducements (net of accumulated amortization of \$12,782 (2009 - \$9,807)) | \$ 33,209 | \$ 29,797 |
| Leasing expenses (net of accumulated amortization of \$23,554 (2009 - \$19,145)) | 26,121 | 27,542 |
| Restricted cash | 19,106 | 20,001 |
| Accounts receivable | 7,420 | 6,543 |
| Prepaid expenses and sundry assets | 6,932 | 12,811 |
| Mortgages and amount receivable | 3,000 | 63,789 |
| Derivative instruments (notes 9(b) and 19(c)) | 1,225 | 3,463 |
| Future income tax asset (note 23) | - | 14,316 |
| | \$ 97,013 | \$ 178,262 |

6. Cash and cash equivalents:

Cash and cash equivalents at December 31, 2010 includes cash on hand of \$6,785 (2009 - \$9,281) and bank term deposits of \$3,945 (2009 - \$99,943) at rates of interest varying between 0.93% to 1.00% (2009 - 0.11% to 0.26%).

7. Mortgages payable:

The mortgages payable are secured by income properties and letters of credit in certain cases, bearing fixed interest with a contractual weighted average rate of 6.2% (2009 - 6.2%) per annum and maturing between 2011 and 2035. Included in mortgages payable at December 31, 2010 are U.S. dollar denominated mortgages of U.S. \$824,066 (2009 - U.S. \$826,906). The Canadian equivalents of these amounts are \$815,826 (2009 - \$868,252).

During the year ended December 31, 2010, the REIT entered into an interest rate swap on one mortgage. The fair value of this interest rate swap as at December 31, 2010 is a liability of \$420. The change in fair value of \$420 and the related \$15 foreign exchange loss for the year ended December 31, 2010, have been recorded as a total unrealized loss of \$435.

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.

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7. Mortgages payable (continued):

Future principal mortgage payments are as follows:

| Years ending December 31: | |
|---|--------------------|
| 2011 | \$ 170,601 |
| 2012 | 363,792 |
| 2013 | 203,380 |
| 2014 | 278,761 |
| 2015 | 320,217 |
| Thereafter | 1,296,418 |
| | <hr/> 2,633,169 |
| Mortgages payable due on demand * | 77,365 |
| Financing costs and mark-to-market adjustment arising on acquisitions | (3,827) |
| | <hr/> \$ 2,706,707 |

* Relates to seven non-recourse mortgages to the REIT for income properties in which the tenants, Boscov's Department Store, Bruno's Supermarkets LLC and Great Atlantic and Pacific Tea Company ("A&P"), have filed for protection under Chapter 11 of the United States Bankruptcy Code. The REIT has handed over control of three of these income 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.

8. Debentures payable:

| | | | | | | | 2010 | 2009 |
|-----------------------------|-----------------------|-------------|-----------|------------|-----------------|------------------|-----------------|------|
| | | Contractual | Effective | | | Carrying | Carrying | |
| | | interest | interest | Conversion | Face | value | value | |
| Maturity | | rate | rate | price | value | value | value | |
| 2013 Convertible Debentures | (a) June 30, 2013 | 6.65% | 9.10% | \$ 23.11 | \$115,000 | \$108,840 | \$106,734 | |
| 2014 Convertible Debentures | (b) December 31, 2014 | 6.75% | 12.30% | 14.00 | 145,027 | 120,153 | 119,427 | |
| 2017 Convertible Debentures | (c) June 30, 2017 | 6.00% | 8.60% | 19.00 | 175,000 | 153,266 | 150,830 | |
| 2020 Convertible Debentures | (d) June 30, 2020 | 5.90% | 7.53% | 23.50 | 100,000 | 89,241 | - | |
| Series A Senior Debentures | (e) February 3, 2015 | 5.20% | 5.40% | - | 115,000 | 114,154 | - | |
| Series B Senior Debentures | (e) February 3, 2017 | 5.90% | 6.06% | - | 115,000 | 114,073 | - | |
| Series C Senior Debentures | (e) December 1, 2018 | 5.00% | 5.30% | - | 125,000 | 122,613 | - | |
| Non-Convertible Debentures | (f) - | 11.50% | 12.90% | - | - | - | 188,767 | |
| | | | | | <hr/> \$890,027 | \$822,340 | <hr/> \$565,758 | |

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8. Debentures payable (continued):

(a) *2013 Convertible Debentures:*

In June 2008, the REIT completed a public offering of \$115,000 convertible unsecured subordinated debentures (the "2013 Convertible Debentures"), bearing interest at the annual contractual rate of 6.65% and an effective interest rate of 9.10% (2009 - 9.10%). The 2013 Convertible Debentures mature on June 30, 2013, and interest is payable semi-annually on June 30 and December 31. Each 2013 Convertible Debenture is convertible into freely tradeable Stapled Units 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 2013 Convertible Debentures, at a conversion price of \$23.11 per Stapled Unit, being a conversion rate of approximately 43.2713 Stapled Units per \$1 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the indenture governing the 2013 Convertible Debentures.

On redemption or maturity of the 2013 Convertible Debentures, the REIT may, at its option and subject to certain conditions, elect to satisfy its obligation to repay all or any portion of the principal amount of the 2013 Convertible Debentures that are to be redeemed or that are to mature through the issuance of Stapled Units by way of issuing (or causing it to be issued) a variable number of Stapled Units equal to the principal amount of the 2013 Convertible Debentures that are to be redeemed or that are to mature divided by 95% of the then fair market value of the Stapled Units. The 2013 Convertible Debentures may not be redeemed by the REIT on or before June 30, 2011. Thereafter, but prior to June 30, 2012, the 2013 Convertible Debentures may be redeemed, in whole or in part, only if the current market price of a Stapled Unit is at least 125% of the conversion price. On or after June 30, 2012 and prior to the maturity date, the 2013 Convertible Debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest. Upon a change of control, the holders of 2013 Convertible Debentures have the right to require the REIT to purchase the 2013 Convertible Debentures at 101% of the principal amount plus accrued and unpaid interest.

The REIT accounted for the 2013 Convertible Debentures by valuing the holders' option to convert into Stapled Units and classifying such value as equity. The remaining value of the 2013 Convertible Debentures is classified as debt.

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 2013 Convertible Debentures into Stapled Units, of \$6,767, net of issue costs of \$277. 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 2013 Convertible Debentures such that, at maturity, the debt component is equal to the face value of the then outstanding 2013 Convertible Debentures.

(b) *2014 Convertible Debentures:*

In July 2009, the REIT completed a public offering of \$150,000 Series B convertible unsecured subordinated debentures (the "2014 Convertible Debentures"), bearing interest at the annual contractual rate of 6.75% and an effective interest rate of 12.30% (2009 - 12.30%). The 2014 Convertible Debentures mature on December 31, 2014, and interest is payable semi-annually on June 30 and December 31. Each 2014 Convertible Debenture is convertible into freely tradeable Stapled Units 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 2014 Convertible Debentures, at a conversion price of \$14.00 per Stapled Unit, being a conversion rate of approximately 71.4286 Stapled Units per \$1 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the indenture governing the 2014 Convertible Debentures.

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8. Debentures payable (continued):

On redemption or maturity of the 2014 Convertible Debentures, the REIT may, at its option and subject to certain conditions, elect to satisfy its obligation to repay all or any portion of the principal amount of the 2014 Convertible Debentures that are to be redeemed or that are to mature through the issuance of Stapled Units by way of issuing (or causing it to be issued) a variable number of Stapled Units equal to the principal amount of the 2014 Convertible Debentures that are to be redeemed or that are to mature divided by 95% of the then fair market value of the Stapled Units. The 2014 Convertible Debentures may not be redeemed by the REIT on or before July 30, 2012. Thereafter, but prior to July 30, 2013, the 2014 Convertible Debentures may be redeemed, in whole or in part, only if the current market price of a Stapled Unit is at least 125% of the conversion price. On or after July 30, 2013 and prior to the maturity date, the 2014 Convertible Debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest. Upon a change of control, the holders of the 2014 Convertible Debentures have the right to require the REIT to purchase the 2014 Convertible Debentures at 101% of the principal amount plus accrued and unpaid interest.

The REIT accounted for the 2014 Convertible Debentures by valuing the holders' option to convert into Stapled Units and classifying such value as equity. The remaining value of the 2014 Convertible Debentures is classified as debt.

On issuance, the REIT recorded a liability of \$117,579, net of issue costs of \$5,015, and equity, which represents the holders' option to convert the 2014 Convertible Debentures into Stapled Units, of \$26,305, net of issue costs of \$1,101. 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 2014 Convertible Debentures such that, at maturity, the debt component is equal to the face value of the then outstanding 2014 Convertible Debentures.

During the year ended December 31, 2010, holders of \$4,973 (2009 - \$nil) 2014 Convertible Debentures at face value exercised their option to convert the 2014 Convertible Debentures to Stapled Units. Of the \$4,973, \$908 was recorded as a reduction of the original equity component and \$4,065 was recorded as a reduction of the debt component. This allocation is consistent with the original equity and debt allocation.

(c) 2017 Convertible Debentures:

In December 2009, the REIT completed a public offering of \$175,000 Series C convertible unsecured subordinated debentures (the "2017 Convertible Debentures"), bearing interest at the annual contractual rate of 6.00% and an effective interest rate of 8.60% (2009 - 8.60%). The 2017 Convertible Debentures mature on June 30, 2017, and interest is payable semi-annually on June 30 and December 31. Each 2017 Convertible Debenture is convertible into freely tradeable Stapled Units 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 2017 Convertible Debentures, at a conversion price of \$19.00 per Stapled Unit, being a conversion rate of approximately 52.6316 Stapled Units per \$1 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the indenture governing the 2017 Convertible Debentures.

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8. Debentures payable (continued):

On redemption or maturity of the 2017 Convertible Debentures, the REIT may, at its option and subject to certain conditions, elect to satisfy its obligation to repay all or any portion of the principal amount of the 2017 Convertible Debentures that are to be redeemed or that are to mature through the issuance of Stapled Units by way of issuing (or causing it to be issued) a variable number of Stapled Units equal to the principal amount of the 2017 Convertible Debentures that are to be redeemed or that are to mature divided by 95% of the then fair market value of the Stapled Units. The 2017 Convertible Debentures may not be redeemed by the REIT on or before June 30, 2013. Thereafter, but prior to June 30, 2015, the 2017 Convertible Debentures may be redeemed, in whole or in part, only if the current market price of a Stapled Unit is at least 125% of the conversion price. On or after June 30, 2015 and prior to the maturity date, the 2017 Convertible Debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest. Upon a change of control, the holders of the 2017 Convertible Debentures have the right to require the REIT to purchase the 2017 Convertible Debentures at 101% of the principal amount plus accrued and unpaid interest.

The REIT accounted for the 2017 Convertible Debentures by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability and classifying such value as debt. The remaining value of the 2017 Convertible Debentures is classified as equity.

On issuance, the REIT recorded a liability of \$150,817, net of issue costs of \$6,446, and equity, which represents the holders' option to convert the 2017 Convertible Debentures into Stapled Units, of \$17,021, net of issue costs of \$716. 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 2017 Convertible Debentures such that, at maturity, the debt component is equal to the face value of the then outstanding 2017 Convertible Debentures.

(d) *2020 Convertible Debentures:*

In July 2010, the REIT completed a public offering of \$100,000 Series D convertible unsecured subordinated debentures (the "2020 Convertible Debentures"), bearing interest at the annual contractual rate of 5.90% and an effective interest rate of 7.53%. The 2020 Convertible Debentures mature on June 30, 2020, and interest is payable semi-annually on June 30 and December 31. Each 2020 Convertible Debenture is convertible into freely tradeable Stapled Units 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 2020 Convertible Debentures, at a conversion price of \$23.50 per Stapled Unit, being a conversion rate of approximately 42.5532 Stapled Units per \$1 principal amount, subject to adjustment upon the occurrence of certain events in accordance with the indenture governing the 2020 Convertible Debentures.

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8. Debentures payable (continued):

On redemption or maturity of the 2020 Convertible Debentures, the REIT may, at its option and subject to certain conditions, elect to satisfy its obligation to repay all or any portion of the principal amount of the 2020 Convertible Debentures that are to be redeemed or that are to mature through the issuance of Stapled Units by way of issuing (or causing to be issued) a variable number of Stapled Units equal to the principal amount of the 2020 Convertible Debentures that are to be redeemed or that are to mature divided by 95% of the then fair market value of the Stapled Units. The 2020 Convertible Debentures may not be redeemed by the REIT on or before June 30, 2014. Thereafter, but prior to June 30, 2016, the 2020 Convertible Debentures may be redeemed, in whole or in part, only if the current market price of a Stapled Unit is at least 125% of the conversion price. On or after June 30, 2016 and prior to the maturity date, the 2020 Convertible Debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest. Upon a change in control, the holders of the 2020 Convertible Debentures have the right to require the REIT to purchase the 2020 Convertible Debentures at 101% of the principal amount plus accrued and unpaid interest.

The REIT accounted for the 2020 Convertible Debentures by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability and classifying such value as debt. The remaining value of the 2020 Convertible Debentures is classified as equity.

On issuance, the REIT recorded a liability of \$88,893, net of issue costs of \$4,223, and equity, which represents the holders' option to convert the 2020 Convertible Debentures into Stapled Units, of \$6,572, net of issue costs of \$312. 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 2020 Convertible Debentures such that, at maturity, the debt component is equal to the face value of the then outstanding 2020 Convertible Debentures.

(e) *Series A Senior Debentures, Series B Senior Debentures and Series C Senior Debentures:*

In February 2010, the REIT issued \$115,000 Series A unsecured senior debentures (the "Series A Senior Debentures"), bearing interest at the annual contractual rate of 5.20% and an effective interest rate of 5.40%. The Series A Senior Debentures mature on February 3, 2015, and interest is paid semi-annually on February 3 and August 3. On issuance, the REIT recorded a liability of \$113,981, net of issue costs of \$1,019.

In February 2010, the REIT issued \$115,000 Series B unsecured senior debentures (the "Series B Senior Debentures"), bearing interest at the annual contractual rate of 5.90% and an effective interest rate of 6.06%. The Series B Senior Debentures mature on February 3, 2017, and interest is paid semi-annually on February 3 and August 3. On issuance, the REIT recorded a liability of \$113,953, net of issue costs of \$1,047.

In September 2010, the REIT issued \$125,000 Series C unsecured senior debentures (the "Series C Senior Debentures"), bearing interest at the annual contractual rate of 5.00% and an effective interest rate of 5.30%. The Series C Senior Debentures mature on December 1, 2018, and interest is paid semi-annually on June 1 and December 1. On issuance, the REIT recorded a liability of \$122,525, net of issue costs of \$2,475.

Interest expense is recorded as a charge to income and is calculated at an effective interest rate with the difference between the coupon rate and the effective rate being credited to the carrying value such that, at maturity, the carrying value is equal to the face value of the then outstanding Series A Senior Debentures, Series B Senior Debentures and Series C Senior Debentures, (collectively "Senior Debentures").

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8. Debentures payable (continued):

At its option, the REIT may redeem any of the Senior Debentures, in whole at any time, or in part from time to time, prior to maturity on payment of a redemption price equal to the greater of (i) the Canada Yield Price as defined in the relevant supplemental trust indenture and (ii) par, together in each case with accrued and unpaid interest to the date fixed for redemption. The REIT will give notice of any redemption at least 30 days but not more than 60 days before the date fixed for redemption. Where less than all of any Senior Debentures are to be redeemed pursuant to their terms, the Senior Debentures to be so redeemed will be redeemed on a pro rata basis according to the principal amount of Senior Debentures registered in the respective name of each holder of Senior Debentures or in such other manner as the indenture trustee may consider equitable.

The Senior Debentures are rated BBB (with a Stable trend) by DBRS Limited.

(f) *Non-Convertible Debentures:*

In April 2009, the REIT issued \$200,000 of unsecured debentures (the "Non-Convertible Debentures") bearing interest at the annual contractual rate of 11.50% and an effective interest rate of 12.90%. The Non-Convertible Debentures mature on April 24, 2014, with interest payable semi-annually on June 30 and December 31. The Non-Convertible Debentures are not redeemable on or before April 24, 2013, except upon the satisfaction of certain conditions upon the occurrence of a change of control. After April 24, 2013 and prior to the maturity date thereof, the Non-Convertible Debentures are redeemable in whole or in part at the option of the REIT at a redemption price equal to the principal amount thereof plus accrued and unpaid interest. Upon a change of control, the holders of the Non-Convertible Debentures have the right to require the REIT to purchase the Non-Convertible Debentures at 101% of the principal amount plus accrued and unpaid interest.

In addition, for no additional proceeds, the REIT issued, simultaneously with the Non-Convertible Debentures, 28,571,429 warrants to purchase Stapled Units at an exercise price of \$7.00 per Stapled Unit exercisable until April 24, 2014. In December 2009, the REIT repurchased the outstanding 28,571,429 warrants at a purchase price of \$185,714. The cost of the redemption was in excess of the assigned value of the warrants by \$177,181, whereby \$28,873 of such excess was recorded as a reduction to contributed surplus and \$148,308 was recorded as a reduction to accumulated net earnings.

The REIT accounted for the Non-Convertible Debentures and the warrants by discounting the stream of future payments of interest and principal, due under the Non-Convertible Debenture indenture, at the prevailing market rate for a similar liability that is not issued simultaneously with warrants and allocated such amounts (net of associated issue costs) to the issuance of the Non-Convertible Debentures. The aggregate proceeds realized from the issuance of the Non-Convertible Debentures and warrants (net of issue costs), less the amount allocated to the Non-Convertible Debentures, has been allocated to the issue of the warrants and is classified as equity.

On issuance, the REIT recorded a liability of \$187,447, net of issue costs of \$1,288, and equity, which represents the warrants issued to purchase Stapled Units, of \$11,183, net of issue costs of \$82, with a further reduction of \$2,650 representing the initial future tax liability related to issuance of the Non-Convertible Debentures. 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 Non-Convertible Debentures such that, at maturity, the debt component is equal to the face value of the then outstanding Non-Convertible Debentures.

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8. Debentures payable (continued):

In February 2010, the REIT repaid the outstanding Non-Convertible Debentures having an aggregate face value of \$200,000 for a total repurchase price of \$229,989. The repurchase price included accrued interest of \$2,237. The REIT recognized a one-time non-recurring charge to the consolidated statement of earnings of \$38,834, representing the difference between the repurchase price, excluding accrued interest expense, and the carrying value of the Non-Convertible Debentures of \$188,918.

9. Bank indebtedness:

The REIT has the following facilities:

- (a) A general operating facility which is secured by fixed charges over certain income properties due on December 31, 2012. The total facility as at December 31, 2010 is \$295,300 (2009 - \$284,650) 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, 2010, after taking into account the bank indebtedness drawn of \$62,603 (including amounts disclosed in note 25) (2009 - \$13,560) and the outstanding letters of credit and other items, is \$188,148 (2009 - \$236,716). The Canadian dollar bank indebtedness bears interest at rates approximating the prime rate of a Canadian chartered bank. At December 31, 2010, the Canadian prime interest rate was 3.00% (2009 - 2.25%) per annum.

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

Included in bank indebtedness at December 31, 2010 are U.S. dollar denominated amounts of \$101 (2009 - U.S. \$33). The Canadian equivalents of these amounts are \$100 (2009 - \$35). The U.S. dollar bank indebtedness bears interest at LIBOR rates.

- (b) A secured construction financing facility for the REIT's development project, the Bow (the "Bow Facility"). The Bow Facility consists of a non-revolving term construction credit facility in the amount of \$425,000 available by way of prime loans, bankers' acceptances and/or letters of credit. As at December 31, 2010, the REIT has drawn \$26,442 under the Bow Facility and the amount available at December 31, 2010 is \$398,558. The initial maturity date of the Bow Facility is October 22, 2012.

The REIT entered into an interest rate swap that is intended to limit its interest rate exposure during the term of the Bow Facility. As at December 31, 2010, the expected annual effective interest rate for the Bow Facility, including the cost of the swap, is 4.65% (2009 - 6.90%). The fair value of this interest rate swap as at December 31, 2010 is a liability of \$2,897 (2009 - asset of \$3,463) resulting in an unrealized loss of \$6,360 for the year ended December 31, 2010 (2009 - unrealized gain of \$3,463).

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10. Non-controlling interest:

Non-controlling interest represents the amount of equity related to the Class B LP units of HRLP, issued to participating vendors in exchange for properties acquired by HRLP. The accounts of HRLP are consolidated into the REIT, and thus included in the combined financial statements. Class B LP units of HRLP are only exchangeable on a one-for-one basis, at the option of the holder, into Stapled Units.

Holders of the Class B LP 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.

Pursuant to the 2009 Reorganization, the 5,437,565 Stapled Units were redeemed in November 2009. As a result of the 2009 Reorganization, HRLP, the REIT, Finance Trust and H&R Portfolio LP Trust entered into an exchange and support agreement that provides, among other things, for (i) certain capital contributions to be made by the REIT in case HRLP has insufficient (a) funds to pay the required distributions on the Class B LP units of HRLP, or (b) Series 1 notes issued by U.S. Holdco to Finance Trust, ("U.S. Holdco Notes"), to pay the fair market value of the Finance Trust Units required to be delivered upon exchange of any Class B LP unit; and (ii) the mechanics whereby Class B LP units may be exchanged for Stapled Units.

The assigned value of the Stapled Units redeemed pursuant to the 2009 Reorganization exceeded the redemption price by \$28,873. This amount was recorded as contributed surplus.

| | Amount | Number of Class B LP units |
|--|------------------|-------------------------------|
| As at December 31, 2008 | \$ 75,367 | 5,437,565 |
| Non-controlling interest from continuing operations | 3,049 | - |
| Non-controlling interest from discontinued operations (note 24) | 621 | - |
| Distributions on Class B LP units of HRLP | (3,915) | - |
| As at December 31, 2009 | 75,122 | 5,437,565 |
| Non-controlling interest from continuing operations | 6,272 | - |
| Non-controlling interest from discontinued operations (note 24) | 149 | - |
| Distributions on Class B LP units of HRLP | (4,282) | - |
| As at December 31, 2010 | \$ 77,261 | 5,437,565 |

11. 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.

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11. Unitholders' equity (continued):

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 Trusts have entered into a support agreement ("Support Agreement") to coordinate the issuance of Stapled Units under various arrangements (note 11(c)).

The units of the Trusts are freely transferable and, other than as disclosed herein, the trustees of the Trusts 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 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.

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 Trusts shall use all reasonable efforts to obtain and maintain a listing for the units of their respective Trusts 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 Declarations 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).

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11. Unitholders' equity (continued):

Upon valid tender for redemption 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.

The following number of Stapled Units are issued and outstanding:

| | |
|---|--------------------|
| As at December 31, 2008 | 147,032,851 |
| Issued under the Distribution Reinvestment Plan and Unit Purchase Plan (the "DRIP") | 1,261,744 |
| Stapled Units redeemed from a subsidiary (note 10) | (5,437,565) |
| Options exercised | 968,232 |
| As at December 31, 2009 | 143,825,262 |
| Issued under the DRIP | 814,074 |
| 2014 Convertible Debentures converted into Stapled Units (note 8(b)) | 355,205 |
| Options exercised | 1,126,101 |
| As at December 31, 2010 | 146,120,642 |

(a) Unit option plan:

As at December 31, 2010, a maximum of 8,800,000 (2009 - 8,800,000) Stapled Units were authorized to be issued to the REIT's officers, employees and certain trustees, of which 7,600,000 options (2009 - 7,000,000 options) have been granted. The exercise price of each option approximated the market price of the Stapled Units on the date of grant and shall be increased by the amount, if any, by which, (i) the fair market value of one Finance Trust unit at the time of exercise of such option, exceeds (ii) the fair market value of one Finance Trust unit at the time of grant of such option. The options vest at 33.3% per year from the grant date, will be fully vested after three years, and expire ten years after the date of the grant.

During the year ended December 31, 2010, 600,000 (2009 - 600,000) options were granted. The fair value of the unit options used to compute compensation cost is the estimated fair value of each option granted on the grant date. This was calculated using an option pricing model with the following weighted average assumptions: expected distribution yield is 5.13%; expected volatility is 25.00%; risk free interest rate is 2.71%; and expected option life is 4.5 years from the date of grant. The grant-date fair value of the options in total is \$1,589. Unit-based compensation expense of \$1,225 for the year ended December 31, 2010 (2009 - \$535) was included in the trust expenses amount recorded in net earnings and charged to unitholders' equity.

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11. Unitholders' equity (continued):

A summary of the status of the unit option plan as at December 31, 2010 and 2009 and the changes during the year ended on those dates are as follows:

| | 2010 | | 2009 | |
|----------------------------------|-------------|---------------------------------|-----------|---------------------------------|
| | Units | Weighted average exercise price | Units | Weighted average exercise price |
| Outstanding, beginning of year | 2,086,434 | \$ 13.05 | 2,454,666 | \$ 13.73 |
| Granted | 600,000 | 15.42 | 600,000 | 9.30 |
| Exercised | (1,126,101) | 13.06 | (968,232) | 12.46 |
| Outstanding, end of year | 1,560,333 | \$ 13.95 | 2,086,434 | \$ 13.05 |
| Options exercisable, end of year | 410,333 | \$ 15.00 | 1,086,434 | \$ 13.82 |

The options outstanding at December 31, 2010 are exercisable at varying prices ranging from \$9.30 to \$16.56 (2009 - \$9.30 to \$16.56) with a weighted average remaining life of 8.4 years (2009 - 6.3 years). The vested options are exercisable at varying prices ranging from \$9.30 to \$16.56 (2009 - \$13.12 to \$16.56) with a weighted average remaining life of 7.7 years (2009 - 3.7 years).

(b) Distributions:

Under the REIT's Declaration of Trust, the total amount of income of the REIT to be distributed to unitholders, due and payable on or before December 31 of any calendar year, shall not be less than the amount necessary to ensure that the REIT will not be liable to pay income tax under Part I of the Income Tax Act (Canada) for that year, after all permitted deductions under such act have been taken (or authorized to be taken by the trustees), and any such payment shall be considered to have been declared by the trustees and to have been payable no later than December 31 of that year. Notwithstanding the foregoing, the total amount of income of the REIT to be distributed to unitholders for each calendar year shall be subject to the absolute discretion of the trustees. For the year ended December 31, 2010, the REIT declared per unit distributions of \$0.68 (2009 - \$0.61).

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. Finance Trust paid per unit distributions of \$0.11 for the year ended December 31, 2010 (2009 - \$0.11).

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11. Unitholders' equity (continued):

The details of the distributions are as follows:

| | 2010 | 2009 |
|--|------------|------------|
| Cash distributions to unitholders | \$ 99,426 | \$ 93,811 |
| Unit distributions (issued under the DRIP) | 14,270 | 8,794 |
| | \$ 113,696 | \$ 102,605 |

(c) *Support Agreement:*

Pursuant to provisions 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 Trusts 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, signing prospectuses or other offering documents.

In the event that the REIT issues additional REIT units, pursuant to the Support Agreement, the Trusts will co-ordinate 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 by the REIT.

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11. Unitholders' equity (continued):

(d) *Short form base shelf prospectus:*

On May 11, 2009, the Trusts issued a short form base shelf prospectus allowing the Trusts to offer and issue the following securities: (i) unsecured debt securities; (ii) subscription receipts exchangeable for Stapled Units and/or other securities of the Trusts; (iii) warrants exercisable to acquire Stapled Units and/or other securities of the Trusts; and (iv) securities comprised of more than one of Stapled Units, debt securities, subscription receipts and/or warrants offered together as a unit, or any combination thereof having an offer price of up to \$500,000 in aggregate (or the equivalent thereof, at the date of issue, in any other currency or currencies, as the case may be) at any time during the 25-month period that the short form base shelf prospectus (including any amendments) remains valid. On July 17, 2009, the Trusts filed Amendment No. 1 to the short form base shelf prospectus dated May 11, 2009, to provide that the securities that may be offered and issued thereunder include senior unsecured debt securities of the REIT. On January 18, 2010, the Trusts filed Amendment No. 2 to the short form base shelf prospectus dated May 11, 2009 and amended July 17, 2009, to increase the aggregate offer price of securities that may be offered under the short form base shelf prospectus from \$500,000 to \$1,000,000 (or the equivalent thereof, at the date of issue, in any other currency or currencies, as the case may be).

(e) *Equity distribution agreement:*

On June 5, 2009, the Trusts entered into an equity distribution agreement with Canaccord Capital Corporation who will act as agent for the issuance and sale of Stapled Units over an approximate two year period, by way of "at-the-market distributions" over the TSX. The timing of any sale over such approximate two year period, and the number of Stapled Units actually sold during such period, are at the discretion of the Trusts. Pursuant to applicable securities laws, the market value of Stapled Units sold pursuant to the equity distribution agreement must not exceed 10% of the aggregate market value of outstanding Stapled Units, as determined as at the last trading day of the month before the month in which the first trade under the equity distribution agreement is made. The Stapled Units will be distributed at market prices prevailing at the time of sale of such Stapled Units (if any) and, as a result, prices may vary between purchasers and during the period of distribution. As at December 31, 2010, no trades were made pursuant to the equity distribution agreement.

With the issue of the Series D Debentures (note 27), the REIT has issued \$960,000 of securities under the short form base shelf prospectus and as such, only a maximum of \$40,000 of Stapled Units can now be issued under the equity distribution agreement.

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12. Accumulated other comprehensive loss:

| | Cash flow hedges | Foreign operations | Total |
|--|---------------------|-----------------------|--------------------|
| Balance as at December 31, 2008 | \$ (8,270) | \$ (10,935) | \$ (19,205) |
| Transfer of realized loss on cash flow hedges to net earnings | 4,444 | - | 4,444 |
| Future income taxes (note 23) | 984 | - | 984 |
| Unrealized loss on translation of self-sustaining foreign operation | - | (16,605) | (16,605) |
| Balance as at December 31, 2009 | (2,842) | (27,540) | (30,382) |
| Transfer of realized loss on cash flow hedges to net earnings | 372 | - | 372 |
| Future income taxes (note 23) | 503 | - | 503 |
| Unrealized gain on translation of self-sustaining foreign operation | - | (7,502) | (7,502) |
| Balance as at December 31, 2010 | \$ (1,967) | \$ (35,042) | \$ (37,009) |

13. Rentals from income properties:

| | 2010 | 2009 |
|--|-------------------|-------------------|
| Rentals from income properties | \$ 608,456 | \$ 597,286 |
| Straight-lining of contractual rent | 11,028 | 11,726 |
| Rent amortization of tenant inducements | (3,233) | (2,772) |
| Rent amortization of above- and below-market rents | (679) | (1,075) |
| | \$ 615,572 | \$ 605,165 |

14. Interest:

| | 2010 | 2009 |
|--|-------------------|-------------------|
| Contractual interest on mortgages payable | \$ 170,293 | \$ 181,442 |
| Contractual interest on debentures payable | 46,400 | 27,884 |
| Effective interest rate accretion | 11,453 | 5,564 |
| Bank interest and charges | 3,573 | 2,193 |
| | 231,719 | 217,083 |
| Capitalized interest | (52,200) | (34,412) |
| | \$ 179,519 | \$ 182,671 |

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15. Depreciation and amortization:

| | 2010 | 2009 |
|---|-------------------|-------------------|
| Depreciation of income properties | \$ 95,793 | \$ 98,871 |
| Amortization of intangible assets on acquisitions | 23,143 | 24,207 |
| Amortization of leasing expenses | 6,198 | 5,565 |
| | \$ 125,134 | \$ 128,643 |

16. Net earnings per Stapled Unit:

| | 2010 | 2009 |
|--|-------------------|------------------|
| Net earnings | \$ 172,348 | \$ 86,525 |
| Add net earnings attributable to non-controlling interest (note 10) | 6,421 | 3,670 |
| Add convertible debenture interest | - | - |
| Diluted net earnings | \$ 178,769 | \$ 90,195 |

The weighted average number of Stapled Units outstanding was as follows:

| | 2010 | 2009 |
|--|--------------------|--------------------|
| Basic Stapled Units | 144,348,657 | 142,508,200 |
| Effect of dilutive securities: | | |
| Unit option plan | 636,044 | 84,765 |
| Convertible debentures | - | - |
| Warrants (note 8(f)) | - | 12,231,559 |
| Non-controlling interest conversion to Stapled Units (note 10) | 5,437,565 | 5,437,565 |
| Diluted Stapled Units | 150,422,266 | 160,262,089 |
| Net earnings per Stapled Unit: | | |
| Basic | \$ 1.19 | \$ 0.61 |
| Diluted | \$ 1.19 | \$ 0.56 |

The convertible debentures are anti-dilutive for the years ended December 31, 2010 and 2009; therefore, the potential conversion of these debentures into Stapled Units has not been included in the calculation of diluted Stapled Units.

Although the warrants were redeemed on December 29, 2009, they are included in the denominator of the diluted earnings per unit for the period which they were outstanding (note 8(f)).

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17. Supplemental cash flow information:

The change in non-cash operating items for the year ended December 31, 2010 and 2009 are as follows:

| | 2010 | 2009 |
|--|---------------|-------------------|
| Leasing expenses and tenant inducements | \$ (5,517) | \$ (6,044) |
| Accrued rent receivable | (11,264) | (11,746) |
| Prepaid expenses and sundry assets | 5,984 | 849 |
| Accounts receivable | (841) | 849 |
| Accounts payable and accrued liabilities | 12,460 | 12,593 |
| | \$ 822 | \$ (3,499) |

The following non-cash amounts recognized during the year ended December 31, 2010 and 2009 have been excluded from operating, financing and investing activities in the combined statements of cash flows:

| | 2010 | 2009 |
|---|-----------|----------|
| Acquisition of income properties through assumption of mortgages payable, net of mark to market adjustments | \$ 82,495 | \$ - |
| Acquisition of property under development through assumption of mortgage payable | 18,000 | - |
| Non-cash issuance of warrants | - | 8,533 |
| Release of mortgage obligations upon lenders consent | (89,484) | (10,424) |
| Non-cash transfer of income properties to lenders | 82,378 | 6,672 |
| Non-cash transfer of property from properties under development to income properties | - | 117,007 |
| Non-cash distributions to unitholders (note 11(b)) | 14,270 | 8,794 |
| Non-cash conversion of convertible debentures (note 8(b)) | 4,973 | - |
| Non-cash assumption of mortgage payable on disposition | - | 117,849 |
| Additions to properties under development included in accounts payable | (7,565) | 26,140 |
| Additions to tenant inducements included in accounts payable | 6,142 | - |

During the year ended December 31, 2010, interest paid amounted to \$207,651 (2009 - \$207,277).

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18. Capital risk management:

The REIT's primary objectives when managing capital are:

- (a) to provide unitholders with stable and growing 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, debentures payable and bank indebtedness. As long as the REIT complies with its investment and debt restrictions set out in its Declaration of Trust, it is 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.

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 and cash. Finance Trust manages its capital by adhering to the investment restrictions outlined in its Declaration of Trust.

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% (provided that for this purpose "indebtedness" excludes the 2013 Convertible Debentures, 2014 Convertible Debentures, 2017 Convertible Debentures and 2020 Convertible Debentures. In June 2010, the Declaration of Trust was amended to exclude from "indebtedness" certain guarantees provided by the REIT of debt assumed by purchasers on a primary obligor basis, in connection with past dispositions of properties, and for which the purchaser has provided the REIT an indemnity or similar arrangement. As at December 31, 2010, this ratio was 50.3% (2009 - 52.5%). Management uses this ratio as a key indicator in managing the REIT's capital.

In addition to the above key ratio, the REIT's general operating facility (note 9(a)) has the following covenants which are required to be calculated based on the REIT's and Finance Trust's combined financial statements:

| | Covenant | 2010 | 2009 |
|--|---|--------------------|-------------|
| (a) Maximum indebtedness to gross book value | 65% | 50.4% | 50.5% |
| (b) Minimum debt service coverage ratio | 1.20 : 1 | 1.43 : 1 | 1.55 : 1 |
| (c) Minimum equity | \$1,300,000 plus 75% of net cash proceeds from future equity offerings | \$1,606,652 | \$1,513,666 |

The REIT has various other covenants with respect to its debt. The REIT is in compliance with the covenants as at December 31, 2010 and 2009.

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18. Capital risk management (continued):

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, 2010 and December 31, 2009. The REIT monitors these ratios and is in compliance with such external requirements, except for those on the mortgages due on demand (note 7).

19. Risk management:

(a) *Credit risk:*

The REIT is exposed to credit risk as an owner of income properties in that tenants may experience financial difficulty and be unable to fulfill their lease commitment or the failure of tenants to occupy and pay rent in accordance with existing lease agreements. 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 and acquires income 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 REIT's cash flow. The only tenants which account for more than 5% of the rental income from income 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 an A low rating by a recognized rating agency. Once the Bow is completed, EnCana Corporation is expected to also account for more than 5% of the rentals from income properties. EnCana Corporation's current public debt rating is A low.

(b) *Liquidity risk:*

The REIT is subject to liquidity risk on its mortgages payable, debentures payable and bank indebtedness whereby it may not be able to refinance or pay its debt obligations when they become due.

Management's strategy for managing liquidity risk is to ensure, to the extent possible, that it will always have sufficient liquidity to meet its liabilities when they come 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 primary strategy of maintaining predictable cash flows. The REIT attempts to appropriately structure the term of mortgages to closely match the term of leases. This strategy enables the REIT to meet its contractual monthly mortgage obligations. Due to the long-term length of most of the REIT's mortgages, a significant amount of principal is usually paid by the time the mortgages mature.

The contractual obligations for mortgages payable are disclosed in note 7. The REIT also has contractual obligations for debentures payable, as described in note 8.

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19. Risk management (continued):

The agreements and indentures governing indebtedness of the REIT contain certain covenants that, among other things, require the REIT to maintain certain financial ratios and thresholds and impose on the REIT certain restrictions (subject in each case to exceptions) regarding: the disposition of the Bow, lands related to the Bow; the creation of liens or granting of negative pledges; the purchase or redemption of securities; the entering into any merger or similar transaction with any person; changes of a fundamental nature (including senior management, business objectives, purposes or operations, capital structure, constating documents, and subordinated debt); the cancellation or waiver of material contracts and changes to the Bow budget. As a result, the REIT is limited by such covenants and restrictions.

Management monitors 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 general operating facility, as described in note 9(a), available to draw on to fund its obligations.

(c) *Market risk:*

The REIT is subject to currency risk 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, resulting in the REIT being subject to foreign currency fluctuations which 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.

During the year ended December 31, 2010, the REIT entered into a foreign exchange forward contract with a Canadian chartered bank effectively locking the REIT's rate to exchange U.S. \$2,000 per month at 1.0402 for a two-year period expiring in April 2012. The fair value of this foreign exchange forward contract as at December 31, 2010 is \$1,225. The change in fair value of \$1,225 and the related \$49 foreign exchange gain for the year ended December 31, 2010, have been recorded as total unrealized gain of \$1,274.

A \$0.10 weakening of the U.S. dollar against the average Canadian dollar exchange rate of \$1.03 for the year ended December 31, 2010 (2009 - \$1.14) would have decreased other comprehensive income by approximately \$13,600 (2009 - \$18,800) and increased (decreased) net earnings by approximately (\$500) (2009 - \$2,300). This analysis assumes that all the variables, in particular interest rates, remain constant (a \$0.10 weakening of the Canadian dollar against the U.S. dollar at December 31, 2010 would have had the equal but opposite effect).

(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, 2010, the percentage of fixed rate debt to total debt was 97.5% (2009 - 99.6%). As at December 31, 2010 and 2009, 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.

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19. Risk management (continued):

The bank indebtedness is subject to variable interest rates. An increase in interest rates of 100 basis points for the year ended December 31, 2010 would have decreased net earnings by approximately \$300 (2009 - \$500). This analysis assumes that all other variables, in particular foreign exchange rates, remain constant.

(d) Fair values:

The fair values of the Trusts' mortgages and amount 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, 2010 has been estimated at \$2,697,922 (2009 - \$2,637,203) compared with the carrying value of \$2,706,707 (2009 - \$2,818,476).

The fair value of the debentures 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 debentures payable at December 31, 2010 has been estimated at \$1,007,812 (2009 - \$704,935) compared with the carrying value of \$822,340 (2009 - \$565,758).

20. 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% and 98.5%, summarized as follows:

| | 2010 | 2009 |
|--|------------------|-----------|
| Assets | \$150,568 | \$157,007 |
| Liabilities | 89,713 | 90,133 |
| Revenue | 26,765 | 26,275 |
| Expenses | 16,481 | 18,695 |
| Operating income from properties | 10,284 | 7,580 |
| Cash flows provided by operations | 11,276 | 11,252 |
| Cash flows used in financing | (15,735) | (6,784) |
| Cash flows provided by (used in) investments | 4,194 | (5,453) |

21. Related party transactions:

H&R Property Management Ltd. (the "Property Manager"), a company partially 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.

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21. Related party transactions (continued):

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 which is effective January 1, 2007. 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. The current agreement expires on January 1, 2015 with one automatic five-year extension.

During the year ended December 31, 2010, the REIT recorded fees pursuant to this agreement of \$14,657 (2009 - \$13,842), of which \$1,062 (2009 - \$nil) was capitalized to the cost of the income properties acquired, \$2,191 (2009 - \$2,073) was capitalized to properties under development and \$1,809 (2009 - \$2,795) was capitalized to leasing 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, 2010, a further amount of \$2,500 (2009 - \$3,630) has been earned by the Property Manager pursuant to the above agreement, in accordance with the annual incentive fee payable to the Property Manager. In 2009, the Property Manager waived payment of the annual incentive fee.

Pursuant to the above agreements, as at December 31, 2010, \$1,682 (2009 - \$857) 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, 2010 is \$1,322 (2009 - \$1,260).

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

22. Segmented disclosures:

Segmented information on identifiable assets by geographic region and property operating income is outlined below.

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

Income properties and properties under development:

| | 2010 | 2009 |
|---------------|---------------------|---------------------|
| Canada | \$ 4,224,243 | \$ 3,823,522 |
| United States | 1,062,943 | 1,095,868 |
| | \$ 5,287,186 | \$ 4,919,390 |

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22. Segmented disclosures (continued):

Net property operating income:

| 2010 | Canada | United States | Total |
|-------------------------------|------------|---------------|------------|
| Operating revenue | \$ 515,033 | \$ 103,128 | \$ 618,161 |
| Property operating costs | (186,875) | (17,209) | (204,084) |
| Interest | (129,893) | (49,626) | (179,519) |
| Depreciation and amortization | (92,111) | (33,023) | (125,134) |
| Net property operating income | \$ 106,154 | \$ 3,270 | \$ 109,424 |

| 2009 | Canada | United States | Total |
|-------------------------------|------------|---------------|------------|
| Operating revenue | \$ 506,679 | \$ 104,708 | \$ 611,387 |
| Property operating costs | (177,351) | (18,264) | (195,615) |
| Interest | (125,294) | (57,377) | (182,671) |
| Depreciation and amortization | (91,625) | (37,018) | (128,643) |
| Net property operating income | \$ 112,409 | \$ (7,951) | \$ 104,458 |

23. Income tax recovery:

| | 2010 | 2009 |
|---|------------|-----------|
| Income tax recovery (expense) included in the determination of net earnings from continuing operations: | | |
| Current | \$ (458) | \$ (364) |
| Future | 123,303 | 9,613 |
| | 122,845 | 9,249 |
| Future income tax included in the determination of other comprehensive income | 503 | 984 |
| | \$ 123,348 | \$ 10,233 |

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23. Income tax recovery (continued):

A reconciliation of expected income tax based upon the 2010 and 2009 statutory rates to the recorded income tax expense is as follows:

| | 2010 | 2009 |
|--|-------------|-------------------|
| Income tax computed at the Canadian statutory rate of \$nil applicable to the REIT for 2010 and 2009 | \$ - | \$ - |
| Future income tax arising from a change in tax status with the enactment of the SIFT Rules | - | - |
| Increase (decrease) of future income tax arising from change in: | | |
| Tax rates | - | (14,053) |
| Estimate of expected reversal of temporary differences | - | 3,456 |
| Future income tax applicable to Canadian corporate subsidiaries | - | - |
| U.S. income tax | - | 364 |
| Future income tax included in the determination of other comprehensive income (loss) | - | 984 |
| | <u>\$ -</u> | <u>\$ (9,249)</u> |

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 certain publicly listed or traded partnerships and trusts and generally includes an income trust. The REIT is a SIFT until December 31, 2010, as discussed below.

Under the SIFT Rules, following a transition period for qualifying SIFTs, certain distributions from a SIFT will no longer be deductible in computing the SIFT's taxable income, and the SIFT will be subject to tax on an amount equal to the amount of 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 such 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 normal growth guidelines at any time prior to 2011.

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 throughout the taxation year (the "REIT Exemption").

The REIT completed the necessary restructuring as of June 30, 2010 to qualify for the REIT Exemption commencing January 1, 2011. Accordingly, the net future income tax liability of \$123,303 was reversed into earnings as of June 30, 2010. After 2010, the REIT will not be subject to the SIFT Rules provided that the REIT qualifies for the REIT Exemption at all times.

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23. Income tax recovery (continued):

In respect of assets and liabilities of the REIT, its subsidiary trust and flow through entities, the net book value for accounting purposes of those net assets exceeds their tax basis by an amount of approximately \$515,000 (2009 - \$521,000).

The SIFT tax effects of temporary differences that give rise to significant portions of the future income tax assets and liabilities in 2009 are as follows:

| | 2009 |
|--------------------------------|------------|
| Future income tax liabilities: | |
| Income properties | \$ 98,875 |
| Properties under development | 10,812 |
| Accrued rent receivable | 26,839 |
| Mortgages receivable | 181 |
| Mortgages payable | - |
| Other assets | 1,415 |
| | 138,122 |
| Future income tax assets: | |
| Intangible liabilities | 10,480 |
| Deferred expenses | 2,408 |
| Issue costs | 1,147 |
| Mortgages payable | 281 |
| | 14,316 |
| | \$ 123,806 |

At December 31, 2010, the U.S. subsidiaries had accumulated net operating losses and deferred interest deductions available for carryforward for income tax purposes of approximately \$113,158 (2009 - \$105,838). The losses expire between 2018 and 2030. The deferred interest deductions do not generally expire. The net future tax assets of these corporate subsidiaries of \$50,221 (2009 - \$54,204) 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 \$50,221 (2009 - \$54,204) has been recorded.

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24. Assets held for sale and discontinued operations:

There are currently no properties held for sale as at December 31, 2010 (2009 - one industrial and one office property).

The following table sets forth the balance sheets associated with income properties classified as discontinued operations:

| | 2010 | 2009 |
|--|-------------|------------------|
| Assets | | |
| Income properties (net of accumulated depreciation of \$nil (2009 - \$3,418)) | \$ - | \$ 17,465 |
| Accrued rent receivable | - | 188 |
| Prepaid expenses and sundry assets | - | 105 |
| Accounts receivable | - | 36 |
| Leasing expenses (net of accumulated amortization of \$nil (2009 - \$1,206)) | - | 960 |
| Cash and cash equivalents | - | 281 |
| | \$ - | \$ 19,035 |
| Liabilities | | |
| Accounts payable and accrued liabilities | \$ - | \$ 2,211 |
| Bank indebtedness | - | 4 |
| | \$ - | \$ 2,215 |

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24. Assets held for sale and discontinued operations (continued):

The REIT sold two properties during the year ended December 31, 2010 and seven properties in the year ended December 31, 2009. The results of operations from these properties are disclosed below:

| Net earnings from discontinued operations | 2010 | 2009 |
|--|----------|-----------|
| Operating revenue: | | |
| Rentals from income properties | \$ 989 | \$ 17,533 |
| Straight-lining of contractual rent | (129) | 1,264 |
| Rent amortization of tenant inducements | - | (92) |
| Rent amortization of above- and below-market rents | - | 8 |
| | 860 | 18,713 |
| Interest income | - | 3 |
| | 860 | 18,716 |
| Operating expenses: | | |
| Property operating costs | 302 | 4,700 |
| Contractual interest on mortgages payable | - | 5,759 |
| Effective interest rate accretion | - | 280 |
| Bank interest and charges | - | 11 |
| Depreciation and amortization | 41 | 1,766 |
| | 343 | 12,516 |
| Net property operating income | 517 | 6,200 |
| Gain on sale of income properties | 3,576 | 10,649 |
| Non-controlling interest (note 10) | (149) | (621) |
| Net earnings from discontinued operations | \$ 3,944 | \$ 16,228 |

25. Commitments and contingencies:

- (a) The REIT is currently constructing a two million square foot office building in Calgary, Alberta (the "Bow"), which is fully pre-leased to EnCana Corporation for a 25-year term. The REIT has committed to incurring additional construction and development costs for this project of approximately \$397,000, including capitalized interest, over the remaining construction period, of which approximately \$360,000 is expected to be incurred during the next twelve months. As at December 31, 2010, the total cost incurred on the project amounted to \$1,150,094 (note 4) (2009 - \$719,173). This budget includes the construction of 1,360 parking stalls. Construction commenced in the spring of 2007 and is planned to be completed in 2012 to meet the completion timetable. The first four tranche completion dates upon which floors are scheduled to be delivered to EnCana Corporation are as follows: floors 1-14 by July 3, 2011, floors 15-24 by August 29, 2011 and floors 25-42 by October 12, 2011. The delivery schedule of floors 43-59 is expected to be set by the end of March 2011. 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 in the form of free rent, which may be significant.

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25. Commitments and contingencies (continued):

- (b) In the normal course of operations, the REIT has issued letters of credit in connection with developments, financings, operations and acquisitions. As at December 31, 2010, the REIT has outstanding letters of credit totalling \$44,524 (2009 - \$34,349), including \$17,939 (2009 - \$18,164) 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 9(a)).
- (c) The REIT provides guarantees on behalf of third parties, including co-owners. As at December 31, 2010, the REIT issued guarantees amounting to \$41,307 (2009 - \$43,278), expiring between 2011 and 2016 (2009 - expiring between 2011 and 2016), relating to the co-owner's share of mortgage liability. In addition, the REIT continues to guarantee certain debt assumed by purchasers in connection with past dispositions of properties, and will remain liable until such debts are extinguished or the lenders agree to release the REIT's covenants. At December 31, 2010 the estimated amount of debt subject to such guarantees, and therefore the maximum exposure to credit risk, is \$116,357 (2009 - \$119,150) which expires between 2013 and 2018 (2009 - expires between 2013 and 2018). There have been no defaults by the primary obligor for debts on which the REIT has provided its guarantees, and as a result, no contingent loss on these guarantees has been recognized in these financial statements.

Credit risks arise in the event that these parties default on repayment of their debt since they are guaranteed by the REIT. These credit risks are mitigated as the REIT has recourse under these guarantees in the event of a default by the borrowers, in which case the REIT's claim would be against the underlying real estate investments.

- (d) 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.

26. Comparative figures:

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

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Notes to Combined Financial Statements

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

Years ended December 31, 2010 and 2009

27. Subsequent events:

- (a) In January 2011, the REIT has entered into an agreement to purchase 595 Bay Street, 20 & 40 Dundas Street West and 306 York Street, which are collectively known as the "Atrium on Bay" in Toronto, Ontario for gross proceeds of \$344,800. The REIT will assume a 7-year non-recourse mortgage of \$190,000. The acquisition is conditional upon the vendor meeting certain conditions. It is anticipated that the acquisition will close by April 2011 upon satisfaction of such conditions.
- (b) In January 2011, the REIT completed the acquisition of the remaining 20% beneficial interest, not already owned by the REIT, of a property under development for an aggregate cash purchase price of approximately \$11,000. The REIT now owns 100% of approximately 81 acres of land located in Brampton, Ontario (known as Airport Road).
- (c) In January 2011, the REIT completed a public offering of \$180,000 of 4.778% Series D senior debentures due July 27, 2016.
- (d) In February 2011, the REIT purchased a 42,000 square foot retail property in Teaneck, New Jersey for a purchase price of U.S. \$10,300. A mortgage payable of U.S. \$6,400 was assumed on closing.
- (e) In February 2011, the REIT purchased a 116,000 square foot retail property in Columbus, Ohio for a purchase price of U.S. \$21,700.

Corporate Information

H&R REIT Board of Trustees

Thomas J. Hofstedter ⁽¹⁾, President and Chief Executive Officer, H&R Real Estate Investment Trust
Robert Dickson ^(2,4), Managing Director, MDC Partners Inc.
Edward Gilbert ^(1,2,3,4), Chief Operating Officer, Firm Capital Mortgage Investment Corporation
The Honourable Robert P. Kaplan, P.C., Q.C. ⁽⁴⁾, Business Consultant, Former Member of Parliament
Laurence A. Lebovic ^(1,3,4), Chief Executive Officer, Runnymede Development Corporation Ltd.
Ronald C. Rutman ^(2,3,4), Partner, Zeifman LLP, Chartered Accountants

H&R Finance Trust Board of Trustees

Thomas J. Hofstedter, President and Chief Executive Officer, H&R Real Estate Investment Trust
Shimshon (Stephen) Gross ⁽²⁾, President and Principal, LRG Holdings Inc. / Initial Corporation
Marvin Rubner ⁽²⁾, Manager and Founder, YAD Investments Limited.
Neil Sigler ⁽²⁾, Vice President, Gold Seal Management Inc.

(1) Investment Committee

(2) Audit Committee

(3) Compensation and Governance Committee

(4) Nominating Committee

Officers

Thomas J. Hofstedter, President and Chief Executive Officer
Larry Froom, Chief Financial Officer
Nathan Uhr, Chief Operating Officer (H&R REIT)

Auditors: KPMG LLP

Legal Counsel: Blake, Cassels & Graydon LLP

Taxability of Distributions: 40% of the distributions made by the H&R REIT and 13% of the distributions made by H&R Finance Trust to Unitholders during 2010 were tax deferred.

Plan Eligibility: RRSP, RRIF, DPSP, RESP, RDSP, TFSA

Stock Exchange Listing: Stapled Units and debentures of H&R are listed on the Toronto Stock Exchange under the trading symbols HR.UN; HR.DB; HR.DB.B, HR.DB.C, HR.DB.D.

Annual Meeting of Unitholders: The AGM will take place on June 16, 2011 at 1:00pm 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 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, 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, Downsview, Ontario, Canada, M3K 1N4

