

# THE KEG ROYALTIES INCOME FUND

## SECOND QUARTER REPORT

For the three and six months ended June 30, 2004

## TO OUR UNITHOLDERS

On behalf of the Board of Trustees, I am pleased to present the results of The Keg Royalties Income Fund (the "Fund") for the three months ended June 30, 2004. The Fund's earnings and cash flows have continued to generate distributions to unitholders in the expected amount of 9 cents per unit per month, or \$1.08 per unit on an annual basis.

### RESULTS

The Keg has once again reached a new sales record for the second quarter. The gross sales reported by the 86 Keg restaurants in the Royalty Pool were \$72,091,000, an increase of \$6,930,000 or 10.6% from the second quarter of 2003. Total system sales for the Keg were even more impressive at \$77,017,000 for the quarter, an increase of \$7,581,000 or 10.9% over the comparable quarter of the prior year. These higher system sales reflect the very successful new Keg restaurants which have opened since October 2, 2003 and which will be added to the Royalty Pool on January 1, 2005.

The Fund generated earnings of \$2,173,000 or 26.7 cents/unit, compared with \$2,010,000 or 24.6 cents/unit for the same quarter of the prior year, an increase of \$163,000 or 8.1%. The earnings increase is of course primarily attributable to the increase in royalty revenue but also due in part to a decrease in the operating expenses of the Fund. Distributable cash available to pay distributions to unitholders increased by \$178,000 or 8.7% to \$2,213,000 or 27.2 cents/unit from \$2,035,000 or 24.9 cents/unit for the second quarter of the prior year.

### OUTLOOK

Following challenging back-to-back years in 2002 and 2003, the foodservice industry appears to be resuming the growth it has typically enjoyed over the past twenty-five years. The perfect storm of one-time events that plagued the industry in 2003 in particular would appear to have been just that – a series of one-time events.

We feel that The Keg's strategies through the past two difficult years will continue to yield positive sales results through the balance of 2004. Overall growth continues at The Keg. Keg management remains committed to maintaining and improving the legendary high standards that have come to define the brand. Most importantly, The Keg continues to deliver consistently great overall experiences and as a result continues to enjoy the loyalty of its guests.

Sincerely,



C.C. Woodward  
Chairman, The Keg Royalties Income Fund  
on behalf of the Board of Trustees

August 16th, 2004

## FINANCIAL HIGHLIGHTS

(\$000's except per unit amounts)	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	Jan. 1 to June 30, <u>2004</u>	Jan. 1 to June 30, <u>2003</u>
<b>Restaurants in the Royalty Pool .....</b>	<b>86</b>	<b>81</b>	<b>86</b>	<b>81</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool .....</b>	<b><u>\$ 72,091</u></b>	<b><u>\$ 65,161</u></b>	<b><u>\$ 147,982</u></b>	<b><u>138,637</u></b>
Royalty income .....	\$ 2,916	\$ 2,615	\$ 5,952	5,554
Interest income .....	<u>1,064</u>	<u>1,068</u>	<u>2,128</u>	<u>2,123</u>
<b>Total income .....</b>	<b>3,980</b>	<b>3,683</b>	<b>8,080</b>	<b>7,677</b>
Expenses .....	(262)	(314)	(543)	(615)
Non-controlling interest <sup>(1)</sup> .....	<u>(1,545)</u>	<u>(1,359)</u>	<u>(3,107)</u>	<u>(2,764)</u>
<b>Earnings for the period .....</b>	<b><u>\$ 2,173</u></b>	<b><u>\$ 2,010</u></b>	<b><u>\$ 4,430</u></b>	<b><u>\$ 4,298</u></b>
<b>Basic and diluted earnings per Fund unit .....</b>	<b><u>\$ .27</u></b>	<b><u>\$ .25</u></b>	<b><u>\$ .54</u></b>	<b><u>\$ .53</u></b>
<b>Distributable cash per Fund unit <sup>(2)</sup> .....</b>	<b><u>\$ .27</u></b>	<b><u>\$ .25</u></b>	<b><u>\$ .55</u></b>	<b><u>\$ .53</u></b>
<b>Distributions declared per Fund unit .....</b>	<b><u>\$ .27</u></b>	<b><u>\$ .27</u></b>	<b><u>\$ .54</u></b>	<b><u>\$ .54</u></b>

Notes:

<sup>(1)</sup> Represents the effective interest of KRL in the earnings of the Fund.

<sup>(2)</sup> Distributable cash is not an earnings measure recognized by generally accepted accounting principles ("GAAP") and therefore may not be comparable to similar measures presented by other issuers. Distributable cash per Fund unit is computed as earnings for the period plus non-cash items such as non-controlling interest and amortization divided by the number of Fund units issued and outstanding.

## MANAGEMENT DISCUSSION AND ANALYSIS

### OVERVIEW

On May 31, 2002, The Keg Royalties Income Fund (the "Fund"), through its subsidiary The Keg Rights Limited Partnership (the "Partnership"), purchased The Keg trademarks and related property (collectively, the "Keg Rights") from Keg Restaurants Ltd. ("KRL"). The Partnership, in turn, granted KRL an exclusive licence to use the Keg Rights for a term of 99 years pursuant to a licence and royalty agreement. This agreement obligates KRL to make a monthly royalty payment equal to 4% of the gross sales of Keg restaurants in Canada and the United States.

The Fund's operating expenses are limited to administration expenses, interest on long-term debt and amortization of deferred financing fees.

KRL effectively owns 17.58% of the units of the Fund on a fully diluted basis through its ownership of Partnership units and has the obligation to pay monthly royalties to the Fund.

## THE ROYALTY POOL

Annually, on January 1<sup>st</sup>, the pool of Keg restaurants on which KRL pays a royalty (the “Royalty Pool”) to the Partnership is adjusted to include the gross sales from new Keg restaurants that have opened on or before October 2<sup>nd</sup> of the prior year, less gross sales from any Keg restaurants that have permanently closed during the year. In return for adding these net sales to the Royalty Pool, KRL receives the right to indirectly acquire additional Fund units (the “Additional Entitlement”). The Additional Entitlement is determined based on 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund units. KRL receives 80% of the estimated Additional Entitlement initially, with the balance received on December 31<sup>st</sup> each year when the actual full year performance of the new restaurants is known with certainty.

On January 1, 2003, three new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2002 were added to the Royalty Pool. The actual gross sales of these three new restaurants were \$13.2 million for the 52 weeks ended September 28, 2003. Two permanently closed Keg restaurants with annual sales of \$3.8 million were removed from the Royalty Pool. This resulted in KRL receiving an Additional Entitlement equivalent to 310,815 Fund units effective as of January 1, 2003. The total number of restaurants in the Royalty Pool increased to 81. The yield of the Fund units was determined to be 11.25% calculated using a weighted average unit price of \$9.60.

On January 1, 2004, seven new Keg restaurants that opened during the period from October 3, 2002 through October 2, 2003 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$25.2 million annually. Two permanently closed Keg restaurants with annual sales of \$4.6 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$20.6 million annually. The total number of restaurants in the Royalty Pool has increased to 86. The yield of the Fund units was determined to be 11.66% calculated using a weighted average unit price of \$9.26. As a result of the contribution of the additional net sales to the Royalty Pool, and assuming 100% of the estimated Additional Entitlement is received, KRL’s Additional Entitlement will be equivalent to 653,193 Fund units, being 6.52% of the Fund units on a fully diluted basis. On January 1, 2004, KRL received 80% of this entitlement representing the equivalent of 522,554 Fund units, being 5.28% of the Fund units on a fully diluted basis. KRL will also receive a proportionate increase in monthly distributions from the Partnership. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2004 once the actual performance of the new restaurants has been confirmed. Including the initial portion of Additional Entitlement described above, KRL has the right to exchange its units in the capital of the Partnership for 1,739,314 Fund units, representing 17.58% of the Fund units on a fully diluted basis. If KRL were to receive 100% of the estimated Additional Entitlement for 2004, it would have the right to exchange its Partnership units for 1,869,952 Fund units, representing 18.66% of the Fund units on a fully diluted basis. All Fund units obtained by KRL in exchange for these Partnership units are subject to a contractual re-sale restriction, which expires on May 31, 2005.

## OWNERSHIP OF THE FUND

The ownership of the Fund on a fully diluted basis is as follows:

	June 30, 2004		June 30, 2003	
	#	%	#	%
Fund units held by public unitholders .....	8,153,500	82.4	8,153,500	87.40
Exchangeable Partnership units held by KRL:				
Class A <sup>(1)</sup> .....	905,944	9.16	905,944	9.71
Class B <sup>(2)</sup> .....	<u>833,370</u>	<u>8.42</u>	<u>269,351</u>	<u>2.89</u>
	<u>1,739,314</u>	<u>17.58</u>	<u>1,175,295</u>	<u>12.60</u>
Total units .....	<u>9,892,814</u>	<u>100.00</u>	<u>9,328,795</u>	<u>100.00</u>

Notes:

<sup>(1)</sup> Represents KRL's initial 10% ownership of the Fund, prior to the entitlement to Class B units.

<sup>(2)</sup> Represents KRL's cumulative entitlement to the date indicated as a result of adding net sales to the Royalty Pool on an annual basis.

## SYSTEM SALES

While the Fund's income is based on a royalty of 4% of sales of Keg restaurants in the Royalty Pool, the total system sales of The Keg chain are of interest to the Fund and its unitholders as the total system sales best reflect the chain's overall performance. The following table sets out The Keg's total system sales for the periods indicated below:

(\$000's)	13 weeks ended		26 weeks ended	
	July 4, 2004	June 29, 2003	July 4, 2004	June 29, 2003
Corporate Keg restaurants .....	\$ 42,094	\$ 38,554	\$ 86,996	\$ 81,941
Franchised Keg restaurants <sup>(1)</sup> .....	<u>34,923</u>	<u>30,881</u>	<u>69,852</u>	<u>64,583</u>
Total system sales .....	<u>\$ 77,017</u>	<u>\$ 69,436</u>	<u>\$ 156,848</u>	<u>\$ 146,524</u>

<sup>(1)</sup> The amount of system sales for the franchised Keg restaurants is the amount of gross sales reported to KRL by franchised Keg restaurants without independent audit and includes the gross sales of a joint venture restaurant located in Coquitlam, British Columbia.

## SECOND QUARTER

Total system sales for the 13 weeks ended July 4, 2004 were \$77.0 million compared to \$69.4 million for the 13 weeks ended June 29, 2003, an increase of \$7.6 million or 10.9%. During the 13 weeks ended July 4, 2004, two new franchised restaurants were opened and three corporate restaurants were closed. The three closures were of restaurants located in the Portland, Oregon area due to lease expiries, which had been planned as part of an ongoing property rationalization process. During the 13-week period of the prior year, one new corporate and one new franchised restaurant were opened, no restaurants were closed and one franchised restaurant was relocated. As at July 4, 2004, there were a total of 87 restaurants as compared with the 86 restaurants at June 29, 2003.

The Keg's same store sales (sales of restaurants that operated during the entire period of both the current year and the prior year) increased by 4.1% in Canada and decreased by 3.0% in the United States. The decline in same store sales in the United States was primarily attributable to the closure of lunch operations at three restaurants earlier in the year. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable quarter increased by 2.1%. The average exchange rate moved from 1.40 in KRL's third quarter of fiscal 2003 to 1.36 in KRL's third quarter of fiscal 2004, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## YEAR TO DATE

System sales for the 26 weeks ended July 4, 2004 were \$156.8 million compared to \$146.5 million for the 26 weeks ended June 29, 2003, an increase of \$10.3 million or 7.0%. During the 26 weeks ended July 4, 2004, two new franchised restaurants were opened and three corporate restaurants were closed. During the 26-week period of the prior year, one new corporate restaurant and one new franchised restaurant were opened, no restaurants were closed and one franchised restaurant was relocated.

The Keg's same store sales (sales of restaurants that operated during the entire 26-week period of both the current year and the prior year) increased by 1.3% in Canada and decreased 1.9% in the United States. The decline in same store sales in the United States was completely attributable to the closure of lunch operations at three restaurants earlier in the year. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 26-week period decreased by 1.0%. This decrease is a function of the fluctuation in the U.S. dollar exchange rate rather than an indication of a slowdown in actual restaurant traffic. The average exchange rate moved from 1.46 in KRL's 26-week period of fiscal 2003 to 1.34 in KRL's 26-week period of fiscal 2004, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## OPERATING RESULTS

### SECOND QUARTER

Gross sales reported by the restaurants in the Royalty Pool increased from \$65,161,000 to \$72,091,000 for the comparable quarter. The increase of \$6,930,000 or 10.6% reflects the net impact of the addition of five net new restaurants to the Royalty Pool at the beginning of the year and the same store sales increases discussed above.

Royalty income increased by \$301,000 from \$2,615,000 in the second quarter of 2003 to \$2,916,000 in the second quarter of 2004 as a result of the increase in gross sales for the reasons explained above.

Operating expenses for the quarter ended June 30, 2004 were \$262,000 and included general and administrative expenses of \$83,000, interest on the long-term debt in the amount of \$150,000 and amortization on the deferred financing charges of \$29,000. General and administrative expenses decreased by \$9,000 over the comparable quarter in 2003. Interest costs have decreased by \$43,000 in the quarter as a result of a decrease in the average interest rate on the Fund debt from 5.33% in the second quarter of 2003 to 4.16% in the second quarter of 2004.

The non-controlling interest expense, which represents KRL's effective interest in the earnings of the Fund, has increased from \$1,359,000 for the three months ended June 30, 2003 to \$1,545,000 for the three months ended June 30, 2004. This increase is due to KRL's increased effective ownership in the Fund from 12.60% to 17.58% as a result of the new store roll-in on January 1, 2004.

Net earnings increased by \$163,000 from \$2,010,000 in the second quarter of 2003 to \$2,173,000 in the second quarter of 2004. Earnings per Fund unit were 26.7 cents compared to 24.6 cents for the comparable quarter in the prior year. Cash available for distribution during the quarter amounted to 27.2 cents per Fund unit versus the 25.0 cents per Fund unit available in the comparable quarter of the prior year. Distributions of 27 cents per Fund unit were declared in the second quarter of both 2004 and 2003. The difference between the Fund's earnings and distributable cash is due to non-cash items included in the Fund's operating expenses.

It is currently anticipated that the monthly distributions to unitholders will continue to be 9.0 cents per unit for the remainder of the current fiscal year, which equates to an annualized distribution of \$1.08 per unit.

## OPERATING RESULTS

### YEAR TO DATE

Gross sales reported by the restaurants in the Royalty Pool increased from \$138,637,000 to \$147,982,000 for the comparable six-month period. The increase of \$9,345,000 or 6.7% reflects the net impact of the addition of five net new restaurants to the Royalty Pool at the beginning of the year and the same store sales declines discussed above.

Royalty income increased by \$398,000 from \$5,554,000 in the second quarter of 2003 to \$5,952,000 in the second quarter of 2004 as a result of the increase in gross sales for the reasons explained previously.

Operating expenses for the quarter ended June 30, 2004 were \$543,000 and included general and administrative expenses of \$169,000, interest on the long-term debt in the amount of \$316,000 and amortization on the deferred financing charges of \$58,000. General and administrative expenses decreased by \$18,000 over the comparable period in 2003. Interest costs have decreased by \$54,000 in the period as a result of a decrease in the average interest rate on the Fund debt from 5.14% in the first half of 2003 to 4.38% in the first half of 2004.

The non-controlling interest expense, which represents KRL's effective interest in the earnings of the Fund, has increased from \$2,764,000 for the six months ended June 30, 2003 to \$3,107,000 for the six months ended June 30, 2004. This increase is due to KRL's increased effective ownership in the Fund from 12.60% to 17.58% as a result of the new store roll-in on January 1, 2004.

Net earnings increased by \$132,000 from \$4,298,000 in the first half of 2003 to \$4,430,000 in the first half of 2004. Earnings per Fund unit were 54.3 cents compared to 52.7 cents for the comparable period in the prior year. Cash available for distribution during the period amounted to 55.3 cents per Fund unit versus the 53.4 cents per Fund unit available in the comparable period of the prior year. Distributions of 54 cents per Fund unit were paid in the first half of both 2004 and 2003.

## OUTLOOK

According to the Long Term Forecast of the Canadian Restaurant and Foodservices Association, foodservice operators can look forward to a brighter 2004; this has proved to be the case for the first half of the year, with momentum appearing to improve each month. Following an unprecedented two-year decline in real foodservice sales, the forecast calls for sales in Canada's commercial foodservice industry to recover throughout 2004 and 2005 as tourism and global economies continue to improve. A return to real growth in the foodservice industry is predicted with full service restaurants, the sector in which KRL operates, experiencing a particularly strong recovery.

KRL anticipates that it will record strong sales growth relative to the foodservice industry as a whole in the future, as it has historically. KRL remains committed to growth, both through expansion into new markets and same store sales increases. In addition to building new Kegs in both Canada and the U.S., KRL continues to refurbish, and in some cases relocate, existing Keg restaurants in order to better serve our guests and to protect and enhance the strong leadership position The Keg brand has enjoyed for over thirty years.

## RISKS AND UNCERTAINTIES

The Fund continues to recognize certain risks and uncertainties associated with the ordinary course of business, including those associated with the business and operations of KRL, upon which the Fund relies solely for its income.

Management of KRL has advised the Trustees that it continues to monitor the situation regarding the two cases of BSE found in North America during 2003. The widespread testing of herds confirms these are isolated cases; the risk to human health appears to be negligible. Most importantly to The Keg, there has not been any significant negative consumer reaction to beef in North America and there has not been a material impact on its restaurant traffic. KRL management has further advised the Trustees that KRL has maintained an uninterrupted supply of quality beef that meets its demanding specifications despite the border closures and the unfortunate impact on cattle producers. Management of KRL expects the demand for beef to remain strong among consumers and its supply to continue uninterrupted.

## FORWARD LOOKING INFORMATION

The information provided in this report includes forward-looking statements with respect to business plans, activities and events anticipated by the Fund and the Fund's future results. Although the Fund believes the assumptions underlying such statements to be reasonable, any of the assumptions may prove to be inaccurate and, as a result, the forward-looking information may prove to be incorrect. The forward-looking information contained in this document is current only as of the date of this document. There should not be an expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.

# THE KEG ROYALTIES INCOME FUND

## CONSOLIDATED FINANCIAL STATEMENTS For the three and six months ended June 30, 2004

## CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of dollars)

	June 30, <u>2004</u> (unaudited)	December 31, <u>2003</u> (audited)
<b>ASSETS</b>		
Current assets:		
Due from Keg Restaurants Ltd. (note 6) .....	\$ 1,562	\$ 1,633
Prepaid expenses and deposits .....	<u>84</u>	<u>35</u>
	1,646	1,668
Note receivable from Keg Restaurants Ltd. ....	57,000	57,000
Intangible assets (note 7) .....	117,174	113,547
Deferred financing charges.....	<u>105</u>	<u>163</u>
	<u>\$ 175,925</u>	<u>\$ 172,378</u>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
Current liabilities:		
Bank indebtedness .....	\$ 104	\$ 197
Accounts payable and accrued liabilities .....	165	198
Interest payable on term loan.....	7	7
Distributions payable to Fund unitholders .....	-	734
Distributions payable to non-controlling interest .....	<u>-</u>	<u>541</u>
	276	1,677
Term loan .....	14,000	14,000
Non-controlling interest (note 8) .....	87,208	83,021
Unitholders' equity .....	<u>74,441</u>	<u>73,680</u>
	<u>\$ 175,925</u>	<u>\$ 172,378</u>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board of Trustees



C.C. Woodward, Trustee



George Tidball, Trustee

## CONSOLIDATED STATEMENTS OF EARNINGS

(Expressed in thousands of dollars, except per unit amounts - unaudited)

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
Gross sales reported by Keg restaurants in the Royalty Pool (note 3) .....	\$ <u>72,091</u>	\$ <u>65,161</u>	\$ <u>147,982</u>	\$ <u>138,637</u>
Revenue:				
Royalty income (note 3) .....	\$ 2,916	\$ 2,615	\$ 5,952	\$ 5,554
Interest income .....	<u>1,064</u>	<u>1,068</u>	<u>2,128</u>	<u>2,123</u>
	3,980	3,683	8,080	7,677
Expenses:				
General and administrative .....	83	92	169	187
Interest and financing fees .....	150	193	316	370
Amortization of deferred financing charges .....	<u>29</u>	<u>29</u>	<u>58</u>	<u>58</u>
	<u>262</u>	<u>314</u>	<u>543</u>	<u>615</u>
Earnings before non-controlling interest .....	3,718	3,369	7,537	7,062
Non-controlling interest (note 8) .....	<u>1,545</u>	<u>1,359</u>	<u>3,107</u>	<u>2,764</u>
Net earnings for the period .....	\$ <u>2,173</u>	\$ <u>2,010</u>	\$ <u>4,430</u>	\$ <u>4,298</u>
Basic and diluted earnings per Fund Unit (8,153,500 units).....	\$ <u>0.27</u>	\$ <u>0.25</u>	\$ <u>0.54</u>	\$ <u>0.53</u>

## CONSOLIDATED STATEMENTS OF UNITHOLDER'S EQUITY

(Expressed in thousands of dollars - unaudited)

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1, to June 30, <u>2003</u>
Balance, beginning of period.....	\$ 74,469	\$ 74,623	\$ 73,680	\$ 73,803
Net earnings for the period .....	2,173	2,010	4,430	4,298
Distributions declared to Fund unitholders (note 5) .....	<u>(2,201)</u>	<u>(2,201)</u>	<u>(3,669)</u>	<u>(3,669)</u>
Balance, end of period.....	\$ <u>74,441</u>	\$ <u>74,432</u>	\$ <u>74,441</u>	\$ <u>74,432</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars - unaudited)

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
<b>Cash provided by (used for):</b>				
<b>OPERATIONS:</b>				
Net earnings for the period .....	\$ 2,173	\$ 2,010	\$ 4,430	\$ 4,298
Items not involving cash:				
Amortization of deferred financing charges .....	29	29	58	58
Non-controlling interest.....	1,545	1,359	3,107	2,764
Change in non-cash operating working capital (note 9(a)) .....	<u>(37)</u>	<u>15</u>	<u>(11)</u>	<u>(8)</u>
	3,710	3,413	7,584	7,112
<b>FINANCING:</b>				
Distributions paid to Fund unitholders (note 5) .....	(2,201)	(2,201)	(4,403)	(4,403)
Distributions paid to non-controlling interest .....	<u>(1,540)</u>	<u>(1,379)</u>	<u>(3,088)</u>	<u>(2,762)</u>
	<u>(3,741)</u>	<u>(3,580)</u>	<u>(7,491)</u>	<u>(7,165)</u>
Increase in cash (bank indebtedness).....	(31)	(167)	93	(53)
Cash (bank indebtedness), beginning of period.....	<u>(73)</u>	<u>74</u>	<u>(197)</u>	<u>(40)</u>
Bank indebtedness, end of period .....	<u>\$ (104)</u>	<u>\$ (93)</u>	<u>\$ (104)</u>	<u>\$ (93)</u>

See note 9(b) for supplementary cash flow information.

See accompanying notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and six months ended June 30, 2004 and 2003

### 1. BASIS OF PRESENTATION:

The Keg Royalties Income Fund (the "Fund") prepares its interim consolidated financial statements in accordance with Canadian generally accepted accounting principles on a basis consistent with those used and described in the annual consolidated financial statements for the year ended December 31, 2003. The disclosures contained in these interim consolidated financial statements do not include all the requirements of Canadian generally accepted accounting principles for annual financial statements.

These interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2003.

### 2. CHANGE IN ACCOUNTING POLICY:

Effective January 1, 2004, the Fund prospectively adopted new recommendations of the Canadian Institute of Chartered Accountants on what constitutes Canadian generally accepted accounting principles and its sources. The Class B units issued by The Keg Rights Limited Partnership (the "Partnership"), a subsidiary of the Fund, which are held by Keg Restaurants Ltd. ("KRL") are entitled to receive distributions from the Partnership and are exchangeable for Fund units. As a result of this change, these units are recorded at their fair value at the date of determination of their respective annual entitlement. The increase in value of these Class B units has been accounted for as an additional cost of the purchase of the trademarks, trade names, operating procedures and systems and other intellectual property (collectively, the "Keg Rights") from KRL and accordingly has been reflected as an increase in the value of intangible assets. The effect of this change on the current year's financial statements is to increase the value of intangible assets and non-controlling interest by \$3,627,169 (note 7). There is no impact to net earnings as a result of this change.

### 3. GROSS SALES:

The gross sales reported by the 86 Keg restaurants on which KRL pays a royalty (the "Royalty Pool") are from January 1, 2004 to June 30, 2004 (January 1, 2003 to June 30, 2003 – 81 Keg restaurants).

The royalty payment from KRL to the Partnership is four percent of system sales for such period reported by Keg restaurants in the Royalty Pool plus a make-whole payment, if required by a restaurant closure, based on four percent of lost system sales. System sales for any period and for any Keg restaurant located in Canada and the United States, as defined in the Licence and Royalty Agreement, means the gross sales by such Keg restaurants for such period. The make-whole payment is based on three restaurant closures for the period from January 1, 2004 to June 30, 2004 (January 1, 2003 to June 30, 2003 – one restaurant closure).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and six months ended June 30, 2004 and 2003

### 3. GROSS SALES (CONTINUED):

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
System sales reported by Keg restaurants in the Royalty Pool .....	\$ <u>72,091</u>	\$ <u>65,161</u>	\$ <u>147,982</u>	\$ <u>138,637</u>
Royalty income at 4% of system sales reported above .....	\$ 2,883	\$ 2,606	\$ 5,919	\$ 5,545
Make-whole payment, based on 4% of lost system sales.....	<u>33</u>	<u>9</u>	<u>33</u>	<u>9</u>
Total royalty income.....	<u>\$ 2,916</u>	<u>\$ 2,615</u>	<u>\$ 5,952</u>	<u>\$ 5,554</u>

### 4. DISTRIBUTABLE CASH:

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
Earnings for the period .....	\$ 2,173	\$ 2,010	\$ 4,430	\$ 4,298
Amortization of deferred financing charges .....	29	29	58	58
Non-controlling interest.....	<u>1,545</u>	<u>1,359</u>	<u>3,107</u>	<u>2,764</u>
	3,747	3,398	7,595	7,120
Distributable cash required for non-controlling interest .....	<u>(1,534)</u>	<u>(1,363)</u>	<u>(3,086)</u>	<u>(2,769)</u>
Distributable cash available for Fund unitholders ....	<u>\$ 2,213</u>	<u>\$ 2,035</u>	<u>\$ 4,509</u>	<u>\$ 4,351</u>
Distributions declared to Fund unitholders (8,153,500 units) .....	<u>\$ 2,201</u>	<u>\$ 2,201</u>	<u>\$ 3,669</u>	<u>\$ 3,669</u>

Distributable cash is not an earnings measure recognized by generally accepted accounting principles ("GAAP") and therefore may not be comparable to similar measures presented by other issuers.

### 5. UNITHOLDER DISTRIBUTIONS:

The \$733,815 difference between the \$3,669,075 in distributions declared and the \$4,402,890 in distributions paid to Fund unitholders during the period from January 1, 2004 to June 30, 2004 is due to the declaration of the January 2004 distribution on December 31, 2003. Annually, two distributions are expected to be declared during the first quarter, three distributions in each of the second and third quarters and four distributions in the fourth quarter. This is done to ensure that the distribution based on December KRL Royalty Pool system sales, which is paid the following month in January, is recorded in the period it was earned for income tax purposes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and six months ended June 30, 2004 and 2003

### 6. DUE FROM KEG RESTAURANTS LTD.:

	<u>June 30,</u> 2004	<u>December 31,</u> 2003
Royalty fee, including GST .....	\$ 1,200	\$ 1,270
Interest on note receivable from Keg Restaurants Ltd. ....	<u>362</u>	<u>363</u>
	<u>\$ 1,562</u>	<u>\$ 1,633</u>

The above amounts were received when due from KRL subsequent to the end of the above periods to facilitate the following month's distribution to Fund unitholders.

### 7. INTANGIBLE ASSETS:

On May 31, 2002, the Partnership acquired the Keg Rights from KRL for \$113,546,820 of which \$30,487,380 was paid in cash, \$9,059,440 was paid by the issuance of 905,944 Class A Partnership units ("Class A Units"), \$17,000,000 was paid by the issuance of 3,376,700 Class B Partnership units ("Class B Units") and \$57,000,000 was paid by the issuance of 5,700,000 Class C Partnership units ("Class C Units").

Concurrently with the acquisition of the Keg Rights, the Partnership granted KRL a licence to use the Keg Rights for a term of 99 years for which KRL pays the Partnership a royalty of four percent of the system sales reported by KRL for restaurants included in the Royalty Pool (note 3).

On January 1, 2004, the number of Keg restaurants in the Royalty Pool was increased by seven restaurants opened during the period from October 3, 2002 to October 2, 2003 less two restaurants which had permanently closed (2003 – net increase of one restaurant). In exchange for adding these restaurants to the Royalty Pool, and assuming 100% of the estimated entitlement for these restaurants is received, KRL's additional entitlement will be equivalent to 653,193 Fund units (2003 – 310,815 Fund units). KRL will also receive a proportionate increase in monthly distributions from the Partnership. On January 1, 2004, KRL received 80% of this entitlement, representing the equivalent of 522,554 Fund units. The yield of the Fund units was determined to be 11.66% (2003 – 11.25%) calculated using a weighted average unit price of \$9.26 (2003 - \$9.60).

As described in note 2, the Fund has adopted a policy of accounting for the entitlement of the Class B Units based on the fair value of these units at the date of determination of the entitlement which results in an increase in intangible assets and non-controlling interest.

	<u>June 30,</u> 2004
Intangible assets (Keg Rights):	
Initial consideration .....	\$ 113,547
2003 adjustment to Royalty Pool .....	1,419
2004 initial adjustment to Royalty Pool .....	<u>2,208</u>
	<u>\$ 117,174</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and six months ended June 30, 2004 and 2003

### 8. NON-CONTROLLING INTEREST:

Non-controlling interest relates to KRL's interest in the Partnership, as follows:

	June 30, <u>2004</u>	December 31, <u>2003</u>
905,944 Class A Units .....	\$ 9,059	\$ 9,059
833,370 Entitled Class B Units (December 31, 2003 – 310,815 units).....	7,823	1,565
2,543,330 Non-entitled Class B Units (December 31, 2003 – 3,065,885 units) .....	12,804	15,435
5,700,000 Class C Units .....	<u>57,000</u>	<u>57,000</u>
	86,686	83,059
Non-controlling interest in earnings of the Partnership, net of distributions declared, beginning of period .....	(38)	(9)
Non-controlling interest in earnings of the Partnership .....	3,107	5,571
Distributions declared to non-controlling interest .....	<u>(2,547)</u>	<u>(5,600)</u>
	<u>522</u>	<u>(38)</u>
Balance, end of period .....	<u>\$ 87,208</u>	<u>\$ 83,021</u>

As described in note 7, KRL added seven new restaurants (2003 – three restaurants) to the Royalty Pool and two permanently closed restaurants were removed from the Royalty Pool (2003 – two restaurants) on January 1, 2004.

In accordance with the terms of the Partnership agreements, the Fund provided entitlements for KRL to receive distributions on an estimated 653,193 (2003 – 310,815) Class B Units in exchange for the addition of these restaurants to the Royalty Pool, 80% of which was received by KRL on January 1, 2004. As described in note 2, the Fund has adopted a policy of accounting for the entitlement of Class B Units as an increase in the value of the entitled units based on their estimated fair value at the determination date of the entitlement which results in an increase in intangible assets and non-controlling interest.

### 9. SUPPLEMENTARY CASH FLOW INFORMATION:

	April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
(a) Change in non-cash operating working capital:				
Accounts receivable .....	\$ -	\$ 1	\$ -	\$ 1
Due from Keg Restaurants Ltd. (note 6) ..	45	143	71	171
Prepaid expenses and deposits .....	(60)	(65)	(49)	(61)
Accounts payable and accrued liabilities ..	<u>(22)</u>	<u>(64)</u>	<u>(33)</u>	<u>(119)</u>
	<u>\$ (37)</u>	<u>\$ 15</u>	<u>\$ (11)</u>	<u>\$ (8)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and six months ended June 30, 2004 and 2003

### 9. SUPPLEMENTARY CASH FLOW INFORMATION (CONTINUED):

		April 1 to June 30, <u>2004</u>	April 1 to June 30, <u>2003</u>	January 1 to June 30, <u>2004</u>	January 1 to June 30, <u>2003</u>
(b) Supplementary information:					
Interest received .....	\$	1,064	\$ 1,080	\$ 2,129	\$ 2,135
Interest paid .....		150	193	316	370
Non-cash transactions:					
Increase in the value of intangible assets and non-controlling interest as a result of the fair value adjustment for the Entitled Class B units (notes 7 and 8)...		-	-	3,627	-

## UNITHOLDER INFORMATION

### CORPORATE HEAD OFFICE

The Keg Royalties Income Fund  
10100 Shellbridge Way  
Richmond, BC V6X 2W7

### BOARD OF TRUSTEES

C. C. Woodward  
George Killy  
George Tidball

### BOARD OF DIRECTORS AND OFFICERS OF THE KEG GP LTD., THE GENERAL PARTNER OF THE KEG RIGHTS LIMITED PARTNERSHIP

C. C. Woodward\*  
Chairman and Director  
David Aisenstat  
President and Director  
Neil Maclean  
Secretary, Treasurer and Director  
George Killy\*  
Director  
George Tidball\*  
Director

\* Audit Committee and Governance Committee Member

### REGISTRAR AND TRANSFER AGENT

Computershare Trust Company of Canada

### STOCK EXCHANGE LISTING

Toronto Stock Exchange: KEG.UN

### INVESTOR ENQUIRIES

Karyn Byrne  
Investor Relations Manager  
Telephone: (416) 646-4960  
Facsimile: (416) 695-2401  
E-mail: [karynb@kegrestaurants.com](mailto:karynb@kegrestaurants.com)

# KEG RESTAURANTS LTD.

## THIRD QUARTER REPORT

13 and 40 weeks ended July 4, 2004

Provided as a supplement to the consolidated financial statements of  
The Keg Royalties Income Fund

## FINANCIAL HIGHLIGHTS

The following table sets out selected financial information and other data of Keg Restaurants Ltd. (“KRL”), which should be read in conjunction with the attached unaudited, consolidated financial statements of KRL for the 13 and 40 weeks ended July 4, 2004.

### SELECTED FINANCIAL INFORMATION OF KRL

	13 weeks ended July 4, <u>2004</u>	13 weeks ended June 29, <u>2003</u>	40 weeks ended July 4, <u>2004</u>	39 weeks ended June 29, <u>2003</u>
	(in thousands of dollars)			
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 77,017</b>	<b>\$ 69,436</b>	<b>\$ 241,423</b>	<b>\$ 219,604</b>
Corporate restaurant sales <sup>(2)</sup> .....	42,462	38,885	134,941	125,203
Retail operating contribution (loss) <sup>(3)</sup> .....	(14)	29	(13)	17
Franchise fee income .....	1,643	1,447	5,031	4,450
Operating costs and expenses .....	<u>(41,809)</u>	<u>(38,517)</u>	<u>(129,955)</u>	<u>(120,044)</u>
<b>Operating earnings</b> .....	<b>\$ 2,282</b>	<b>\$ 1,844</b>	<b>\$ 10,004</b>	<b>\$ 9,626</b>
Equity income <sup>(4)</sup> .....	1,534	1,363	4,547	4,085
Royalty fee expense .....	<u>(2,916)</u>	<u>(2,615)</u>	<u>(8,969)</u>	<u>(8,281)</u>
<b>EBITDA</b> <sup>(5)</sup> .....	<b>\$ 900</b>	<b>\$ 592</b>	<b>\$ 5,582</b>	<b>\$ 5,430</b>

Notes:

- (1) Represents the gross sales of all restaurants owned by KRL and the gross sales reported to KRL by franchised Keg restaurants without independent audit.
- (2) Includes gross sales for all restaurants owned by KRL and its proportionate share of gross sales from a joint venture restaurant located in Coquitlam, BC.
- (3) Represents the revenue net of related expenses of a wholly owned subsidiary, which sells Keg branded food and liquor products.
- (4) Represents the equity income from KRL's investment in The Keg Rights Limited Partnership and its 17.6% (2003 – 12.6%) effective interest in The Keg Royalties Income Fund, which began on May 31, 2002.
- (5) EBITDA is earnings before amounts for interest, taxes, depreciation and amortization and loss on disposal of property, plant and equipment. EBITDA is not a recognized measure under Canadian Generally Accepted Accounting Principles.

## MANAGEMENT DISCUSSION AND ANALYSIS

### OVERVIEW

Keg Restaurants Ltd. (“KRL”) is the owner/operator and franchisor of casual dining steakhouse restaurants operating under the trade name “The Keg Steakhouse & Bar” in Canada and select markets in the United States. The revenue of KRL is derived from sales from corporate Keg restaurants, its proportionate share of a joint venture Keg restaurant, franchise fee income and revenue from sales of food and liquor products marketed under the Keg brand name. Sales from corporate Keg restaurants are affected by the number of new corporate Keg restaurants that are opened or closed. Franchise fee income is affected by the amount of sales generated by existing franchised Keg restaurants and the number of franchised Keg restaurants that are opened or closed.

Operating costs and expenses include food and beverage costs, premises costs, and labour costs of corporate Keg restaurants, marketing and advertising expenses net of franchisee contributions, as well as general and administrative costs associated with the operations of KRL in providing services to the corporate and franchised Keg restaurants.

On May 31, 2002, KRL completed a transaction in which KRL sold the Keg trademarks and related property (collectively, the “Keg Rights”) to The Keg Rights Limited Partnership (the “Partnership”), a subsidiary of The Keg Royalties Income Fund (the “Fund”). The Partnership in turn licensed the use of these Keg Rights to KRL under a licence and royalty agreement for a term of 99 years. KRL pays the Partnership a royalty of 4% of system sales (the “Royalty”). The Royalty was initially based on the 80 Keg restaurants in existence on March 31, 2002.

Annually, on January 1<sup>st</sup>, the pool of Keg restaurants on which KRL pays a royalty to the Partnership (the “Royalty Pool”) is adjusted to include the gross sales from new Keg restaurants that have opened on or before October 2<sup>nd</sup> of the prior year, less gross sales from any Keg restaurants that have permanently closed during the year. In return for adding these net sales to the Royalty Pool, KRL receives the right to indirectly acquire additional Fund units (the “Additional Entitlement”). The Additional Entitlement is determined based on 92.5% of the royalty revenue added to the Royalty Pool, divided by the yield of the Fund units. KRL receives 80% of the estimated Additional Entitlement initially, with the balance received on December 31<sup>st</sup> each year when the actual full year performance of the new restaurants is known with certainty.

On January 1, 2003, three new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2002 were added to the Royalty Pool. The actual gross sales of these three new restaurants were \$13.2 million for the 52 weeks ended September 28, 2003. Two permanently closed Keg restaurants with annual sales of \$3.8 million were removed from the Royalty Pool. This resulted in KRL receiving an Additional Entitlement equivalent to 310,815 Fund units effective as of January 1, 2003. The total number of restaurants in the Royalty Pool increased to 81. The yield of the Fund units was determined to be 11.25% calculated using a weighted average unit price of \$9.60.

## OVERVIEW (CONTINUED)

On January 1, 2004, seven new Keg restaurants that opened during the period from October 3, 2002 through October 2, 2003 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$25.2 million annually. Two permanently closed Keg restaurants with annual sales of \$4.6 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$20.6 million annually. The total number of restaurants in the Royalty Pool has increased to 86. The yield of the Fund units was determined to be 11.66% calculated using a weighted average unit price of \$9.26. As a result of the contribution of the additional net sales to the Royalty Pool, and assuming 100% of the estimated Additional Entitlement is received, KRL's Additional Entitlement will be equivalent to 653,193 Fund units, being 6.52% of the Fund units on a fully diluted basis. On January 1, 2004, KRL received 80% of this entitlement representing the equivalent of 522,554 Fund units, being 5.28% of the Fund units on a fully diluted basis. KRL will also receive a proportionate increase in monthly distributions from the Partnership. Including the initial portion of the Additional Entitlement described above, KRL has the right to exchange its units in the capital of the Partnership for 1,739,314 Fund units, representing 17.58% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2004 once the actual performance of the new restaurants have been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2004, it would have the right to exchange its Partnership units for 1,869,952 Fund units, representing 18.66% of the Fund units on a fully diluted basis. All Fund units obtained by KRL in exchange for these Partnership units are subject to a contractual re-sale restriction, which expires on May 31, 2005.

## THIRD QUARTER OPERATING RESULTS

System sales for the 13 weeks ended July 4, 2004 were \$77,017,000 compared to \$69,436,000 for the 13 weeks ended June 29, 2003, an increase of \$7,581,000 or 10.9%. During the 13 weeks ended July 4, 2004, two new franchised restaurants were opened and three corporate restaurants were closed. The three closures were of restaurants located in the Portland, Oregon area due to lease expiries, which had been planned as part of an ongoing property rationalization process. During the 13 week period of the prior year, one new corporate and one new franchised restaurant were opened, no restaurants were closed and one franchised restaurant was relocated. As at July 4, 2004, there were a total of 87 restaurants as compared with the 86 restaurants at June 29, 2003.

Same store sales (sales of restaurants that operated during the entire period of both the current year and the prior year) increased by 4.1% in Canada and decreased by 3.0% in the United States. The decline in same store sales in the United States was primarily attributable to the closure of lunch operations at three restaurants earlier in the year. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable quarter increased by 2.1%. The average exchange rate moved from 1.40 for the third quarter of fiscal 2003 to 1.36 for the third quarter of fiscal 2004, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

Franchise fee income climbed from \$1,447,000 during the third quarter of the prior year to \$1,643,000 during the third quarter of the current year, an increase of \$196,000 or 13.5%. The increase in additional franchise fees earned was due to a combination of same store sales growth at existing locations, one franchised restaurant that opened in the second half of the prior fiscal year and three franchised restaurants that opened during the current fiscal year.

### THIRD QUARTER OPERATING RESULTS (CONTINUED)

Operating costs and expenses increased to \$41,809,000 for the 13 week period ended July 4, 2004 from \$38,517,000 for the 13 week period ended June 29, 2003. The increase of \$3,292,000 was primarily due to three expense categories. Restaurant variable operating costs increased by \$2,276,000 due to the increased sales for the period. Restaurant fixed costs increased by \$644,000 due to increased management and facility costs related to three new corporate restaurants and significantly higher insurance costs. General and administrative expenses, which include marketing and advertising expenses as well as corporate administrative expenses, increased by \$330,000 for the period. Marketing and advertising expenses decreased by \$80,000 due to the timing of certain marketing expenditures. Corporate administrative expenses increased by \$410,000 partly as a result of the addition of new corporate personnel and higher facility costs related to the new corporate office in Richmond, BC.

Operating earnings increased by \$438,000 from \$1,844,000 for the 13 weeks ended June 29, 2003 to \$2,282,000 for the 13 weeks ended July 4, 2004. Management views operating earnings as a key figure as it indicates the funds generated by KRL which are available to meet its royalty payment obligations to the Fund, interest and income tax obligations, and to pay any discretionary expenses.

Investment income from KRL's effective interest in the Fund amounted to \$1,534,000 (2003 - \$1,363,000) and the royalty expense paid for the use of the Keg Rights totalled \$2,916,000 (2003 - \$2,615,000) during the 13 weeks ended July 4, 2004, resulting in a net expense of \$1,382,000 (2003 - \$1,252,000). These figures do not include interest of \$1,063,000 (2003 - \$1,066,000) on a \$57,000,000 note payable to the Fund, which has been included in interest expense for the year.

EBITDA for the 13 week period of the current year was \$900,000 compared to \$592,000 for the 13 week period of the prior year. The increase in EBITDA of \$308,000 for the quarter is due to the net impact of the increase in operating earnings of \$438,000, and the increase of \$130,000 in net expenses related to the Fund, as explained above.

The net loss before taxes for the 13 weeks ended July 4, 2004 amounted to \$3,013,000 compared to a net loss before taxes of \$2,235,000 for the 13 weeks ended June 29, 2003.

### YEAR TO DATE OPERATING RESULTS

KRL's year end falls on the Sunday closest to September 30<sup>th</sup>, in any year. As a result of the floating year end date, approximately every fifth fiscal year contains 53 weeks of operation. The fiscal year ending October 3, 2004 will contain 53 weeks of sales and related costs and the period ending July 4, 2004 will contain 40 weeks of sales and related costs.

## YEAR TO DATE OPERATING RESULTS (CONTINUED)

System sales for the 40 weeks ended July 4, 2004 were \$241,423,000 compared to \$219,604,000 for the 39 weeks ended June 29, 2003, an increase of \$21,819,000 or 9.9%. System sales due to the extra week of operation were \$5,519,000, so on a comparable basis, system sales increased by \$16,300,000 or 7.4%. During the 40 weeks ended July 4, 2004, two new corporate restaurants and three new franchised restaurants were opened and four corporate restaurants were closed. Three of the closures were of restaurants located in the Portland, Oregon area due to lease expiries, which had been planned as part of an ongoing property rationalization process. During the 39 week period of the prior year, two new corporate restaurants and three new franchised restaurants were opened, no restaurants were closed and one franchised restaurant was relocated.

Same store sales (sales of restaurants that operated during the entire 40 week period of the current year and the 39 week period of the prior year) increased by 1.7%. After adjusting for the extra week of operation, same store sales for the comparable 39 week periods increased by 2.1% in Canada and decreased by 0.5% in the United States. The decline in same store sales in the United States was completely attributable to the closure of lunch operations at three restaurants earlier in the year. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 39 week periods decreased by 0.7%. This decrease is a function of the fluctuation in the U.S. dollar exchange rate rather than an indication of a slowdown in actual restaurant traffic. The average exchange rate moved from 1.49 for the 39 week period in fiscal 2003 to 1.33 for the 40 week period in fiscal 2004, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

Franchise fee income climbed from \$4,450,000 for the 39 week period of the prior year to \$5,031,000 for the 40 week period of the current year, an increase of \$581,000 or 13.1%. The increase in additional franchise fees earned was due to a combination of same store sales growth at existing locations, one franchised restaurant that opened in the second half of the prior fiscal year and three franchised restaurants that opened during the current fiscal year.

Operating costs and expenses increased to \$129,955,000 for the 40 week period ended July 4, 2004 from \$120,044,000 for the 39 week period ended June 29, 2003. The increase of \$9,911,000 was primarily due to four expense categories. Restaurant variable operating costs increased by \$6,038,000 due to the increased sales for the period. Food costs increased by \$704,000 primarily as a result of significantly higher beef prices in the United States than in the comparable period of the prior year. The increase in beef prices in the United States was due to the partial closure of the U.S. border to Canadian beef. Restaurant fixed costs increased by \$1,839,000 due to increased management and facility costs related to three additional corporate restaurants and significantly higher insurance costs. General and administrative expenses, which include marketing and advertising expenses as well as corporate administrative expenses, increased by \$955,000 for the period. Marketing and advertising expenses decreased by \$119,000 due to the timing of certain marketing expenditures. Corporate administrative expenses increased by \$1,074,000 mainly as a result of the extra week of operations, the addition of new corporate personnel, higher facility costs related to the new corporate office in Richmond, BC and non-recurring costs related to the relocation of the corporate office.

Operating earnings increased by \$378,000 from \$9,626,000 for the 39 weeks ended June 29, 2003 to \$10,004,000 for the 40 weeks ended July 4, 2004. Management views operating earnings as a key figure as it indicates the funds generated by KRL which are available to meet its royalty payment obligations to the Fund, interest and income tax obligations, and to pay any discretionary expenses.

## YEAR-TO-DATE OPERATING RESULTS (CONTINUED)

Investment income from KRL's effective interest in the Fund amounted to \$4,547,000 (2003 - \$4,085,000) and the royalty expense paid for the use of the Keg Rights totalled \$8,969,000 (2003 - \$8,281,000) during the 40 weeks ended July 4, 2004, resulting in a net expense of \$4,422,000 (2003 - \$4,196,000). These figures do not include interest of \$3,274,000 (2003 - 3,197,000) on a \$57,000,000 note payable to the Fund, which has been included in interest expense for the year.

EBITDA for the 40 week period of the current year was \$5,582,000 compared to \$5,430,000 for the 39 week period of the prior year. The increase in EBITDA of \$152,000 for the year is due to the net impact of the increase in operating earnings of \$378,000, and the increase of \$226,000 in net expenses related to the Fund, as explained above.

The net loss before taxes for the 40 weeks ended July 4, 2004 amounted to \$4,645,000 compared to a net loss before taxes of \$3,025,000 for the 39 weeks ended June 29, 2003.

## LIQUIDITY AND CAPITAL RESOURCES

KRL must invest in the maintenance of the corporate Keg restaurants on an annual basis and it is estimated that the costs of these maintenance capital expenditures is \$2,300,000 per annum.

KRL will use cash flow from operations to fund seasonal fluctuations in working capital and maintenance capital expenditures. Management plans to continue to utilize traditional bank financing to fund the opening of new corporate Keg restaurants in Canada. Subsequent to KRL's fiscal year end certain Canadian expansion costs incurred in the prior year have been financed in this manner as noted below. Management further anticipates additional loan facilities for the expansion of corporate Keg restaurants in the United States on similar terms and conditions as exist currently, and financing in this regard was also completed subsequent to KRL's fiscal year end, also as noted below.

On September 30, 2003, KRL entered into a CDN\$5,250,000 credit facility agreement with a major Canadian chartered bank. This secured facility has been increased to \$8,000,000 and includes a demand loan in the amount of \$6,000,000, the proceeds of which will be used solely for the expansion of restaurant operations in Canada and a line of credit in the amount of \$2,000,000, which is available for general corporate purposes including working capital and letters of credit. In October 2003, KRL's wholly owned subsidiary, Keg Restaurants U.S., Inc. obtained secured debt financing in the amount of US\$3,500 000 for expansion of U.S. restaurant operations.

## OUTLOOK

According to the Long Term Forecast of the Canadian Restaurant and Foodservices Association, foodservice operators can look forward to a brighter 2004/2005. Following an unprecedented two year decline in real foodservice sales, the forecast calls for sales in Canada's commercial foodservice industry to recover throughout 2004 and 2005 as tourism and global economies continue to improve. A return to real growth in the foodservice industry is predicted, with full service restaurants, the sector in which KRL operates, experiencing a particularly strong recovery.

## OUTLOOK (CONTINUED)

KRL anticipates that it will record strong sales growth relative to the foodservice industry as a whole in the future, as it has historically. KRL remains committed to growth, both through expansion into new markets and same store sales increases. In addition to building new Kegs in both Canada and the U.S., we continue to refurbish, and in some cases relocate, existing Keg restaurants in order to better serve our guests and to protect and enhance the strong leadership position The Keg brand has enjoyed for over thirty years.

## RISKS AND UNCERTAINTIES

Management of KRL continues to anticipate certain risks and uncertainties associated with the ordinary course of business. Such risks and uncertainties include the competitive nature of the restaurant industry, the availability and quality of raw materials, the ability of KRL to maintain and grow Keg restaurants, government regulation and fluctuation in foreign currency, among others.

Management continues to monitor the situation regarding the two cases of BSE found in North America during 2003. The widespread testing of herds confirms these are isolated cases; the risk to human health appears to be negligible. Most importantly to the Keg, there has not been any significant negative consumer reaction to beef in North America and there has not been a material impact on our restaurant traffic. KRL has maintained an uninterrupted supply of quality beef that meets our demanding specifications despite the border closures and the unfortunate impact on cattle producers. We expect the demand for beef to remain strong among consumers and our supply to continue uninterrupted.

## FORWARD LOOKING INFORMATION

The information provided in this report includes forward-looking statements with respect to business plans, activities, prospects, opportunities and events anticipated or being pursued by management of KRL and KRL's future results. Although management of KRL believes the assumptions underlying such statements to be reasonable, any of the assumptions may prove to be inaccurate and, as a result, the forward-looking information may prove to be incorrect. The anticipated results or events upon which current expectations are based may differ materially from actual results or events. The forward-looking information contained in this document is current only as of the date of this document. There should not be an expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.


## CONSOLIDATED BALANCE SHEETS


(Expressed in thousands of dollars)

	July 4, <u>2004</u> (unaudited)	September 28, <u>2003</u> (audited)
<b>ASSETS</b>		
Current assets:		
Cash .....	\$ 1,183	\$ 1,313
Restricted cash .....	-	750
Accounts receivable .....	4,501	2,839
Inventories .....	4,013	3,848
Prepaid expenses and deposits .....	4,652	3,183
Current portion of notes receivable .....	<u>519</u>	<u>143</u>
	14,868	12,076
Long-term investments (note 4) .....	31,701	28,829
Notes receivable .....	66	68
Due from related company .....	-	219
Property, plant and equipment .....	47,785	46,013
Deferred charges .....	3,160	3,177
Future income taxes .....	<u>6,435</u>	<u>6,340</u>
	<u>\$ 104,015</u>	<u>\$ 96,722</u>
<b>LIABILITIES AND SHAREHOLDER'S DEFICIENCY</b>		
Current liabilities:		
Accounts payable and accrued liabilities .....	\$ 18,030	\$ 22,571
Unearned revenue .....	7,799	5,450
Current portion of long-term debt .....	<u>4,574</u>	<u>543</u>
	30,403	28,564
Note payable to The Keg Royalties Income Fund .....	57,000	57,000
Long-term debt .....	9,826	6,158
Deferred gain on sale of intangible assets (note 5) .....	40,072	37,105
Due to related company .....	3,784	-
Shareholder's deficiency:		
Share capital .....	1	1
Cumulative translation adjustment .....	(2,569)	(2,153)
Deficit .....	<u>(34,502)</u>	<u>(29,953)</u>
	<u>(37,070)</u>	<u>(32,105)</u>
	<u>\$ 104,015</u>	<u>\$ 96,722</u>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board

  
 \_\_\_\_\_  
 David Aisenstat, Director

  
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 Neil Maclean, Director

## CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

(Expressed in thousands of dollars - unaudited)

	13 weeks ended July 4, <u>2004</u>	13 weeks ended June 29, <u>2003</u>	40 weeks ended July 4, <u>2004</u>	39 weeks ended June 29, <u>2003</u>
<b>System sales</b> (note 3) .....	<b><u>\$ 77,017</u></b>	<b><u>\$ 69,436</u></b>	<b><u>\$ 241,423</u></b>	<b><u>\$ 219,604</u></b>
Revenue:				
Restaurant sales .....	\$ 42,462	\$ 38,885	\$ 134,941	\$ 125,203
Retail sales .....	<u>1,106</u>	<u>1,605</u>	<u>2,370</u>	<u>2,857</u>
	43,568	40,490	137,311	128,060
Operating costs:				
Restaurant operating costs .....	38,191	35,234	118,791	109,833
Retail operations .....	<u>1,120</u>	<u>1,576</u>	<u>2,383</u>	<u>2,840</u>
	<u>39,311</u>	<u>36,810</u>	<u>121,174</u>	<u>112,673</u>
Earnings from operations .....	4,257	3,680	16,137	15,387
Equity income (note 4) .....	1,534	1,363	4,547	4,085
Franchise fee income .....	1,643	1,447	5,031	4,450
Other investment income .....	<u>2</u>	<u>(2)</u>	<u>2</u>	<u>(1)</u>
	7,436	6,488	25,717	23,921
Royalty expense .....	2,916	2,615	8,969	8,281
General and administrative expenses .....	<u>3,620</u>	<u>3,281</u>	<u>11,166</u>	<u>10,210</u>
Earnings before undernoted items .....	900	592	5,582	5,430
Amortization .....	1,986	1,686	5,733	5,091
Amortization of deferred gain .....	(103)	(95)	(293)	(285)
Interest .....	1,350	1,205	4,092	3,610
Loss on disposal of property, plant and equipment .....	<u>680</u>	<u>31</u>	<u>695</u>	<u>39</u>
Loss before income taxes .....	(3,013)	(2,235)	(4,645)	(3,025)
Income taxes (recovery):				
Current .....	(5)	(45)	(1)	(11)
Future .....	<u>(143)</u>	<u>(264)</u>	<u>(95)</u>	<u>(186)</u>
	<u>(148)</u>	<u>(309)</u>	<u>(96)</u>	<u>(197)</u>
Net loss for the period .....	(2,865)	(1,926)	(4,549)	(2,828)
Deficit, beginning of period .....	<u>(31,637)</u>	<u>(12,323)</u>	<u>(29,953)</u>	<u>(11,421)</u>
Deficit, end of period .....	<u>\$ (34,502)</u>	<u>\$ (14,249)</u>	<u>\$ (34,502)</u>	<u>\$ (14,249)</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars - unaudited)

	13 weeks ended July 4, <u>2004</u>	13 weeks ended June 29, <u>2003</u>	40 weeks ended July 4, <u>2004</u>	39 weeks ended June 29, <u>2003</u>
<b>Cash provided by (used for):</b>				
<b>OPERATIONS:</b>				
Net loss for the period .....	\$ (2,865)	\$ (1,926)	\$ (4,549)	\$ (2,828)
Items not involving cash:				
Amortization .....	1,986	1,686	5,733	5,091
Amortization of deferred gain .....	(103)	(95)	(293)	(285)
Share of equity earnings from investments .....	(1,536)	(1,361)	(4,549)	(4,084)
Loss on disposition of property, plant and equipment .....	680	31	695	39
Future income tax recovery .....	(143)	(264)	(95)	(186)
Change in non-cash operating working capital (note 7(a)) .....	<u>2,409</u>	<u>(780)</u>	<u>(5,296)</u>	<u>(6,182)</u>
	428	(2,709)	(8,354)	(8,435)
<b>INVESTMENTS:</b>				
Additions to property, plant and equipment and deferred charges .....	(2,103)	(3,874)	(8,390)	(10,852)
Net proceeds (costs) from disposition of property, plant and equipment .....	(430)	8	(408)	13
Proceeds from disposition of property, plant and equipment held for resale .....	-	-		2,237
Distributions and advances from investments .....	1,543	1,374	4,937	4,073
Notes receivable .....	(312)	(63)	(374)	(38)
Restricted cash .....	<u>-</u>	<u>750</u>	<u>750</u>	<u>750</u>
	(1,302)	(1,805)	(3,485)	(3,817)
<b>FINANCING:</b>				
Shareholder loan .....	(136)	(319)	(156)	881
Due to related company .....	784	3,672	4,003	3,672
Issuance of long-term debt .....	-	-	8,638	-
Repayment of long-term debt .....	<u>(346)</u>	<u>(139)</u>	<u>(776)</u>	<u>(369)</u>
	<u>302</u>	<u>3,214</u>	<u>11,709</u>	<u>4,184</u>
Decrease in cash .....	(572)	(1,300)	(130)	(8,068)
Cash, beginning of period .....	<u>1,755</u>	<u>4,091</u>	<u>1,313</u>	<u>10,859</u>
Cash, end of period .....	<u>\$ 1,183</u>	<u>\$ 2,791</u>	<u>\$ 1,183</u>	<u>\$ 2,791</u>

See note 7(b) for supplementary cash flow information.

See accompanying notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

13 weeks ended July 4, 2004 and June 29, 2003

40 weeks ended July 4, 2004 and 39 weeks ended June 29, 2003

### 1. BASIS OF PRESENTATION:

Keg Restaurants Ltd. ("KRL") prepares its interim consolidated financial statements in accordance with Canadian generally accepted accounting principles on a basis consistent with those used and described in the annual consolidated financial statements for the 52 weeks ended September 28, 2003. The disclosures contained in these interim consolidated financial statements do not include all requirements of Canadian generally accepted accounting principles for annual financial statements.

These interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements for the 52 weeks ended September 28, 2003.

### 2. CHANGE IN ACCOUNTING POLICY:

Effective January 1, 2004, KRL prospectively adopted new recommendations of the Canadian Institute of Chartered Accountants on what constitutes Canadian generally accepted accounting principles and its sources. The Class B units issued by The Keg Rights Limited Partnership (the "Partnership"), a subsidiary of The Keg Royalties Income Fund (the "Fund"), which are held by KRL are entitled to receive distributions from the Partnership and are exchangeable for Fund units. As a result of this change, these units are recorded at their fair value at the date of determination of their respective annual entitlement. The effect of this change on the current year's financial statements is to increase the long-term investments and deferred gain on sale of intangible assets by \$3,261,037 (note 4).

### 3. SYSTEM SALES:

System sales for any period and for any Keg restaurants located in Canada and the United States means the gross sales by such Keg restaurants for such period.

Gross sales are the sales reported to KRL by owners of Keg restaurants in Canada and the United States under franchise agreements, without audit or other form of independent assurance, and the sales of Keg restaurants in Canada and the United States owned by KRL and its subsidiaries. In each case, these sales are reported net of discounts for coupons and other promotional items and applicable sales taxes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

13 weeks ended July 4, 2004 and June 29, 2003

40 weeks ended July 4, 2004 and 39 weeks ended June 29, 2003

### 4. LONG-TERM INVESTMENTS:

	July 4, 2004	September 28, 2003
The Keg Rights Limited Partnership:		
905,944 Class A units of the Partnership .....	\$ 9,059	\$ 9,059
833,370 Entitled Class B units of the Partnership (September 28, 2003 – 269,351 units) .....	7,823	1,356
2,543,330 Non-entitled Class B units of the Partnership (September 28, 2003 – 3,107,349 units) .....	12,804	15,644
5,700,000 Class C units of the Partnership .....	57,000	57,000
Equity income to date .....	11,771	7,224
Distributions and advances from the Partnership to date .....	<u>(11,234)</u>	<u>(6,299)</u>
	87,223	83,984
Portion of gain on sale of Keg Rights relating to KRL's ownership interest in the Partnership .....	<u>(55,556)</u>	<u>(55,190)</u>
	31,667	28,794
Saskatoon Property Partnership .....	33	34
The Keg GP Ltd. ....	<u>1</u>	<u>1</u>
	<u>\$ 31,701</u>	<u>\$ 28,829</u>

On January 1, 2004, KRL added seven new restaurants (2003 – three restaurants) to the Royalty Pool and two permanently closed restaurants were removed from the Royalty Pool (2003 – two restaurants). In accordance with the terms of the Partnership agreements, the Fund provided entitlements for KRL to receive distributions on an estimated 653,193 (2003 – 310,815) Class B units of the Partnership in exchange for the addition of these restaurants to the Royalty Pool, 80% of which was received by KRL on January 1, 2004. The balance of the entitlement for 2004 will be adjusted to be effective January 1, 2004 once the actual performance of the new restaurants has been confirmed. As of July 4, 2004, 833,370 Class B units of the Partnership (September 28, 2003 – 269,351) were entitled to receive distributions.

As described in note 2, KRL has adopted a policy of accounting for the entitlement of Class B units of the Partnership as an increase in the value of the entitled units based on their estimated fair value at the determination date of the entitlement which results in an increase in long-term investments and deferred gain on sale of intangible assets.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

13 weeks ended July 4, 2004 and June 29, 2003

40 weeks ended July 4, 2004 and 39 weeks ended June 29, 2003

### 5. DEFERRED GAIN ON SALE OF INTANGIBLE ASSETS:

	July 4, 2004	September 28, 2003
Cash .....	\$ 30,487	\$ 30,487
905,944 Class A units of the Partnership .....	9,059	9,059
833,370 Entitled Class B units of the Partnership (September 28, 2003 – 269,351 units) .....	7,823	1,356
2,543,330 Non-entitled Class B units of the Partnership (September 28, 2003 - 3,107,349 units) .....	12,804	15,644
5,700,000 Class C units of the Partnership .....	<u>57,000</u>	<u>57,000</u>
	117,173	113,546
Disposition costs .....	(322)	(322)
Net book value of intangible assets .....	<u>(20,423)</u>	<u>(20,423)</u>
Total gain on sale of intangible assets .....	96,428	92,801
Portion of gain relating to KRL's ownership in the Partnership .....	<u>(55,556)</u>	<u>(55,190)</u>
	40,872	37,611
Accumulated amortization .....	<u>(800)</u>	<u>(506)</u>
	<u>\$ 40,072</u>	<u>\$ 37,105</u>

As described in note 2, the deferred gain on sale of intangible assets increased due to the Class B units of the Partnership being recorded at their fair value at the date of determination of their respective annual entitlement.

### 6. SEGMENT DISCLOSURES:

KRL's principal business activity is the operation and franchising of Keg Steakhouse and Bar restaurants in Canada and the United States; accordingly, KRL is considered to operate in only one reportable segment.

Geographic information:

	13 weeks ended July 4, 2004	13 weeks ended June 29, 2003	40 weeks ended July 4, 2004	39 weeks ended June 29, 2003
Restaurant sales:				
Canada .....	\$ 26,771	\$ 23,775	\$ 84,394	\$ 76,602
United States .....	<u>15,691</u>	<u>15,110</u>	<u>50,547</u>	<u>48,601</u>
	<u>\$ 42,462</u>	<u>\$ 38,885</u>	<u>\$ 134,941</u>	<u>\$ 125,203</u>
Franchise fee revenue:				
Canada .....	\$ 1,623	\$ 1,426	\$ 4,963	\$ 4,374
United States .....	<u>20</u>	<u>21</u>	<u>68</u>	<u>76</u>
	<u>\$ 1,643</u>	<u>\$ 1,447</u>	<u>\$ 5,031</u>	<u>\$ 4,450</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

13 weeks ended July 4, 2004 and June 29, 2003

40 weeks ended July 4, 2004 and 39 weeks ended June 29, 2003

### 6. SEGMENT DISCLOSURES (CONTINUED):

	July 4, <u>2004</u>	September 28, <u>2003</u>
Property, plant and equipment:		
Canada .....	\$ 23,504	\$ 19,601
United States .....	<u>24,281</u>	<u>26,412</u>
	<u>\$ 47,785</u>	<u>\$ 46,013</u>

### 7. SUPPLEMENTARY CASH FLOW INFORMATION:

	13 weeks ended July 4, <u>2004</u>	13 weeks ended June 29, <u>2003</u>	40 weeks ended July 4, <u>2004</u>	39 weeks ended June 29, <u>2003</u>
(a) Change in non-cash operating working capital:				
Accounts receivable .....	\$ (933)	\$ 574	\$ (1,662)	\$ (390)
Inventories .....	32	(395)	(165)	(648)
Prepaid expenses and deposits .....	332	464	(1,469)	(1,006)
Accounts payable and accrued liabilities ..	2,502	(873)	(4,385)	(5,038)
Unearned revenue .....	516	(615)	2,349	814
Cumulative translation adjustment .....	<u>(40)</u>	<u>65</u>	<u>36</u>	<u>86</u>
	<u>\$ 2,409</u>	<u>\$ (780)</u>	<u>\$ (5,296)</u>	<u>\$ (6,182)</u>
(b) Supplementary information:				
Interest received .....	\$ 15	\$ 40	\$ 51	\$ 154
Interest paid .....	1,371	1,232	4,395	4,110
Income taxes paid (recovered) .....	(11)	(45)	(1)	(15)
Non-cash transactions:				
Increase in the value of long-term investments and deferred gain on sale of intangible assets as a result of the fair value adjustment for the Entitled Class B units (notes 4 and 5) .....	-	-	3,261	-