

# THE KEG ROYALTIES INCOME FUND

## THIRD QUARTER REPORT

For the three and nine months ended September 30, 2006

## **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 and nine months ended September 30, 2006.

### **RESULTS**

The Trustees are delighted to report that The Keg has reached another sales record for the third quarter. The gross sales reported by the 91 Keg restaurants in the Royalty Pool were \$91,564,000, an increase of \$11,687,000 or 14.6% from the comparable quarter of the prior year. Total system sales for The Keg were even more impressive at \$97,972,000 for the quarter, an increase of \$10,399,000 or 11.9% over the comparable quarter of the prior year. These higher system sales reflect the very successful new Keg restaurants which opened during the period from October 3, 2004 through October 2, 2005 and which were added to the Royalty Pool on January 1, 2006 as well as very strong same store sales growth.

The Fund generated earnings of \$2,606,000 or 28.8 cents/Fund unit compared with \$2,273,000 or 27.1 cents/Fund unit during the same quarter of the prior year, an increase of \$333,000. Distributable cash available to pay distributions to public Unitholders also increased by \$333,000 to \$2,612,000 or 28.9 cents/Fund unit, from \$2,279,000 or 27.2 cents/Fund unit for the third quarter of the prior year.

### **DISTRIBUTION INCREASE**

On August 3, 2006, the Trustees were pleased to authorize another distribution increase to Unitholders, the third such increase in the past twelve months. The monthly distributions were increased by 2.0% from \$0.0937 per unit to \$0.0956 per unit, beginning with the September 2006 distribution. This equals an annualized distribution slightly in excess of \$1.147 per unit. The Fund's objective is to provide consistent, monthly distributions to Unitholders at the highest sustainable level, and the Fund will continue to review distribution levels on an ongoing basis to fulfill that objective.

### **FEDERAL GOVERNMENT TAX ON INCOME FUNDS**

On October 31, 2006, The Federal Department of Finance announced a new Distribution Tax on publicly traded income trusts. We are very disappointed with the government's sudden about face on its tax treatment of income trusts, and are extremely unhappy with the impact that this has had on our unitholders. That having been said, we are confident that the management of The Keg will remain focused on running great steakhouses and bars, and increasing sales at both new locations and existing restaurants.

## OUTLOOK

The Canadian Restaurant and Foodservice Association (CRFA) has projected foodservice sales growth of 5.0% in 2006, which marks the industry's strongest annual growth since 2000.

The Keg remains an industry leader in the full-service restaurant category, showing continued growth in both overall sales and same store sales. Management remains committed to maintaining and improving the legendary high standards that have come to define the brand, including The Keg's high quality menu, knowledgeable service and marketing innovation. The Keg's management team is focused not only on developing new Kegs in new markets where opportunities exist, but also on growing sales in existing Kegs year after year, further strengthening the company's position as a market leader throughout North America.

Sincerely,



C.C. Woodward  
Chairman, The Keg Royalties Income Fund  
on behalf of the Board of Trustees  
November 6, 2006

## FINANCIAL HIGHLIGHTS

(\$000's except per unit amounts)	Jul. 1 to Sept. 30, 2006	Jul. 1 to Sept. 30, 2005	Jan. 1 to Sept. 30, 2006	Jan. 1 to Sept. 30, 2005
<b>Restaurants in the Royalty Pool</b>	<b>91</b>	<b>86</b>	<b>91</b>	<b>86</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool</b> .....	<b><u>\$ 91,564</u></b>	<b><u>\$ 79,877</u></b>	<b><u>\$ 273,788</u></b>	<b><u>\$ 240,500</u></b>
Royalty income <sup>(1)</sup> .....	\$ 3,734	\$ 3,227	\$ 11,059	\$ 9,688
Partnership expenses <sup>(2)</sup> .....	(94)	(100)	(351)	(351)
Partnership earnings .....	3,640	3,127	10,708	9,337
KRL's interest <sup>(3)</sup> .....	(1,880)	(1,756)	(5,430)	(5,209)
<b>Equity income</b> <sup>(4)</sup> .....	<b>1,760</b>	<b>1,371</b>	<b>5,278</b>	<b>4,128</b>
Interest income <sup>(5)</sup> .....	1,081	1,079	3,207	3,202
<b>Total income</b> .....	<b>2,841</b>	<b>2,450</b>	<b>8,485</b>	<b>7,330</b>
Interest and financing expenses <sup>(6)</sup> .....	(235)	(177)	(667)	(519)
<b>Earnings for the period</b> .....	<b><u>\$ 2,606</u></b>	<b><u>\$ 2,273</u></b>	<b><u>\$ 7,818</u></b>	<b><u>\$ 6,811</u></b>
<b>Earnings per Fund unit</b> <sup>(7)</sup> .....	<b><u>\$ .288</u></b>	<b><u>\$ .271</u></b>	<b><u>\$ .879</u></b>	<b><u>\$ .827</u></b>
<b>Distributable cash per Fund unit</b> <sup>(7)(8)</sup> .....	<b><u>\$ .289</u></b>	<b><u>\$ .272</u></b>	<b><u>\$ .881</u></b>	<b><u>\$ .829</u></b>
<b>Distributions declared per Fund unit</b> <sup>(7)</sup> .....	<b><u>\$ .283</u></b>	<b><u>\$ .272</u></b>	<b><u>\$ .754</u></b>	<b><u>\$ .723</u></b>

Notes:

- <sup>(1)</sup> The Fund, indirectly through the Partnership, earns royalty income equal to 4% of gross sales of Keg restaurants included in the Royalty Pool.
- <sup>(2)</sup> The Fund, indirectly through the Partnership, incurs administrative expenses and interest on an operating line of credit, to the extent utilized.
- <sup>(3)</sup> Represents the interest of KRL in the earnings of the Partnership from the Class A, entitled Class B and Class C Partnership units. The Class A and entitled Class B Partnership units are exchangeable into Fund units on a one-for-one basis.
- <sup>(4)</sup> The Fund directly earns equity income from its investment in the Partnership.
- <sup>(5)</sup> The Fund directly earns interest income on the \$57.0 million Keg Loan, with interest income accruing at 7.5% per annum, payable monthly.
- <sup>(6)</sup> The Fund directly incurs interest expenses on the long-term debt and amortization of deferred financing charges.
- <sup>(7)</sup> All per unit amounts are calculated based on the weighted average number of Fund units outstanding, which are those units held by public unitholders during the respective period. The weighted average number of Fund units outstanding for the three months ended September 30, 2006 were 9,053,500 (2005 – 8,395,348) and for the nine months ended September 30, 2006 were 8,893,976 (2005 – 8,235,002).
- <sup>(8)</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 unit is computed as earnings for the period plus non-cash items, divided by the weighted average number of Fund units issued and outstanding.

	Sept. 30, 2006	Dec. 31, 2005
Total assets .....	\$ 106,317	\$ 97,671
Total liabilities .....	14,125	14,836

## SUMMARY OF QUARTERLY FINANCIAL RESULTS

	Q3 2006	Q2 2006	Q1 2006	Q4 2005
	(\$000's except per unit amounts)			
Restaurants in the Royalty Pool .....	91	91	91	86
<b>Gross sales reported by Keg restaurants in the Royalty Pool .....</b>	<b><u>\$ 91,564</u></b>	<b><u>\$ 88,266</u></b>	<b><u>\$ 93,957</u></b>	<b><u>\$ 85,217</u></b>
Royalty income <sup>(1)</sup> .....	\$ 3,734	\$ 3,564	\$ 3,761	\$ 3,449
Partnership expenses <sup>(2)</sup> .....	(94)	(120)	(138)	(89)
Partnership earnings .....	3,640	3,444	3,623	3,360
KRL's interest <sup>(3)</sup> .....	(1,880)	(1,726)	(1,823)	(1,756)
<b>Equity income <sup>(4)</sup> .....</b>	<b>1,760</b>	<b>1,718</b>	<b>1,800</b>	<b>1,604</b>
Interest income <sup>(5)</sup> .....	1,081	1,069	1,056	1,079
<b>Total income .....</b>	<b>2,841</b>	<b>2,787</b>	<b>2,856</b>	<b>2,683</b>
Interest and financing expenses <sup>(6)</sup> .....	(235)	(226)	(205)	(192)
<b>Earnings for the period .....</b>	<b><u>\$ 2,606</u></b>	<b><u>\$ 2,561</u></b>	<b><u>\$ 2,651</u></b>	<b><u>\$ 2,491</u></b>
<b>Earnings per Fund unit <sup>(7)</sup> .....</b>	<b><u>\$.288</u></b>	<b><u>\$.283</u></b>	<b><u>\$.309</u></b>	<b><u>\$.296</u></b>
<b>Distributable cash per Fund unit <sup>(7)(8)</sup> .....</b>	<b><u>\$.289</u></b>	<b><u>\$.284</u></b>	<b><u>\$.310</u></b>	<b><u>\$.297</u></b>
<b>Distributions declared per Fund unit <sup>(7)</sup> .....</b>	<b><u>\$.283</u></b>	<b><u>\$.281</u></b>	<b><u>\$.184</u></b>	<b><u>\$.367</u></b>

	Q3 2005	Q2 2005	Q1 2005	Q4 2004
	(\$000's except per unit amounts)			
Restaurants in the Royalty Pool .....	86	86	86	86
<b>Gross sales reported by Keg restaurants in the Royalty Pool .....</b>	<b><u>\$ 79,877</u></b>	<b><u>\$ 79,433</u></b>	<b><u>\$ 81,190</u></b>	<b><u>\$ 75,263</u></b>
Royalty income <sup>(1)</sup> .....	\$ 3,227	\$ 3,209	\$ 3,253	\$ 3,096
Partnership expenses <sup>(2)</sup> .....	(100)	(136)	(116)	(93)
Partnership earnings .....	3,127	3,073	3,137	3,003
KRL's interest <sup>(3)</sup> .....	(1,756)	(1,718)	(1,735)	(1,597)
<b>Equity income <sup>(4)</sup> .....</b>	<b>1,371</b>	<b>1,355</b>	<b>1,402</b>	<b>1,406</b>
Interest income <sup>(5)</sup> .....	1,079	1,067	1,056	1,076
<b>Total income .....</b>	<b>2,450</b>	<b>2,422</b>	<b>2,458</b>	<b>2,482</b>
Interest and financing expenses <sup>(6)</sup> .....	(177)	(172)	(170)	(244)
<b>Earnings for the period .....</b>	<b><u>\$ 2,273</u></b>	<b><u>\$ 2,250</u></b>	<b><u>\$ 2,288</u></b>	<b><u>\$ 2,238</u></b>
<b>Earnings per Fund unit <sup>(7)</sup> .....</b>	<b><u>\$.271</u></b>	<b><u>\$.276</u></b>	<b><u>\$.281</u></b>	<b><u>\$.274</u></b>
<b>Distributable cash per Fund unit <sup>(7)(8)</sup> .....</b>	<b><u>\$.272</u></b>	<b><u>\$.277</u></b>	<b><u>\$.281</u></b>	<b><u>\$.284</u></b>
<b>Distributions declared per Fund unit <sup>(7)</sup> .....</b>	<b><u>\$.272</u></b>	<b><u>\$.270</u></b>	<b><u>\$.180</u></b>	<b><u>\$.360</u></b>

# MANAGEMENT DISCUSSION AND ANALYSIS

**For the Three and Nine Months Ended September 30, 2006  
As of November 6, 2006**

## 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, which obligates KRL to make monthly royalty payments to the Partnership.

During 2005, the Partnership was determined to be a variable interest entity in accordance with the criteria established in the new Canadian Institute of Chartered Accountants’ Guideline, Consolidation of Variable Interest Entities (“AcG-15”). As a result of this guideline, the Fund accounts for its investment in the Partnership on an equity basis and KRL consolidates the Partnership. Readers are advised that this is an accounting basis of presentation only and that earnings and distributable cash attributable to Fund unitholders are not impacted nor does this impact the contractual obligations between the Fund, and the Partnership, and KRL. The consolidated financial statements of the Fund therefore include the accounts of the Fund, its wholly-owned subsidiary The Keg Holdings Trust (“KHT”) and its 90% owned subsidiary The Keg GP Ltd. (“KGP”) (collectively, the “Companies”). KGP is the managing general partner of the Partnership. All residual ownership of the Companies is either directly or indirectly controlled by KRL.

The Fund earns equity income from its investment in the Partnership and interest income on a \$57.0 million loan to KRL (the “Keg Loan”). The Fund’s equity income from the Partnership is calculated as the royalty income less the Partnership’s operating expenses less earnings attributable to KRL. The Fund’s interest income on the Keg Loan is calculated at 7.5% per annum, payable monthly.

The Fund, indirectly through the Partnership, earns royalty income equal to 4% of gross sales of Keg restaurants included in a specific royalty pool (the “Royalty Pool”).

The Fund, indirectly through the Partnership, incurs administrative expenses and interest expense on the operating line of credit, to the extent utilized (the “Partnership Expenses”). See “Liquidity and Capital Resources – Operating Line of Credit”.

KRL’s interest in the earnings of the Partnership is from its ownership of Class A, entitled Class B and Class C Partnership units. The Class A and entitled Class B Partnership units are exchangeable into Fund units on a one-for-one basis in certain circumstances. On July 4, 2005 KRL exchanged 250,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 8,403,500 and on July 6, 2005 sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange. On March 9, 2006 KRL exchanged 650,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 9,053,500 and on March 14, 2006 sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange. As of September 30, 2006, KRL owned 2,301,926 of the entitled exchangeable units of the Partnership or the equivalent of 20.27% of the Fund units on a fully diluted basis.

The Fund’s operating expenses are limited to interest on the term loan and amortization of deferred financing charges. See “Liquidity and Capital Resources – Term Loan”.

## THE ROYALTY POOL

Annually, on January 1<sup>st</sup>, 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 preceding calendar 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 estimated 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> of each year when the actual full year performance of the new restaurants is known with certainty.

Readers should note that the number of restaurants added to the Royalty Pool each year may differ from the number of restaurant openings and closings reported by KRL on an annual basis, as the periods for which they are reported differ slightly.

During 2005, it was determined that the roll-in formula used to calculate the Additional Entitlement was inconsistent with other restaurant royalty funds in the Fund’s peer group such that the accretion that was intended to result from the addition of new sales to the Royalty Pool was affected by the Fund’s unit price at the time of the roll-in. If the unit price was above \$10, the addition of new restaurant sales to the Royalty Pool would be less accretive to unitholders than intended and conversely, if the unit price was below \$10, the addition of new restaurant sales would be more accretive than intended. As a result, on December 12, 2005, the Fund’s Trustees and KRL’s management amended the arrangements between the Fund and KRL (with effect as if the amendments had been made on May 31, 2002, the date of the Fund’s initial public offering) to ensure that the intended accretion to unitholders continues regardless of the Fund’s unit price. As part of these new arrangements, KRL agreed to waive its entitlement to receive the equivalent of 43,718 Fund units in connection with the Additional Entitlement as of December 31, 2005 pursuant to the existing formula.

The total number of Keg restaurants included in the Royalty Pool has increased from the 80 Keg restaurants in existence on March 31, 2002, to 86 as of December 31, 2005. Fourteen new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2004, with annual gross sales of \$66.1 million, have been added to the Royalty Pool. Eight permanently closed Keg restaurants with annual sales of \$18.8 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$47.3 million annually and KRL receiving a cumulative Additional Entitlement equivalent to 1,621,730 Fund units as of December 31, 2005.

On January 1, 2006, seven new Keg restaurants that opened during the period from October 3, 2004 through October 2, 2005 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$30.7 million annually. Two permanently closed Keg restaurants with annual sales of \$6.0 million were removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$24.7 million annually. The total number of restaurants in the Royalty Pool increased to 91. The yield of the Fund units was determined to be 8.19% calculated using a weighted average unit price of \$13.21.

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 842,815 Fund units, being 7.31% of the Fund units on a fully diluted basis. On January 1, 2006, KRL received 80% of this entitlement representing the equivalent of 674,252 Fund units, being 5.94% of the Fund units on a fully diluted basis. KRL will also receive a proportionate increase in monthly distributions from the Partnership.

## ROYALTY POOL (CONTINUED)

Including the initial portion of the Additional Entitlement described above, KRL will have the right to exchange its units in the capital of the Partnership for 2,301,926 Fund units (after giving effect to the sale of 650,000 Fund units on March 14, 2006), representing 20.27% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2006 once the actual performance of the new restaurants have been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2006, it would have the right to exchange its Partnership units for 2,470,489 Fund units (after giving effect to the sale of 650,000 Fund units on March 14, 2006), representing 21.44% of the Fund units on a fully diluted basis.

## OWNERSHIP OF THE FUND

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

	September 30, 2006 <sup>(1)</sup>		September 30, 2005	
	#	%	#	%
Fund units held by public unitholders <sup>(2)</sup> .....	9,053,500	79.73	8,403,500	79.99
Exchangeable Partnership units held by KRL: <sup>(3)</sup>				
Class A units <sup>(4)</sup> .....	905,944	7.98	905,944	8.62
Class B units <sup>(5)</sup> .....	<u>1,395,982</u>	<u>12.29</u>	<u>1,196,710</u>	<u>11.39</u>
Total Exchangeable Partnership units <sup>(6)</sup> .....	<u>2,301,926</u>	<u>20.27</u>	<u>2,102,654</u>	<u>20.01</u>
Total Fund and Exchangeable Partnership units.....	<u>11,355,426</u>	<u>100.00</u>	<u>10,506,154</u>	<u>100.00</u>

Notes:

<sup>(1)</sup> Information is current as of September 30, 2006.

<sup>(2)</sup> On July 4, 2005, KRL exchanged 250,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 8,403,500 and on July 6, 2005, sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange. On March 9, 2006, KRL exchanged 650,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 9,053,500 and on March 14, 2006, sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange. The weighted average number of Fund units outstanding for the three months ended September 30, 2006 were 9,053,500 (2005 – 8,395,348), and for the nine months ended September 30, 2006 were 8,893,976 (2005 – 8,235,002).

<sup>(3)</sup> Exchangeable into Fund units on a one-for-one basis. Class D Partnership units are also exchangeable into Fund units on a one-for-one basis, but may only be issued after all Class B units have become fully entitled. As at September 30, 2006, no Class D Partnership units have been issued.

<sup>(4)</sup> Represents KRL's initial 10% effective ownership of the Fund, prior to the entitlement to Class B units.

<sup>(5)</sup> KRL is the registered holder of 2,476,700 Class B units as of the date hereof, although only a portion of such are entitled to proportionate distributions from the Partnership, which as at September 30, 2006 comprised 1,395,982 Class B units and as at September 30, 2005 comprised 1,196,710 Class B units. This cumulative entitlement is as a result of adding net sales to the Royalty Pool on an annual basis. Also included in these figures is 80% of the Additional Entitlement estimated at the beginning of each year, pursuant to which KRL receives a proportionate increase in monthly distributions from the Partnership. The remaining 20% of KRL's Additional Entitlement to Class B units is adjusted retroactively to January 1<sup>st</sup> of each year once the actual sales performance of the new restaurants has been confirmed. KRL is not entitled to proportionate monthly distributions from the Partnership on the remaining 20% of KRL's Additional Entitlement until such time as the Additional Entitlement is adjusted retroactively at the end of each year.

<sup>(6)</sup> Represents KRL's total effective ownership of the Fund as of September 30, 2006 and 2005. KRL's average effective ownership, based on the weighted average number of Fund and exchangeable units held by KRL, was 20.27% during the three-month period ended September 30, 2006 (2005 – 20.09%) and 21.68% during the nine-month period ended September 30, 2006 (2005 – 21.62%).

## SYSTEM SALES

While the Fund's income is indirectly 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		39 weeks ended	
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Corporate Keg restaurants .....	\$ 46,917	\$ 43,401	\$ 141,634	\$ 132,235
Franchised Keg restaurants <sup>(1)</sup> .....	<u>51,055</u>	<u>44,172</u>	<u>145,129</u>	<u>128,031</u>
Total system sales .....	<u>\$ 97,972</u>	<u>\$ 87,573</u>	<u>\$ 286,763</u>	<u>\$ 260,266</u>

Notes:

<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.

## THIRD QUARTER

System sales for the 13 weeks ended October 1, 2006 were \$98.0 million compared to \$87.6 million for the 13 weeks ended October 2, 2005, an increase of \$10.4 million or 11.9%. During the 13 weeks ended October 1, 2006, one new corporate and two new franchised restaurants were opened and no restaurants were closed. During the 13 weeks ended October 2, 2005, one new franchised restaurant was opened and no restaurants were closed. As of October 1, 2006, there were a total of 95 Keg restaurants as compared with 92 restaurants at October 2, 2005.

The Keg's same store sales (sales of restaurants that operated during the entire 13-week period of both the current year and the prior year) increased by 8.9% in Canada and by 7.1% in the United States. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 13-week period increased by 7.3%. The average exchange rate moved from 1.20 in KRL's fourth quarter of fiscal 2005 to 1.12 in KRL's fourth quarter of fiscal 2006, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## YEAR TO DATE

System sales for the 39 weeks ended October 1, 2006 were \$286.8 million compared to \$260.3 million for the 39 weeks ended October 2, 2005, an increase of \$26.5 million or 10.2%. During the 39 weeks ended October 1, 2006, one new corporate and four new franchised restaurants were opened, and one corporate and one franchised restaurant were closed. The closed corporate restaurant, located in Portland, Oregon, closed due to a lease expiry which had been planned as part of an ongoing property rationalization process. The closed franchised restaurant, located in Oakville, Ontario, is to be relocated to a far superior site within the year. During the 39 weeks ended October 2, 2005, one new corporate and two new franchised restaurants were opened and one corporate restaurant was closed. The closed restaurant, located in Olympia, Washington closed due to a lease expiry, which had been planned as part of an ongoing property rationalization process.

The Keg's same store sales (sales of restaurants that operated during the entire 39-week period of both the current year and the prior year) increased by 8.1% in Canada and by 7.0% in the United States. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 39-week period increased by 6.4%. The average exchange rate moved from 1.22 in KRL's 39-week period of fiscal 2005 to 1.13 in KRL's 39-week period of fiscal 2006, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## **OPERATING RESULTS**

### **THIRD QUARTER**

#### **GROSS SALES**

Gross sales reported by the restaurants in the Royalty Pool increased from \$79,877,000 to \$91,564,000 for the comparable quarter. The increase of \$11,687,000 or 14.6% reflects both the addition of net new sales to the Royalty Pool at the beginning of the year and the same store sales increases discussed previously.

#### **ROYALTY INCOME**

Royalty income earned by the Partnership increased by \$507,000 from \$3,227,000 in the third quarter of 2005 to \$3,734,000 in the third quarter of 2006, as a result of the increase in gross sales for the reasons explained previously.

#### **PARTNERSHIP EXPENSES**

Expenses incurred by the Partnership for the three months ended September 30, 2006 were \$94,000 and included general and administrative expenses of \$94,000, interest expense on the operating line of credit of \$1,000 and interest income on the surplus cash balances of \$1,000. The decrease of \$6,000 over the comparable quarter in 2005 was due to a decrease in general and administrative expenses of \$5,000 due to the timing of certain expenditures and an increase in interest income of \$1,000 due to surplus cash balances on hand during the quarter.

#### **KRL'S INTEREST**

KRL's interest in the earnings of the Partnership from the Class A, entitled Class B and Class C Partnership units increased from \$1,756,000 for the three months ended September 30, 2005 to \$1,880,000 for the three months ended September 30, 2006. The increase of \$124,000 was primarily due to the increase in Partnership earnings as a result of the increased royalty income. In addition, KRL's average effective ownership interest in the Partnership increased from 20.09% during the three-month period ended September 30, 2005 to 20.27% during the three-month period ended September 30, 2006. The change in the average effective ownership of the Partnership during the period was a result of the Additional Entitlement received on January 1, 2006, the sale of 250,000 Fund units owned by KRL on July 6, 2005 and the sale of an additional 650,000 Fund units owned by KRL on March 14, 2006.

#### **EQUITY INCOME**

The Fund's equity income from its investment in the Partnership increased from \$1,371,000 during the third quarter of 2005 to \$1,760,000 during the third quarter of 2006. The increase of \$389,000 is due to the net impact of the increase in royalty income of \$507,000, the decrease in Partnership expenses of \$6,000, and the increase in KRL's interest in the earnings of the Partnership of \$124,000.

#### **INTEREST INCOME**

Interest income earned by the Fund for the quarter was \$1,081,000 and included interest income on the Keg Loan of \$1,078,000 and other interest income of \$3,000.

## **INTEREST AND FINANCING EXPENSES**

Interest and financing expenses incurred by the Fund were \$235,000 for the three months ended September 30, 2006 and included interest on the long-term debt of \$229,000 and amortization of deferred financing charges of \$6,000. Interest costs increased by \$58,000 in the quarter as a result of an increase in the average interest rate on the long-term debt from 4.81% in the third quarter of 2005 to 6.50% in the third quarter of 2006.

## **NET EARNINGS**

Net earnings increased by \$333,000 from \$2,273,000 (27.1 cents/Fund unit) in the third quarter of 2005 to \$2,606,000 (28.8 cents/Fund unit) in the third quarter of 2006.

## **DISTRIBUTABLE CASH**

Cash available for distribution to Fund unitholders increased by \$333,000 from \$2,279,000 (27.2 cents/Fund unit) to \$2,612,000 (28.9 cents/Fund unit) during the quarter. Distributions of 27.2 cents per Fund unit were declared in the third quarter of 2005 and 28.3 cents per Fund unit in the third quarter of 2006. The difference between the Fund's earnings and distributable cash is due to non-cash items included in the Fund's operating expenses.

## **YEAR TO DATE**

### **GROSS SALES**

Gross sales reported by the restaurants in the Royalty Pool increased from \$240,500,000 to \$273,788,000 for the comparable nine-month period. The increase of \$33,288,000 or 13.8% reflects both the addition of net new sales to the Royalty Pool at the beginning of the year and the same store sales increases discussed previously.

### **ROYALTY INCOME**

Royalty income earned by the Partnership increased by \$1,371,000 from \$9,688,000 in the first nine months of 2005 to \$11,059,000 in the first nine months of 2006, as a result of the increase in gross sales for the reasons explained previously.

### **PARTNERSHIP EXPENSES**

Expenses incurred by the Partnership for the nine months ended September 30, 2006 were \$351,000 and included general and administrative expenses of \$354,000, interest expense on the operating line of credit of \$2,000, and interest income on the surplus cash balances of \$5,000. Although there was no net increase in expenses over the comparable nine-month period in 2005, general and administrative expenses increased by \$10,000 due to the timing of certain expenditures; interest on the operating line of credit decreased by \$5,000 due to lower utilization of the credit facility during the period, and interest income increased by \$5,000 due to surplus cash balances on hand during the period.

### **KRL'S INTEREST**

KRL's interest in the earnings of the Partnership from the Class A, entitled Class B and Class C Partnership units increased from \$5,209,000 for the nine months ended September 30, 2005 to \$5,430,000 for the nine months ended September 30, 2006. The increase of \$221,000 was primarily due to the increase in Partnership earnings as a result of the increased royalty income. In addition, KRL's average effective ownership interest in the Partnership increased from 21.62% during the nine-month period ended September 30, 2005 to 21.68% during the nine-month period ended September 30, 2006. The change in the average effective ownership of the Partnership during the period was a result of the Additional Entitlement received in January 1, 2006, the sale of 250,000 Fund units owned by KRL on July 6, 2005 and the sale of an additional 650,000 Fund units owned by KRL on March 14, 2006.

## **EQUITY INCOME**

The Fund's equity income from its investment in the Partnership increased from \$4,128,000 during the first nine months of 2005 to \$5,278,000 during the first nine months of 2006. The increase of \$1,150,000 is due to the net impact of the increase in royalty income of \$1,371,000, and the increase in KRL's income in the earnings of the Partnership of \$221,000.

## **INTEREST INCOME**

Interest income earned by the Fund for the nine-month period was \$3,207,000 and included interest income on the Keg Loan of \$3,197,000 and other interest income of \$10,000.

## **INTEREST AND FINANCING EXPENSES**

Interest and financing expenses incurred by the Fund were \$667,000 for the nine months ended September 30, 2006 and included interest on the long-term debt of \$647,000 and amortization of deferred financing charges of \$19,000. Interest costs increased by \$148,000 in the nine-month period as a result of an increase in the average interest rate on the long-term debt from 4.77% in the first nine months of 2005 to 6.18% in the first nine months of 2006.

## **NET EARNINGS**

Net earnings increased by \$1,007,000 from \$6,811,000 (82.7 cents/Fund unit) in the first nine months of 2005 to \$7,818,000 (87.9 cents/Fund unit) in the first nine months of 2006.

## **DISTRIBUTABLE CASH**

Cash available for distribution to Fund unitholders increased by \$1,007,000 from \$6,830,000 (82.9 cents/Fund unit) to \$7,837,000 (88.1 cents/Fund unit) during the period. Distributions of 72.3 cents per Fund unit were declared in the first nine months of 2005 and 75.4 cents per Fund unit in the first nine months of 2006. The difference between the Fund's earnings and distributable cash is due to non-cash items included in the Fund's operating expenses.

## **LIQUIDITY & CAPITAL RESOURCES**

It is the Fund's policy to distribute all available cash on a monthly basis in order to provide consistent returns to unitholders and to maximize those returns. Any increase in distributions in the future will be implemented in such a manner so as to maintain uniform monthly distributions.

## **TERM LOAN**

The Keg Holdings Trust, a subsidiary of the Fund, has a \$14 million non-revolving term loan facility, which bears interest at bank prime plus 0.50% per annum. The facility was originally arranged during the IPO to partially finance the purchase of the Keg Rights from KRL, and to provide term debt as part of the capital structure. On September 26, 2006, this facility was refinanced, and the maturity date extended to April 3, 2011. Certain conditions must be maintained for the term loan to be in good standing, all of which have been met.

## **OPERATING LINE OF CREDIT**

The Partnership, a subsidiary of the Fund, has a \$1 million operating line of credit, which bears interest at bank prime plus 0.25% per annum. This facility is used primarily to bridge timing differences between the receipt of the royalty payments and distributions on the Partnership securities. This operating line is also available for general working capital purposes, or if required, to help finance periodic differences between receipt of the royalty payment, (which may vary due to small seasonal variations in the gross sales of those restaurants in the Royalty Pool), and distributions to unitholders.

## **CRITICAL ACCOUNTING ESTIMATES**

The Fund's only critical accounting estimate is the valuation of its investment in the Partnership. As the Partnership's only significant assets are intangible assets consisting of the Keg Rights, the valuation of the Fund's investment is based primarily upon the valuation of intangible assets in the Partnership. The Keg Rights are not amortized as they have an indefinite life. The Keg GP Ltd., as the general partner of the Partnership and administrator of the Fund, reviews the carrying values of the intangible assets in the Partnership and the Fund's investment at least annually, taking into consideration any events or circumstances which may have impaired the carrying values of these items. If permanent declines in the carrying amounts are determined, these items are written down to their estimated net recoverable amount. The Keg GP Ltd. believes that there have been no declines in either the carrying value of the intangible assets in the Partnership or in the carrying value of the Fund's investment in the Partnership as of September 30, 2006.

## **FINANCIAL INSTRUMENTS**

The Fund's financial instruments consist of cash, accounts receivable, note receivable, accounts payable and accrued liabilities, and the term loan. Due to the interrelationship between the note receivable from KRL and the Class C Partnership units held by KRL, it is not practicable to estimate the fair value of the note receivable with sufficient reliability. The Keg GP Ltd., as the general partner and administrator of the Fund, estimates that the fair value of these financial instruments approximate their carrying values. It is The Keg GP Ltd.'s opinion that the Fund is not exposed to significant interest rate or credit risk arising from these financial instruments.

## **SUBSEQUENT EVENT**

On October 31, 2006, The Federal Department of Finance announced a new tax on distributions from publicly traded income trusts and limited partnerships. This new tax will be called a Distribution Tax, according to the statement issued by Finance Minister Jim Flaherty. For existing income trusts, the government has proposed a four-year transition period.

While the full implications of the new tax measures are still being reviewed, this proposal would make the tax treatment of income trusts comparable to that of regular corporations. Assuming the proposed tax structure is implemented, the Fund will not be subject to the new measures until the 2011 taxation year.

## **OUTLOOK**

Management of KRL has advised the Trustees that it intends to continue to focus on growing same store sales and to continue to expand the number of corporate and franchised restaurants in Canada and the United States. KRL management has also advised the Trustees that it believes that the strong same store sales growth KRL has delivered in the past will continue to be realized in the future through a combination of increased guest counts and increased guest average cheque. Advertising and promotions programs will continue to focus on food taste, quality and excellent service in a friendly atmosphere. Management of KRL has further advised the Trustees that it believes that continued Canadian market expansion will be leveraged by KRL's leading market position and national presence. Corporate market expansion in the United States will continue to focus on three target markets, specifically Phoenix, Arizona; Denver, Colorado; and Dallas, Texas. KRL management has advised the Trustees that it intends to aggressively pursue franchising opportunities in the United States.

## **OUTLOOK (CONTINUED)**

KRL continues to refurbish, and in some cases, relocate existing Keg restaurants in order to better serve its guests and to protect and enhance the strong leadership position The Keg brand has enjoyed for over thirty-five years.

Management of KRL has also advised the Trustees that it expects to add one new corporate and four new franchised restaurants, to relocate one franchised restaurant and to close one corporate restaurant during 2006. Management of KRL has further advised the Trustees that it intends to open 30 new restaurants over the next ten 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.

## **THE RESTAURANT INDUSTRY**

The performance of the Fund is directly dependent upon the royalty and interest payments received from KRL. The amount of the royalty is dependent upon restaurant sales, which is subject to a number of factors that affect the restaurant industry generally, and the casual dining segment of the industry in particular. The casual dining segment of the restaurant industry is intensely competitive with respect to price, service, location and food quality. There are many well-established competitors, particularly in the United States with substantially greater financial and other resources than KRL. Competitors include national and regional chains, as well as individually owned restaurants. Recently, competition has increased in the mid-price, full-service, casual dining segment in which Keg restaurants operate. If KRL and the Keg franchisees are unable to successfully compete in the casual dining segment of the restaurant industry, sales may be adversely affected, the amount of the royalty reduced and the ability of KRL to pay the royalty or interest on the Keg Loan may be impaired. The restaurant business is also affected by changes in demographic trends, traffic patterns, and the type, number, and location of competing restaurants. In addition, factors such as inflation, increased food, labour and benefits costs, government regulations, smoking by-laws and the availability of experienced management and hourly employees may adversely affect the restaurant industry in general and therefore potentially KRL and its franchisees. Changing consumer preferences, discretionary spending patterns and factors affecting the availability of beef could force KRL to modify its restaurant content and menu and could result in a reduction of restaurant sales. Accordingly, this could impact the amount of the royalty and financial condition of KRL.

Consumer preferences could be affected by health concerns about the consumption of beef, the primary item served at Keg restaurants, and specific events such as the outbreak of “mad cow disease” could reduce the available supply of beef or significantly raise the price of beef. KRL’s success also depends on numerous factors affecting discretionary consumer spending including economic conditions, disposable consumer income and consumer confidence. Adverse changes in these factors could reduce guest traffic or impose practical limits on pricing, either of which could reduce restaurant sales and operating income, which could adversely affect the royalty and the ability of KRL to pay the royalty, the make-whole payment or interest on the Keg Loan.

## **AVAILABILITY AND QUALITY OF RAW MATERIALS**

Management of KRL has advised the Trustees that it continues to monitor the situation regarding the cases of BSE found in North America during the past two years. 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 been no 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 has advised the Trustees that it expects the demand for beef to remain strong among consumers and its supply to continue uninterrupted.

## **FLUCTUATIONS IN FOREIGN EXCHANGE RATES**

KRL presently has 17 restaurants located in the United States, 16 of which are corporately owned through its wholly owned subsidiaries, and one of which is franchised. Keg restaurants located in the United States generate sales in United States dollars, which must be translated into their Canadian dollar equivalent for Fund reporting purposes. Fluctuations in foreign exchange rates will affect the Canadian dollar equivalent of the sales of the restaurants located in the United States, which will affect the amount of the royalty.

## **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.

## **ADDITIONAL INFORMATION**

Additional information about the Fund including the Fund's most recent annual information form is available on SEDAR at [www.sedar.com](http://www.sedar.com).

## 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)  
Website: [www.kegincomefund.com](http://www.kegincomefund.com)

# THE KEG ROYALTIES INCOME FUND

## CONSOLIDATED FINANCIAL STATEMENTS

For the three and nine months ended September 30, 2006 and 2005

## CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of dollars)

	September 30, 2006 (unaudited)	December 31, 2005 (audited)
<b>ASSETS</b>		
Current assets:		
Cash .....	\$ 528	\$ 185
Due from Keg Restaurants Ltd. (note 4) .....	351	363
Due from The Keg Rights Limited Partnership (note 5) .....	269	962
	1,148	1,510
Note receivable from Keg Restaurants Ltd. ....	57,000	57,000
Investment in The Keg Rights Limited Partnership (note 2) .....	48,091	39,114
Deferred financing charges .....	78	47
	\$ 106,317	\$ 97,671
 <b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities .....	\$ 50	\$ -
Interest payable on term loan .....	75	65
Distributions payable to Fund unitholders .....	-	771
	125	836
Term loan .....	14,000	14,000
Unitholders' equity:		
Capital contributions (note 6(a)) .....	90,946	82,696
Retained earnings .....	1,246	139
	92,192	82,835
	\$ 106,317	\$ 97,671

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board of Trustees

“C.C. Woodward”  
**C.C. Woodward, Trustee**

“George Tidball”  
**George Tidball, Trustee**

## CONSOLIDATED STATEMENTS OF EARNINGS

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

	July 1 to Sept 30, 2006	July 1 to Sept 30, 2005	January 1 to Sept 30, 2006	January 1 to Sept 30, 2005
Gross sales reported by Keg restaurants in the Royalty Pool (note 2) .....	\$ <u>91,564</u>	\$ <u>79,877</u>	\$ <u>273,788</u>	\$ <u>240,500</u>
Revenue:				
Equity income (note 2) .....	\$ 1,760	\$ 1,371	\$ 5,278	\$ 4,128
Interest income .....	<u>1,081</u>	<u>1,079</u>	<u>3,207</u>	<u>3,202</u>
	2,841	2,450	8,485	7,330
Expenses:				
Interest and financing fees.....	229	171	648	500
Amortization of deferred financing charges .....	<u>6</u>	<u>6</u>	<u>19</u>	<u>19</u>
	<u>235</u>	<u>177</u>	<u>667</u>	<u>519</u>
Net earnings for the period .....	\$ <u>2,606</u>	\$ <u>2,273</u>	\$ <u>7,818</u>	\$ <u>6,811</u>
Weighted average units outstanding (note 6(a)) .....	<u>9,053,500</u>	<u>8,395,348</u>	<u>8,893,976</u>	<u>8,235,002</u>
Earnings per unit .....	\$ <u>0.29</u>	\$ <u>0.27</u>	\$ <u>0.88</u>	\$ <u>0.83</u>

## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

(Expressed in thousands of dollars - unaudited)

	July 1 to Sept 30, 2006	July 1 to Sept 30, 2005	January 1 to Sept 30, 2006	January 1, to Sept 30, 2005
Retained earnings (deficit), beginning of period.....	\$ 1,203	\$ 745	\$ 139	\$ (124)
Net earnings .....	2,606	2,273	7,818	6,811
Distributions declared to Fund unitholders .....	<u>(2,563)</u>	<u>(2,284)</u>	<u>(6,711)</u>	<u>(5,953)</u>
Retained earnings, end of period.....	\$ <u>1,246</u>	\$ <u>734</u>	\$ <u>1,246</u>	\$ <u>734</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars - unaudited)

	July 1 to Sept 30, <u>2006</u>	July 1 to Sept 30, <u>2005</u>	January 1 to Sept 30, <u>2006</u>	January 1 to Sept 30, <u>2005</u>
<b>Cash provided by (used for):</b>				
<b>OPERATIONS:</b>				
Net earnings for the period .....	\$ 2,606	\$ 2,273	\$ 7,818	\$ 6,811
Items not involving cash:				
Amortization of deferred financing charges .....	6	6	19	19
Equity income (note 2) .....	(1,760)	(1,371)	(5,278)	(4,128)
Distributions from The Keg Rights Limited Partnership	1,783	1,451	4,550	3,638
Change in non-cash operating working capital (note 7(a)) .....	<u>100</u>	<u>3</u>	<u>765</u>	<u>138</u>
	2,735	2,362	7,874	6,478
<b>FINANCING:</b>				
Distributions paid to Fund unitholders .....	(2,563)	(2,284)	(7,481)	(6,687)
Deferred financing charges .....	<u>(50)</u>	<u>-</u>	<u>(50)</u>	<u>-</u>
	(2,613)	(2,284)	(7,531)	(6,687)
Increase (decrease) in cash.....	122	78	343	(209)
Cash, beginning of period .....	<u>406</u>	<u>102</u>	<u>185</u>	<u>389</u>
Cash, end of period .....	<u>\$ 528</u>	<u>\$ 180</u>	<u>\$ 528</u>	<u>\$ 180</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)

For the three and nine months ended September 30, 2006 and 2005

### 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, 2005. 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, 2005.

### 2. EQUITY INVESTMENT:

	September 30, <u>2006</u>	December 31, <u>2005</u>
Investment in the Partnership, at cost .....	\$ 47,601	\$ 39,352
Accumulated equity earnings less distributions received, beginning of period .....	(238)	(159)
Equity income in the Partnership .....	5,278	5,732
Distributions from the Partnership .....	<u>(4,550)</u>	<u>(5,811)</u>
Equity investment in the Partnership .....	<u>\$ 48,091</u>	<u>\$ 39,114</u>

The Keg Rights Limited Partnership (the "Partnership") owns the trademarks, trade names, operating procedures and systems and other intellectual property (collectively, the "Keg Rights") used in connection with the operation of Keg steakhouse restaurants and bars.

The Fund, through its ownership of The Keg Holdings Trust ("KHT"), holds all of the issued and outstanding Limited Partnership units ("LP units"), 900,000 Class B units and 99% of the General Partnership units ("GP units") of the Partnership through its 90% interest in KGP.

Summarized financial information of the Partnership is as follows:

	September 30, <u>2006</u>	December 31, <u>2005</u>
Current assets .....	\$ 1,695	\$ 1,726
Long-term assets, being Keg Rights .....	<u>127,716</u>	<u>122,201</u>
Total assets .....	<u>\$ 129,411</u>	<u>\$ 123,927</u>
Current liabilities .....	\$ 641	\$ 2,008
Partners' equity .....	<u>128,770</u>	<u>121,919</u>
Total liabilities and equity .....	<u>\$ 129,411</u>	<u>\$ 123,927</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2006 and 2005

### 2. EQUITY INVESTMENT (CONTINUED):

	July 1 to Sept 30, <u>2006</u>	July 1 to Sept 30, <u>2005</u>	January 1 to Sept 30, <u>2006</u>	January 1 to Sept 30, <u>2005</u>
System sales reported by Keg restaurants in the Royalty Pool .....	\$ 91,564	\$ 79,877	\$ 273,788	\$ 240,500
Royalty income at 4% of system sales reported above .....	\$ 3,663	\$ 3,195	\$ 10,952	\$ 9,620
Make-whole payment, based on 4% of lost system sales .....	<u>71</u>	<u>32</u>	<u>107</u>	<u>68</u>
Total royalty income .....	3,734	3,227	11,059	9,688
Expenses .....	<u>(94)</u>	<u>(100)</u>	<u>(351)</u>	<u>(351)</u>
Net earnings of the Partnership for the period .....	3,640	3,127	10,708	9,337
KRL's interest in the net earnings of the Partnership .....	<u>(1,880)</u>	<u>(1,756)</u>	<u>(5,430)</u>	<u>(5,209)</u>
Equity income for the period .....	<u>\$ 1,760</u>	<u>\$ 1,371</u>	<u>\$ 5,278</u>	<u>\$ 4,128</u>

The gross sales reported by the 91 Keg restaurants on which KRL pays a royalty to the Partnership (the "Royalty Pool") are from January 1 to September 30, 2006 (January 1 to September 30, 2005 – 86 Keg restaurants).

On January 1, 2006, seven new Keg restaurants that opened during the period from October 3, 2004 to October 2, 2005 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$30.7 million annually. Two permanently closed Keg restaurants with annual sales of \$6.0 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$24.7 million annually.

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 two restaurant closures for the period from January 1 to September 30, 2006 (January 1 to September 30, 2005 – one restaurant closure).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars, except unit and per unit amounts - unaudited)

For the three and nine months ended September 30, 2006 and 2005

### 3. UNITHOLDER DISTRIBUTIONS:

	July 1 to Sept 30, <u>2006</u>	July 1 to Sept 30, <u>2005</u>	January 1 to Sept 30, <u>2006</u>	January 1 to Sept 30, <u>2005</u>
Distributions declared to Fund unitholders .....	\$ <u>2,563</u>	\$ <u>2,284</u>	\$ <u>6,711</u>	\$ <u>5,953</u>
Weighted average Fund units outstanding (note 6(a))	<u>9,053,500</u>	<u>8,395,348</u>	<u>8,893,976</u>	<u>8,235,002</u>
Distributions declared per unit .....	\$ <u>0.28</u>	\$ <u>0.27</u>	\$ <u>0.75</u>	\$ <u>0.72</u>

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.

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

	September 30, <u>2006</u>	December 31, <u>2005</u>
Interest on note receivable from Keg Restaurants Ltd. ....	\$ <u>351</u>	\$ <u>363</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.

### 5. DUE FROM THE KEG RIGHTS LIMITED PARTNERSHIP:

The amounts due from the Partnership are working capital items owing to the Fund or its subsidiaries and are in the normal course of operations.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars, except unit amounts - unaudited)

For the three and nine months ended September 30, 2006 and 2005

### 6. UNITHOLDERS' EQUITY:

#### (a) Fund units:

On May 31, 2002, the Fund issued 8,153,500 Fund units at \$10.00 per unit pursuant to a public underwriting. Expenses of the offering amounted to \$2,150,000 and were charged to unitholders' equity.

On July 4, 2005, the Fund issued 250,000 Fund units to KRL in exchange for 250,000 Class B units. The fair value of these units was approximately \$13.25 which resulted in an additional \$3,312,500 recorded as unitholders' equity. Thereafter, on July 6, 2005, KRL sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange.

On March 9, 2006, the Fund issued 650,000 Fund units to KRL in exchange for 650,000 Class B units. The fair value of these units was approximately \$12.69 which resulted in an additional \$8,248,500 recorded as unitholders' equity. Thereafter, on March 14, 2006, KRL sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange.

The declaration of trust of the Fund provides that an unlimited number of Fund units may be issued. Each Fund unit is transferable and represents an equal undivided beneficial interest in any distributions of the Fund and in the net assets of the Fund. All units have equal rights and privileges. Each Fund unit entitles the holder thereof to participate equally in the allocations and distributions and to one vote at all meetings of Fund unitholders for each whole Fund unit held. The Fund units issued are not subject to future calls or assessments.

Fund units are redeemable at any time at the option of the holder at a price based on market value as defined in the trust agreement, subject to a maximum of \$50,000 in cash redemptions by the Fund in any one month. The limitation may be waived at the discretion of the Trustees of the Fund. Redemption in excess of these amounts, assuming no waiving of the limitation, shall be paid by way of a pro-rata distribution of Partnership securities held by the Fund.

#### (b) Exchangeable Partnership units:

	September 30, <u>2006</u>	December 31, <u>2005</u>
Class A Partnership units (i) .....	905,944	905,944
Class B Partnership units (ii) .....	<u>1,395,982</u>	<u>1,371,730</u>
	<u><u>2,301,926</u></u>	<u><u>2,277,674</u></u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2006 and 2005

### 6. UNITHOLDERS' EQUITY (CONTINUED):

#### (b) Exchangeable Partnership units (continued):

Pursuant to the declaration of trust, the holders (other than the Fund or its subsidiaries) of the Class A units and Class B units of the Partnership are entitled to vote in all votes of Fund unitholders as if they were holders of the number of Fund units they would receive if Class A units and entitled Class B units were exchanged into Fund units as of the record date of such votes, and will be treated in all respects as Fund unitholders for the purpose of any such votes.

- (i) The Class A units are entitled to a preferential proportionate distribution equal to the distribution on the Class C Partnership units, multiplied by the number of Class A units divided by the number of LP units issued and outstanding. KHT holds all of the 8,153,500 LP units issued and outstanding at September 30, 2006. In addition, the Class A units receive a residual distribution proportionately with the Class B units, LP units and GP units relative to the aggregate number of each class issued and outstanding (or in the case of the Class B units, the number issued and outstanding multiplied by the Class B current distribution entitlement). Class A units are exchangeable for Fund units on the basis of one Fund unit for one Class A unit.
- (ii) The Class B units are entitled to a preferential proportionate distribution and a residual distribution based on the incremental royalty paid to the Partnership from new Keg restaurants. The distribution entitlements of the Class B units are adjusted annually on January 1. Class B units held by KRL are exchangeable for Fund units based upon a defined calculation that itself is based on system sales from new restaurants. As at September 30, 2006, 1,395,982 (December 31, 2005 – 1,371,730) Class B units held by KRL receive a distribution entitlement.

In addition to these exchangeable Class B units, KRL also holds 1,080,718 (December 31, 2005 – 1,754,970) Class B units which are not yet entitled to receive distributions and are not exchangeable for Fund units.

### 7. SUPPLEMENTARY CASH FLOW INFORMATION:

	July 1 to Sept 30, <u>2006</u>	July 1 to Sept 30, <u>2005</u>	January 1 to Sept 30, <u>2006</u>	January 1 to Sept 30, <u>2005</u>
(a) Change in non-cash operating working capital:				
Due from Keg Restaurants Ltd. (note 4) ..	\$ -	\$ -	\$ 12	\$ 11
Due from The Keg Rights Limited				
Partnership .....	50	1	693	126
Accounts payable and accrued liabilities ..	50	-	50	-
Interest payable on term loan .....	<u>-</u>	<u>2</u>	<u>10</u>	<u>1</u>
	<u>\$ 100</u>	<u>\$ 3</u>	<u>\$ 765</u>	<u>\$ 138</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2006 and 2005

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

	July 1 to Sept 30, <u>2006</u>	July 1 to Sept 30, <u>2005</u>	January 1 to Sept 30, <u>2006</u>	January 1 to Sept 30, <u>2005</u>
(b) Supplementary information:				
Interest received .....	\$ 1,081	\$ 1,079	\$ 3,219	\$ 3,213
Interest paid .....	229	169	638	499

# KEG RESTAURANTS LTD.

## YEAR END REPORT

For the 13 and 52 weeks ended October 1, 2006

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 audited, consolidated financial statements of KRL for the 52 weeks ended October 1, 2006.

### SELECTED FINANCIAL INFORMATION OF KRL

	13 weeks ended Oct. 1, 2006	13 weeks ended Oct. 2, 2005	52 weeks ended Oct. 1, 2006	52 weeks ended Oct. 2, 2005
(in thousands of dollars)				
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 97,972</b>	<b>\$ 87,572</b>	<b>\$ 380,181</b>	<b>\$ 344,531</b>
Corporate restaurant sales <sup>(2)</sup> .....	47,172	43,780	191,195	178,449
Retail operating contribution (loss) <sup>(3)</sup> .....	(16)	34	42	61
Franchise fee income .....	2,455	2,094	9,108	7,937
Operating costs and expenses .....	<u>(43,935)</u>	<u>(42,031)</u>	<u>(176,904)</u>	<u>(168,787)</u>
<b>Operating earnings</b> .....	<b>\$ 5,676</b>	<b>\$ 3,877</b>	<b>\$ 23,441</b>	<b>\$ 17,660</b>
Partnership expenses <sup>(4)</sup> .....	(94)	(100)	(440)	(445)
Non-controlling interest <sup>(5)</sup> .....	(1,760)	(1,371)	(6,883)	(5,534)
Gain on sale of Class B units <sup>(6)</sup> .....	-	686	713	686
Executive bonus <sup>(7)</sup> .....	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>
<b>EBITDA</b> <sup>(8)</sup> .....	<b>\$ 3,322</b>	<b>\$ 2,592</b>	<b>\$ 16,331</b>	<b>\$ 11,867</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) Includes administrative expenses and interest on an operating line of credit, to the extent utilized, incurred directly by The Keg Rights Limited Partnership (the “Partnership”).
- (5) Represents the earnings of the Partnership attributable to the public unitholders of The Keg Royalties Income Fund (the “Fund”) from the Fund’s investment in the Partnership. The amount is calculated as the royalty income earned by the Partnership from KRL, less Partnership expenses, and less earnings of the Partnership attributable to KRL from its ownership of Class A, entitled Class B and Class C Partnership units.
- (6) On March 9, 2006, KRL exchanged 650,000 Class B units of the Partnership for an equal number of Fund units and on March 14, 2006, sold these Fund units. On July 4, 2005, KRL exchanged 250,000 Class B units of the Partnership for an equal number of Fund units and on July 6, 2005, sold these Fund units. A gain on sale was realized in both instances as the net proceeds received from the sale of these Fund units exceeded the weighted average cost of the units sold.
- (7) The Executive bonus is a discretionary expense applicable to certain Executive members and is based on several criteria, including the profitability of KRL and the performance of the Fund.
- (8) EBITDA is earnings before 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.

## SUMMARY OF QUARTERLY FINANCIAL RESULTS

	Q4 2006	Q3 2006	Q2 2006	Q1 2006
(in thousands of dollars)				
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 97,972</b>	<b>\$ 91,750</b>	<b>\$ 97,040</b>	<b>\$ 93,419</b>
Corporate restaurant sales <sup>(2)</sup> .....	47,172	46,168	49,395	48,460
Retail operating contribution (loss) <sup>(3)</sup> .....	(16)	113	(33)	(22)
Franchise fee income .....	2,455	2,192	2,311	2,150
Operating costs and expenses .....	<u>(43,935)</u>	<u>(43,725)</u>	<u>(45,059)</u>	<u>(44,185)</u>
<b>Operating earnings</b> .....	<b>\$ 5,676</b>	<b>\$ 4,748</b>	<b>\$ 6,614</b>	<b>\$ 6,403</b>
Partnership expenses <sup>(4)</sup> .....	(94)	(120)	(138)	(89)
Non-controlling interest <sup>(5)</sup> .....	(1,760)	(1,718)	(1,800)	(1,604)
Gain on sale of Class B units <sup>(6)</sup> .....	-	-	713	-
Executive bonus <sup>(7)</sup> .....	<u>(500)</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>EBITDA</b> <sup>(8)</sup> .....	<b>\$ 3,322</b>	<b>\$ 2,910</b>	<b>\$ 5,389</b>	<b>\$ 4,710</b>

	Q4 2005	Q3 2005	Q2 2005	Q1 2005
(in thousands of dollars)				
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 87,572</b>	<b>\$ 85,796</b>	<b>\$ 86,898</b>	<b>\$ 84,265</b>
Corporate restaurant sales <sup>(2)</sup> .....	43,780	44,211	45,416	45,042
Retail operating contribution (loss) <sup>(3)</sup> .....	34	(11)	39	(1)
Franchise fee income .....	2,094	1,991	1,979	1,873
Operating costs and expenses .....	<u>(42,031)</u>	<u>(42,662)</u>	<u>(42,229)</u>	<u>(41,865)</u>
<b>Operating earnings</b> .....	<b>\$ 3,877</b>	<b>\$ 3,529</b>	<b>\$ 5,205</b>	<b>\$ 5,049</b>
Partnership expenses <sup>(4)</sup> .....	(100)	(136)	(116)	(93)
Non-controlling interest <sup>(5)</sup> .....	(1,371)	(1,355)	(1,402)	(1,406)
Gain on sale of Class B units <sup>(6)</sup> .....	686	-	-	-
Executive bonus <sup>(7)</sup> .....	<u>(500)</u>	<u>-</u>	<u>-</u>	<u>-</u>
<b>EBITDA</b> <sup>(8)</sup> .....	<b>\$ 2,592</b>	<b>\$ 2,038</b>	<b>\$ 3,687</b>	<b>\$ 3,550</b>

	Oct. 1, 2006	Oct. 2, 2005
Total assets .....	\$ 104,126	\$ 95,362
Total long-term liabilities .....	125,345	114,280

## MANAGEMENT DISCUSSION AND ANALYSIS

For the 13 and 52 weeks ended October 1, 2006  
As of December 28, 2006

### 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. 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 for which 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.

The Canadian Institute of Chartered Accountants’ Guideline, Consolidation of Variable Interest Entities (“AcG-15”) requires the consolidation of a variable interest entity (“VIE”) by the primary beneficiary of the expected residual returns, or losses, or both, of the VIE. A VIE is any type of legal structure in which consolidation is required due to contractual or other financial arrangements, as opposed to traditional voting rights, if certain conditions exist. The Partnership has been determined to be a VIE in accordance with the criteria established in AcG-15. As a result of this guideline, the Fund does not consolidate the Partnership but instead accounts for its investment in the Partnership on an equity basis. KRL consolidates the Partnership based on this same guideline, whereas previously, KRL accounted for its investment in the Partnership on an equity basis. This accounting policy does not affect the contractual obligations nor the cash flows between the Fund, the Partnership and KRL.

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.

The operating costs and expenses of KRL 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.

KRL, indirectly through the Partnership, incurs administrative expenses and interest expense on an operating line of credit, to the extent utilized. See “Liquidity and Capital Resources – Operating Lines of Credit”.

The non-controlling interest represents the earnings of the Partnership attributable to the public unitholders of the Fund from the Fund’s indirect ownership of Partnership units. The amount is calculated as the royalty income earned by the Partnership from KRL, less Partnership expenses, and less earnings of the Partnership attributable to KRL from its ownership of Class A, entitled Class B and Class C Partnership units.

## THE ROYALTY POOL

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> of each year when the actual full year performance of the new restaurants is known with certainty.

Readers should note that the number of restaurants added to the Royalty Pool each year may differ from the number of restaurant openings and closings reported by KRL on an annual basis, as the periods for which they are reported differ slightly.

The total number of Keg restaurants included in the Royalty Pool has increased from the 80 Keg restaurants in existence on March 31, 2002, to 86 as of December 31, 2005. Fourteen new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2004, with annual gross sales of \$66.1 million, have been added to the Royalty Pool. Eight permanently closed Keg restaurants with annual sales of \$18.8 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$47.3 million annually and KRL receiving a cumulative Additional Entitlement equivalent to 1,621,730 Fund units as of December 31, 2005.

On January 1, 2006, seven new Keg restaurants that opened during the period from October 3, 2004 through October 2, 2005 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$30.7 million annually. Two permanently closed Keg restaurants with annual sales of \$6.0 million were removed from the Royalty Pool resulting in an estimated net increase in Royalty Pool sales of \$24.7 million annually. The total number of restaurants in the Royalty Pool increased to 91. The yield of the Fund units was determined to be 8.19% calculated using a weighted average unit price of \$13.21.

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 842,815 Fund units, being 7.31% of the Fund units on a fully diluted basis. On January 1, 2006, KRL received 80% of this entitlement representing the equivalent of 674,252 Fund units, being 5.94% 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 2,301,926 Fund units (after giving effect to the sale of 650,000 Fund units on March 14, 2006), representing 20.27% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted on December 31, 2006, to be effective January 1, 2006, once the actual performance of the new restaurants has been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2006, it would have the right to exchange its Partnership units for 2,470,489 Fund units (after giving effect to the sale of 650,000 Fund units on March 14, 2006), representing 21.44% of the Fund units on a fully diluted basis.

## OWNERSHIP OF THE FUND

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

	October 1, 2006		October 2, 2005	
	#	%	#	%
Fund units held by public unitholders <sup>(1)</sup> .....	9,053,500	79.73	8,403,500	79.99
Exchangeable Partnership units held by KRL: <sup>(2)</sup>				
Class A units <sup>(3)</sup> .....	905,944	7.98	905,944	8.62
Class B units (including 80% Additional Entitlement) <sup>(4)</sup> .....	<u>1,395,982</u>	<u>12.29</u>	<u>1,196,710</u>	<u>11.39</u>
Total Exchangeable Partnership units <sup>(5)</sup> .....	<u>2,301,926</u>	<u>20.27</u>	<u>2,102,654</u>	<u>20.01</u>
Total Fund and Exchangeable Partnership units.....	<u>11,355,426</u>	<u>100.00</u>	<u>10,506,154</u>	<u>100.00</u>

Notes:

- <sup>(1)</sup> On July 4, 2005, KRL exchanged 250,000 Class B units of the Partnership for an equal number of Fund units, increasing the number of issued and outstanding Fund units to 8,403,500 and on July 6, 2005, KRL sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange. On March 9, 2006, KRL exchanged 650,000 Class B units of the Partnership for an equal number of Fund units, increasing the number of issued and outstanding Fund units to 9,053,500 and on March 14, 2006, sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange. The weighted average number of Fund units issued and outstanding for the 13-week period ended October 1, 2006 were 9,053,500 (October 2, 2005 – 8,395,348) and for the 52-week period ended October 1, 2006 were 8,770,349 (October 2, 2005 – 8,214,459). The public's average effective ownership of the Fund (based on the weighted average number of Fund units held by public unitholders) was 79.73% during the 13-week period ended October 1, 2006 (October 2, 2005 – 79.91%) and 78.41% during the 52-week period ended October 1, 2006 (October 2, 2005 – 79.09%)
- <sup>(2)</sup> Exchangeable into Fund units on a one-for-one basis. Class D Partnership units are also exchangeable into Fund units on a one-for-one basis, but may only be issued after all Class B units have become fully entitled. As of October 1, 2006, no class D Partnership units have been issued.
- <sup>(3)</sup> Represents KRL's initial 10% effective ownership of the Fund, prior to the entitlement to Class B units.
- <sup>(4)</sup> KRL is the registered holder of 2,476,700 Class B units as of the date hereof, though only a portion of such are entitled to distributions from the Partnership, which as of October 1, 2006 comprised 1,395,982 Class B units and as of October 2, 2005 comprised 1,196,710 Class B units. This cumulative entitlement is as a result of adding net sales to the Royalty Pool on an annual basis. Also included in these figures is 80% of the Additional Entitlement estimated at the beginning of each year, pursuant to which KRL receives a proportionate increase in monthly distributions from the Partnership. The remaining 20% of KRL's Additional Entitlement to Class B units is adjusted retroactively to January 1<sup>st</sup> of each year once the actual sales performance of the new restaurants has been confirmed. KRL is not entitled to monthly distributions from the Partnership on the remaining 20% of KRL's Additional Entitlement until such time as the Additional Entitlement is adjusted retroactively on December 31<sup>st</sup> of each year.
- <sup>(5)</sup> Represents KRL's total effective ownership of the Fund as of October 1, 2006 and October 2, 2005. KRL's average effective ownership of the Fund (based on the weighted average number of Fund and exchangeable units held by KRL) was 20.27% during the 13-week period ended October 1, 2006 (October 2, 2005 – 20.09%) and 21.59% during the 52-week period ended October 1, 2006 (October 2, 2005 – 20.91%).

## NON-CONTROLLING INTEREST

The non-controlling interest represents the earnings of the Partnership attributable to the public unitholders of the Fund from the Fund's indirect ownership of Partnership units. The amount is calculated as the royalty income earned by the Partnership from KRL, less Partnership expenses, and less earnings of the Partnership attributable to KRL from its ownership of Class A, entitled Class B and Class C Partnership units.

	13 weeks ended Oct. 1, <u>2006</u>	13 weeks ended Oct. 2, <u>2005</u>	52 weeks ended Oct. 1, <u>2006</u>	52 weeks ended Oct. 2, <u>2005</u>
Royalty income <sup>(1)</sup> .....	\$ 3,734	\$ 3,227	\$ 14,508	\$ 12,785
Partnership expenses <sup>(2)</sup> .....	<u>(94)</u>	<u>(100)</u>	<u>(440)</u>	<u>(445)</u>
Partnership earnings .....	3,640	3,127	14,068	12,340
KRL's interest <sup>(3)</sup> .....	<u>(1,880)</u>	<u>(1,756)</u>	<u>(7,185)</u>	<u>(6,806)</u>
Non-controlling interest <sup>(4)</sup> .....	<u>\$ 1,760</u>	<u>\$ 1,371</u>	<u>\$ 6,883</u>	<u>\$ 5,534</u>

Notes:

<sup>(1)</sup> The Fund, indirectly through the Partnership, earns royalty income equal to 4% of gross sales of Keg restaurants included in the Royalty Pool.

<sup>(2)</sup> The Fund, indirectly through the Partnership, incurs administrative expenses and interest on an operating line of credit, to the extent utilized.

<sup>(3)</sup> Represents the interest of KRL in the earnings of the Partnership from the Class A, entitled Class B and Class C Partnership units. The Class A and entitled Class B Partnership units are exchangeable into Fund units on a one-for-one basis in certain circumstances.

<sup>(4)</sup> The Fund directly earns equity income from its investment in the Partnership.

## FOURTH QUARTER OPERATING RESULTS

### SALES

System sales for the 13 weeks ended October 1, 2006 were \$97,972,000 compared to \$87,572,000 for the 13 weeks ended October 2, 2005, an increase of \$10,400,000 or 11.9%. During the 13 weeks ended October 1, 2006, one new corporate and two new franchised restaurants were opened and no restaurants were closed. During the 13 weeks ended October 2, 2005, one new franchised restaurant was opened and no restaurants were closed. As of October 1, 2006, there were a total of 95 Keg restaurants as compared with 92 restaurants at October 2, 2005.

Same store sales (sales of restaurants that operated during the entire 13-week period of both the current year and the prior year) increased by 8.9% in Canada and by 7.1% in the United States. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 13-week period increased by 7.3%. The average exchange rate moved from 1.20 for the fourth quarter of fiscal 2005 to 1.12 for the fourth quarter of fiscal 2006, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## RETAIL OPERATIONS

Retail operating contribution (revenue net of related expenses of a wholly owned subsidiary which sells Keg branded food and liquor products) decreased from a profit of \$34,000 during the 13-week period ended October 2, 2005 to a loss of \$16,000 during the 13-week period ended October 1, 2006.

## FRANCHISE FEE REVENUE

Franchise fee revenue climbed from \$2,094,000 for the fourth quarter of the prior year to \$2,455,000 for the fourth quarter of the current year, an increase of \$361,000 or 17.2%. The net increase in franchise fees earned was due to a combination of same store sales growth at existing franchised restaurants, and additional franchise fees earned from four franchised restaurants that opened during the current fiscal year, and one franchised restaurant that was relocated during the current fiscal year, less lost franchise fees from one franchised restaurant that was closed during the current fiscal year.

## OPERATING COSTS

Operating costs and expenses increased from \$42,031,000 for the 13-week period ended October 2, 2005, to \$43,935,000 for the 13-week period ended October 1, 2006. The increase of \$1,904,000 was primarily due to five expense categories. Restaurant variable operating costs increased by \$2,078,000 due to the increased sales for the period. Restaurant staff labour costs decreased by \$256,000 due to improving labour as a percentage of sales resulting from improved labour efficiency at corporate restaurants. Restaurant management labour costs increased by \$111,000 primarily due to increased restaurant management bonuses resulting from improved restaurant profitability. Restaurant facility costs increased by \$235,000 partly due to increased percentage rent and business taxes, due to the increased sales for the period. General and administrative expenses, which include marketing and advertising expenses as well as corporate administrative expenses, decreased by \$195,000 for the period. Marketing and advertising expenses decreased by \$138,000 and corporate administrative expenses decreased by \$57,000 due to the timing of certain expenditures.

## OPERATING EARNINGS

Operating earnings increased by \$1,799,000 from \$3,877,000 for the 13 weeks ended October 2, 2005, to \$5,676,000 for the 13 weeks ended October 1, 2006. 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.

## PARTNERSHIP EXPENSES

Expenses incurred by the Partnership for the 13 weeks ended October 1, 2006 were \$94,000 and included general and administrative expenses of \$94,000, interest expense on its operating line of credit of \$1,000 and interest income on the surplus cash balances of \$1,000. The decrease of \$6,000 in Partnership expenses over the comparable quarter in fiscal 2005 was due to a decrease in general and administrative expenses of \$5,000 due to the timing of certain expenditures and an increase in interest income of \$1,000 due to surplus cash balances on hand during the quarter.

### NON-CONTROLLING INTEREST

The non-controlling interest increased from \$1,371,000 for the 13-week period of the prior year to \$1,760,000 for the 13-week period of the current year. The increase in non-controlling interest of \$389,000 was primarily due to higher earnings of the Partnership arising from increased royalty income earned by the Partnership. This was partially offset by a decrease in the average effective ownership interest in the Partnership held by public unitholders from 79.91% during the 13-week period of the prior year to 79.73% during the 13-week period of the current year. The change in effective ownership of the Partnership during the period was the net result of the Additional Entitlement received by KRL on January 1, 2006, the sale of 250,000 Fund units owned by KRL on July 6, 2005 and the sale of 650,000 Fund units owned by KRL on March 14, 2006.

### GAIN ON SALE OF CLASS B UNITS

On March 9, 2006 KRL exchanged 650,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issues and outstanding Fund units to 9,053,500. Thereafter, on March 14, 2006, KRL sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange. A gain on sale was recorded in the second quarter of the current year as the net proceeds received exceeded the weighted average cost of these units by \$713,000.

On July 4, 2005, KRL exchanged 250,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 8,403,500. Thereafter, on July 6, 2005, KRL sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange. A gain on sale was recorded in the fourth quarter of the prior year, as the net proceeds received exceeded the weighted average cost of these units by \$686,000.

### EXECUTIVE BONUS

The Executive bonus, which is a discretionary expense applicable to certain Executive members and based on several criteria, including the profitability of KRL and the performance of the fund, was recorded during the fourth quarter of both the current and prior year.

### EBITDA

EBITDA for the 13-week period of the current year was \$3,322,000 compared to \$2,592,000 for the 13-week period of the prior year. The increase in EBITDA of \$730,000 for the quarter was due to the net impact of the increase in operating earnings of \$1,799,000, the decrease in Partnership expenses of \$6,000, the increase in non-controlling interest of \$389,000, and the decrease in the gain on sale of Class B units of \$686,000, as explained previously.

### NET LOSS

The net loss before taxes for the 13 weeks ended October 1, 2006 amounted to \$833,000 compared to net loss before taxes of \$1,990,000 for the 13 weeks ended October 2, 2005.

## **YEAR END OPERATING RESULTS**

### **SALES**

System sales for the 52 weeks ended October 1, 2006 were \$380,181,000 compared to \$344,531,000 for the 52 weeks ended October 2, 2005, an increase of \$35,650,000 or 10.3%. During the 52 weeks ended October 1, 2006, one new corporate and four new franchised restaurants were opened, one franchised restaurant was relocated, and one corporate and one franchised restaurant were closed. The closed corporate restaurant, located in Portland, Oregon, closed due to a lease expiry which had been planned as part of an ongoing property rationalization process. The closed franchised restaurant, located in Oakville, Ontario, is to be relocated to a far superior site within the year. During the 52-week period of the prior year, two new corporate and four new franchised restaurants were opened, one corporate restaurant was relocated and one corporate restaurant was closed. The closed restaurant, located in Olympia, Washington, closed due to a lease expiry which had been planned as part of an ongoing property rationalization process.

Same store sales (sales of restaurants that operated during the entire 52-week period of both the current year and the prior year) increased by 7.7% in Canada and by 7.1% in the United States. After translating the sales of the U.S. restaurants into their Canadian dollar equivalent, consolidated same store sales for the comparable 52-week period increased by 6.3%. The average exchange rate moved from 1.22 for the 52-week period of fiscal 2005 to 1.14 for the 52-week period of fiscal 2006, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

### **RETAIL OPERATIONS**

Retail operating contribution (revenue net of related expenses of a wholly owned subsidiary which sells Keg branded food and liquor products) decreased from a profit of \$61,000 during the 52-week period ended October 2, 2005 to a profit of \$42,000 during the 52-week period ended October 1, 2006.

### **FRANCHISE FEE REVENUE**

Franchise fee revenue climbed from \$7,937,000 for the 52-week period of the prior year to \$9,108,000 for the 52-week period of the current year, an increase of \$1,171,000 or 14.8%. The net increase in franchise fees earned was due to a combination of same store sales growth at existing restaurants, and additional franchise fees earned from four franchised restaurants that opened during the prior fiscal year, four franchised restaurants that opened during the current fiscal year, and one franchised restaurant that was relocated, less lost franchise fees from one franchised restaurant that closed during the current fiscal year.

### **OPERATING COSTS**

Operating costs and expenses increased from \$168,787,000 for the 52-week period ended October 2, 2005 to \$176,904,000 for the 52-week period ended October 1, 2006. The increase of \$8,117,000 was primarily due to seven expense categories. Restaurant variable operating costs increased by \$7,763,000 due to increased sales for the period. Food costs decreased by \$1,016,000 relative to the same period of the prior year as a result of menu pricing and improving beef prices. Restaurant staff labour costs decreased by \$739,000 due to improving labour as a percentage of sales resulting from improved labour efficiency at corporate restaurants. Restaurant management labour costs increased by \$433,000 partly as a result of increased management bonuses resulting from improved restaurant profitability. Restaurant trade costs grew by \$513,000 largely due to increased utility costs and credit card commissions. Restaurant facility costs increased by \$340,000 due to higher percentage rent and business taxes due to increased sales for the period, increased insurance costs, and one additional corporate restaurant operating during the entire period.

### OPERATING COSTS (CONTINUED)

General and administrative expenses, which include marketing and advertising expenses as well as corporate administrative expenses, increased by \$1,410,000 for the period. Marketing and advertising expenses increased by \$601,000 partly due to the increased sales for the period as the company targets to spend at least 2½% of restaurant sales on advertising. Corporate administrative expenses increased by \$809,000 due to start-up costs associated with franchise expansion in a number of new markets, the addition of new corporate personnel, non-recurring costs related to the implementation of new restaurant point of sale and inventory management systems, increased corporate management bonuses resulting from improved corporate profitability and incremental costs related to the company's annual conference.

### OPERATING EARNINGS

Operating earnings increased by \$5,781,000 from \$17,660,000 for the 52-weeks ended October 2, 2005 to \$23,441,000 for the 52-weeks ended October 1, 2006. 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.

### PARTNERSHIP EXPENSES

Expenses incurred by the Partnership for the 52-weeks ended October 1, 2006 were \$440,000 and included general and administrative expenses of \$442,000, interest expense on its operating line of credit of \$3,000 and interest income on the surplus cash balances of \$5,000. The decrease in Partnership expenses of \$5,000 was due to an increase in general and administrative expenses of \$8,000 over the comparable period in fiscal 2005 due to the timing of certain expenditures, a decrease in interest expense on the Partnership's operating line of credit of \$8,000 due to lower utilization of its credit facility during the period, and an increase in interest income of \$5,000 due to surplus cash balances on hand during the period.

### NON-CONTROLLING INTEREST

The non-controlling interest increased from \$5,534,000 for the 52-week period of the prior year to \$6,883,000 for the 52-week period of the current year. The increase in non-controlling interest of \$1,349,000 was primarily due to higher earnings of the Partnership arising from increased royalty income earned by the Partnership. This was partially offset by a decrease in the average effective ownership interest in the Partnership held by public unitholders from 79.09% during the 52-week period of the prior year, to 78.41% during the 52-week period of the current year. The change in effective ownership of the Partnership during the period was the net result of the Additional Entitlement received by KRL on January 1, 2006, the sale of 250,000 Fund units owned by KRL on July 6, 2005 and the sale of 650,000 Fund units owned by KRL on March 14, 2006.

### GAIN ON SALE OF CLASS B UNITS

On March 9, 2006 KRL exchanged 650,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issues and outstanding Fund units to 9,053,500. Thereafter, on March 14, 2006, KRL sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange. A gain on sale was recorded in the second quarter of the current year as the net proceeds received exceeded the weighted average cost of these units by \$713,000.

On July 4, 2005, KRL exchanged 250,000 Class B units of the Partnership for an equal amount of Fund units, increasing the number of issued and outstanding Fund units to 8,403,500. Thereafter, on July 6, 2005, KRL sold these 250,000 Fund units through the facilities of the Toronto Stock Exchange. A gain on sale was recorded in the fourth quarter of the prior year, as the net proceeds received exceeded the weighted average cost of these units by \$686,000.

## **EXECUTIVE BONUS**

The Executive bonus, which is a discretionary expense applicable to certain Executive members and based on several criteria, including the profitability of KRL and the performance of the Fund, was recorded during the fourth quarter of both the current year and the prior year.

## **EBITDA**

EBITDA for the 52-week period of the current year was \$16,331,000 compared to \$11,867,000 for the 52-week period of the prior year. The increase in EBITDA of \$4,464,000 for the year was due to the net impact of the increase in operating earnings of \$5,781,000, the decrease in Partnership expenses of \$5,000, the increase in non-controlling interest of \$1,349,000 and the increase in the gain on sale of Class B units of \$27,000, as explained previously.

## **NET EARNINGS**

The net earnings before taxes for the 52 weeks ended October 1, 2006 amounted to \$647,000 compared to a net loss before taxes of \$3,578,000 for the 52 weeks ended October 2, 2005.

## **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 \$2,500,000 per annum. KRL will use cash flow from operations to fund seasonal fluctuations in working capital and maintenance capital expenditures.

## **LONG-TERM DEBT OBLIGATIONS**

KRL had a CDN\$19,370,000 revolving credit/term loan facility with a syndicate of two Canadian banks which was available to finance the construction of certain new corporate restaurants and major renovations in Canada. On September 26, 2006, this facility was re-financed and the borrowing limit increased to CDN\$28,000,000. The amended facility is comprised of a \$16,000,000 term facility and a \$12,000,000 revolving facility and is scheduled to mature on April 3, 2011. The term facility requires interest only payments until December 30, 2007 and quarterly principal repayments thereafter. The revolving facility requires annual principal repayments based on 25% of excess operating cash flow, beginning in KRL's financial year ending in 2008. The credit facilities in Canada are secured by a general security agreement over KRL's Canadian assets, a personal limited recourse guarantee from the sole shareholder of KRL and a pledge of equity interests in the Partnership.

Keg Restaurants U.S., Inc., a wholly owned subsidiary of KRL, has credit facilities with GE Capital in the amount of US\$10,603,000. Management anticipates additional loan facilities for the expansion of corporate Keg restaurants in the United States on similar terms and conditions as exist currently. The credit facilities in the United States are secured by certain property, plant and equipment located in the United States.

## LONG-TERM DEBT OBLIGATIONS (CONTINUED)

Principal repayments on long-term debt obligations for the next five years (ending on or about September 30th each year) are as follows:

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(in thousands of dollars)	
2007 .....	\$ 1,081
2008 .....	3,280
2009 .....	5,240
2010 .....	7,246
2011 .....	5,269
Thereafter .....	5,710

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## OPERATING LINES OF CREDIT

KRL has a revolving demand operating facility of up to \$2,000,000 with a Canadian chartered bank, which bears interest at a rate between bank prime and bank prime plus 1.00% based on certain financial criteria. This credit facility is available for general corporate purposes, including working capital, overdrafts and letters of credit.

The Partnership has a demand operating facility of up to \$1,000,000 which bears interest at bank prime plus 0.25% per annum. This credit facility is used primarily to bridge timing differences between the receipt of the royalty payments and distributions on the Partnership securities. This operating line is also available for general working capital purposes, or if required, to help finance periodic differences between receipt of the royalty payment (which may vary due to small seasonal variations in the gross sales of those restaurants in the Royalty Pool) and distributions to Unitholders.

## OTHER LONG-TERM COMMITMENTS

KRL has base rental obligations under operating leases for office and restaurant premises as well as certain franchise restaurants. Some of the restaurant premises leases require additional payments contingent on sales volume. KRL has sub-leased certain restaurants to franchisees and, under the terms of the sub-leases, the franchisee assumes all rights and obligations under the head lease. Under the terms of the head lease agreements, KRL remains contingently liable to the landlord for any default in payment by franchisees. However KRL has personal guarantees and full indemnities from certain of the principals of the franchisees, for any and all costs related to the head lease. Accordingly, the company records net lease expense in its statements of earnings. As of October 1, 2006, substantially all sub-lease accounts were current.

## FINANCIAL INSTRUMENTS

KRL's financial instruments consist of cash, accounts receivable, notes receivable, accounts payable and accrued liabilities, notes payable and long-term debt. Management estimates that the fair value of these financial instruments approximate their carrying values. It is management's belief that KRL is not exposed to significant interest rate or credit risk arising from these financial instruments.

## **OUTLOOK**

The Canadian Restaurant and Foodservice Association (CRFA) has projected foodservice sales growth of 3.6% in 2007, with the full-service restaurant category, the category in which The Keg operates, posting some of the strongest gains. Management of KRL believes that The Keg will continue to outperform the full-service restaurant category with respect to same store sales growth.

Management of KRL intends to continue to focus on growing same store sales and to continue to expand the number of corporate and franchised restaurants in Canada and the United States. KRL management believes that the strong same store sales growth KRL has delivered in the past will be realized in the future through a combination of increased guest counts and increased guest average cheque. Advertising and promotions programs will continue to focus on food taste, quality and excellent service in a friendly atmosphere. Management of KRL believes that continued Canadian market expansion will be leveraged by KRL's leading market position and national presence. Corporate market expansion in the United States will continue to focus on three target markets, specifically: Phoenix, Arizona; Denver, Colorado; and Dallas, Texas. KRL management also intends to aggressively pursue franchising opportunities in the United States. KRL continues to refurbish, and in some cases, relocate existing Keg restaurants in order to better serve its guests and to protect and enhance the strong leadership position The Keg brand has enjoyed for thirty-five years.

During fiscal 2007, management of KRL expects to add four new corporate and three new franchised restaurants and to relocate two corporate restaurants. In addition, management of KRL is in late-stage negotiations regarding numerous other locations both in Canada and the United States. KRL anticipates opening 30 new restaurants over the next ten years.

## **RISKS AND UNCERTAINTIES**

### **THE RESTAURANT INDUSTRY**

The performance of KRL is dependent upon restaurant sales and operating income, which are subject to a number of factors that affect the restaurant industry generally, and the casual dining segment of the industry in particular. The casual dining segment of the restaurant industry is intensely competitive with respect to price, service, location and food quality. There are many well-established competitors, particularly in the United States, with substantially greater financial and other resources than KRL. Competitors include national and regional chains, as well as individually owned restaurants. Recently, competition has increased in the mid-price, full-service, casual dining segment in which Keg restaurants operate. If KRL and the Keg franchisees are unable to successfully compete in the casual dining segment of the restaurant industry, sales may be adversely affected and the ability of KRL to pay the royalty or interest on the Keg Loan may be impaired. The restaurant business is also affected by changes in demographic trends, traffic patterns, and the type, number, and location of competing restaurants. In addition, factors such as inflation, increased food, labour and benefits costs, government regulations, smoking by-laws and the availability of experienced management and hourly employees may adversely affect the restaurant industry in general, and therefore, potentially KRL and its franchisees. Changing consumer preferences and discretionary spending patterns and factors affecting the availability of beef could potentially force KRL to modify its restaurant content and menu and could result in a reduction of restaurant sales. Accordingly, this could reduce the amount of the royalty and impact the financial condition of KRL. Consumer preferences could be affected by health concerns about the consumption of beef, the primary item served at Keg restaurants, and specific events such as the outbreak of "mad cow disease" could reduce the available supply of beef or significantly raise the price of beef.

## **THE RESTAURANT INDUSTRY (CONTINUED)**

KRL's success also depends on numerous factors affecting discretionary consumer spending, including economic conditions, disposable consumer income and consumer confidence. Adverse changes in these factors could reduce guest traffic or impose practical limits on pricing, either of which could reduce restaurant sales and operating income, which could adversely affect the ability of KRL to pay the royalty, the make-whole payment or interest on the Keg Loan.

## **AVAILABILITY AND QUALITY OF RAW MATERIALS**

Management of KRL continues to monitor the situation regarding the cases of BSE (mad cow disease) found in North America during the past two years. 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 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, 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.

# **KEG RESTAURANTS LTD.**

## **CONSOLIDATED FINANCIAL STATEMENTS**

52 weeks ended October 1, 2006

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

## **AUDITORS' REPORT TO THE DIRECTORS OF KEG RESTAURANTS LTD.**

We have audited the consolidated balance sheets of Keg Restaurants Ltd. as at October 1, 2006 and October 2, 2005 and the consolidated statements of operations and deficit and cash flows for the 52 week periods then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at October 1, 2006 and October 2, 2005 and the results of its operations and its cash flows for the 52 week periods then ended in accordance with Canadian generally accepted accounting principles.

*KPMG LLP*

Chartered Accountants  
Vancouver, Canada

November 27, 2006

## CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of dollars)

	October 1, <u>2006</u>	October 2, <u>2005</u>
<b>ASSETS</b>		
Current assets:		
Cash .....	\$ 15,060	\$ 3,224
Accounts receivable .....	3,387	4,038
Inventories .....	3,911	3,861
Prepaid expenses and deposits .....	<u>2,416</u>	<u>3,292</u>
	24,774	14,415
Long-term investments .....	2	36
Notes receivable (note 3) .....	56	133
Property, plant and equipment (note 4) .....	49,701	49,927
Deferred charges .....	2,032	2,545
Intangible assets (note 5) .....	20,423	20,423
Future income taxes (note 6) .....	<u>7,138</u>	<u>7,883</u>
	<u>\$ 104,126</u>	<u>\$ 95,362</u>
<b>LIABILITIES AND SHAREHOLDER'S DEFICIENCY</b>		
Current liabilities:		
Accounts payable and accrued liabilities .....	\$ 18,525	\$ 17,334
Due to related parties (note 12).....	269	219
Unearned revenue .....	8,334	6,460
Current portion of long-term debt (note 8) .....	<u>1,081</u>	<u>2,215</u>
	28,209	26,228
Unearned revenue .....	1,704	1,932
Note payable to The Keg Royalties Income Fund (note 7) .....	57,000	57,000
Long-term debt (note 8) .....	26,744	21,906
Deferred gain on sale of intangible assets (note 10) .....	23,123	15,934
Non-controlling interest (note 11) .....	16,774	16,667
Due to related company (note 12) .....	-	841
Shareholder's deficiency:		
Share capital (note 13) .....	1	1
Cumulative translation adjustment .....	(3,814)	(3,638)
Deficit .....	<u>(45,615)</u>	<u>(41,509)</u>
	<u>(49,428)</u>	<u>(45,146)</u>
	<u>\$ 104,126</u>	<u>\$ 95,362</u>

Commitments and contingent liabilities (note 14)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board

"David Aisenstat"  
David Aisenstat, Director

"Neil Maclean"  
Neil Maclean, Director

## CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

(Expressed in thousands of dollars)

	52 weeks ended October 1, <u>2006</u>	52 weeks ended October 2, <u>2005</u>
<b>System sales</b> (note 17) .....	<b><u>\$ 380,181</u></b>	<b><u>\$ 344,531</u></b>
Revenue:		
Restaurant sales .....	\$ 191,195	\$ 178,449
Retail sales .....	<u>2,524</u>	<u>2,840</u>
	<u>193,719</u>	<u>181,289</u>
Operating costs:		
Restaurant operating costs .....	(160,550)	(153,846)
Retail operations .....	<u>(2,482)</u>	<u>(2,779)</u>
	<u>(163,032)</u>	<u>(156,625)</u>
Earnings from operations .....	30,687	24,664
Franchise fee revenue .....	9,108	7,937
General and administrative expenses (note 12) .....	(16,354)	(14,941)
Partnership expenses .....	(440)	(445)
Non-controlling interest (note 11) .....	(6,883)	(5,534)
Gain on sale of marketable securities (note 10) .....	713	686
Executive bonus .....	<u>(500)</u>	<u>(500)</u>
Earnings before undernoted items .....	16,331	11,867
Amortization .....	(9,604)	(9,612)
Amortization of deferred gain (note 10) .....	228	148
Interest .....	(6,172)	(5,849)
Loss on disposal of property, plant and equipment .....	<u>(136)</u>	<u>(132)</u>
Earnings (loss) before income taxes .....	647	(3,578)
Income taxes (note 6):		
Current .....	(8)	(17)
Future .....	<u>(745)</u>	<u>910</u>
	<u>(753)</u>	<u>893</u>
Net loss for the period .....	(106)	(2,685)
Deficit, beginning of period .....	(41,509)	(37,224)
Dividends .....	<u>(4,000)</u>	<u>(1,600)</u>
Deficit, end of period .....	<u>\$ (45,615)</u>	<u>\$ (41,509)</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars)

	52 weeks ended October 1, <u>2006</u>	52 weeks ended October 2, <u>2005</u>
<b>Cash provided by (used for):</b>		
<b>OPERATIONS:</b>		
Net loss for the period .....	\$ (106)	\$ (2,685)
Items not involving cash:		
Amortization .....	9,604	9,612
Amortization of deferred gain .....	(228)	(148)
Non-controlling interest (note 11) .....	6,883	5,534
Loss on disposition of property, plant and equipment .....	136	132
Gain on sale of marketable securities (note 10) .....	(713)	(686)
Future income tax expense (recovery) .....	745	(910)
Distributions declared to non-controlling interest (note 11) .....	(6,723)	(5,608)
Change in non-cash operating working capital (note 19(a)) .....	<u>4,663</u>	<u>(557)</u>
	14,261	4,684
<b>INVESTMENTS:</b>		
Additions to property, plant and equipment and deferred charges .....	(9,836)	(11,182)
Distributions from long-term investment .....	31	-
Net proceeds (costs) from disposition of property, plant and equipment .....	31	375
Net proceeds from sale of marketable securities (note 10) .....	8,077	3,234
Notes receivable .....	<u>77</u>	<u>370</u>
	(1,620)	(7,203)
<b>FINANCING:</b>		
Shareholder loan .....	(93)	281
Dividends paid .....	(4,000)	(1,600)
Due to related company .....	(841)	(1,952)
Issuance of long-term debt (note 8) .....	6,354	16,745
Repayment of long-term debt (note 8) .....	<u>(2,225)</u>	<u>(8,728)</u>
	(805)	4,746
Increase in cash .....	11,836	2,227
Cash, beginning of period .....	<u>3,224</u>	<u>997</u>
Cash, end of period .....	<u>\$ 15,060</u>	<u>\$ 3,224</u>

Cash is defined as cash less bank indebtedness.

See note 19(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)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

## 1. OPERATIONS:

Keg Restaurants Ltd. (“KRL”), was formed by the amalgamation of Resolut Corporation, Raleigh Corporation, Raleigh Investments Ltd., Raleigh Restaurants Inc. and Keg Restaurants Ltd. under the laws of Ontario. Its principal business activity is the operation and franchising of Keg steakhouse restaurants and bars in Canada and the United States.

## 2. SIGNIFICANT ACCOUNTING POLICIES:

### (a) Basis of presentation:

These consolidated financial statements include the accounts of KRL, its wholly owned subsidiary, Keg Restaurants U.S., Inc., and The Keg Rights Limited Partnership (the “Partnership”) (note 5) and have been prepared in accordance with Canadian generally accepted accounting principles. The investment in a joint venture is accounted for using the proportionate consolidation method. Under this method, KRL’s proportionate share of joint venture revenues, expenses, assets and liabilities are included in the accounts.

### (b) Inventories:

Inventories, which consist of food, beverages and tableware, are stated at the lower of cost (first-in, first-out) and replacement cost.

### (c) Property, plant and equipment:

Property, plant and equipment are stated at cost less accumulated amortization and write-downs. Amortization is provided on a straight-line basis at the following annual rates:

Description	Rate
Buildings .....	20 years
Buildings on leased land .....	Lesser of 20 years and term of the lease plus the first renewal option
Equipment and furnishings .....	3 to 6 years
Leasehold improvements .....	Lesser of 20 years and term of the lease plus the first renewal option

KRL reviews the carrying value for property, plant and equipment on an ongoing basis, taking into consideration any events or circumstances which might have impaired the carrying value. If a permanent decline in the carrying amount is determined, the asset is written down to its estimated net recoverable amount.

### (d) Deferred charges:

Deferred charges consist of direct costs associated with opening new restaurants, which primarily include training, operational testing and advertising and are amortized over three years, commencing the month after the restaurant opens. Commitment and financing fees are also included in deferred charges and are amortized over the lesser of 5 years and the term of the loan.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

(e) Deferral and amortization of gain on sale of intangible assets:

The gain on the sale of intangible assets is deferred and amortized on a straight-line basis over the 99-year term of the licence (note 10). The deferred gain is also adjusted to reflect changes in The Keg Royalties Income Fund's (the "Fund") ownership interest in the Keg Rights (note 5).

(f) Income taxes:

KRL uses the asset and liability method of accounting for future tax assets and liabilities and recognizes the future tax consequences attributable to differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Where it is considered to be more likely than not that the future income tax assets will not be realized, a valuation allowance is provided for the difference.

(g) Revenue recognition:

Revenue from restaurant operations is recognized when services are rendered.

Franchise fees are recorded as they are earned which, in the case of initial franchise fees for the sale of a franchise, is at the time the restaurant is opened.

Unearned revenue consists primarily of the aggregate redemption amounts of gift certificates and giftcards issued during the last two years, which remain unredeemed. The amount of any certificates previously included in income is expensed in the year of redemption.

The long-term portion of unearned revenue represents leasehold inducements that are being amortized as a reduction in rent over the term of the lease.

(h) Vacant leasehold property:

KRL recognizes all future net costs related to vacant leasehold property as a property expense in the period in which it decides to stop using the property. The amount is determined using management's best estimate of net cash flows such as lease payments, operating costs and sub-lease income.

(i) Foreign currency:

KRL's functional currency is the Canadian dollar. KRL uses the current rate method of accounting for the translation of its U.S. operations. Under this method, assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the year-end rate of exchange. Revenue and expenses are translated at the average rates during the period. Exchange gains and losses resulting from the translation are deferred and included as a separate component of shareholder's deficiency.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

(j) Use of estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of management estimates relate to the determination of unearned revenue, impairment in the value of assets, useful lives for depreciation and amortization, income taxes and provisions for contingencies. Actual results could differ from those estimates.

### 3. NOTES RECEIVABLE:

	October 1, <u>2006</u>	October 2, <u>2005</u>
Employee relocation loans without interest, no fixed term of repayment .....	\$ <u>56</u>	\$ <u>133</u>

### 4. PROPERTY, PLANT AND EQUIPMENT:

	<u>Cost</u>	Accumulated <u>amortization</u>	October 1, 2006 Net book <u>value</u>
Buildings .....	\$ 29,661	\$ 9,300	\$ 20,361
Equipment and furnishings .....	39,713	29,045	10,668
Leasehold improvements .....	41,734	26,139	15,595
Construction in progress .....	<u>3,077</u>	<u>-</u>	<u>3,077</u>
	<u>\$ 114,185</u>	<u>\$ 64,484</u>	<u>\$ 49,701</u>

  

	<u>Cost</u>	Accumulated <u>amortization</u>	October 2, 2005 Net book <u>value</u>
Buildings .....	\$ 25,485	\$ 6,688	\$ 18,797
Equipment and furnishings .....	38,140	27,556	10,584
Leasehold improvements .....	41,605	25,581	16,024
Construction in progress .....	<u>4,522</u>	<u>-</u>	<u>4,522</u>
	<u>\$ 109,752</u>	<u>\$ 59,825</u>	<u>\$ 49,927</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 5. INTANGIBLE ASSETS:

On May 31, 2002, KRL sold the trademarks and trade names used in connection with the operation of Keg restaurants in Canada and the United States (the "Keg Rights") to the Partnership for cash proceeds of \$30,487,000 and 950,944 Class A, 3,376,700 Class B, and 5,700,000 Class C Partnership units. Concurrent with the sale of the Keg Rights, the Partnership granted KRL a licence to use the Keg Rights for a period of 99 years. As consideration, KRL pays the Partnership a royalty of four percent of system sales reported by the Keg restaurants included in the royalty pool (the "Royalty Pool").

As a result of consolidation of the Partnership as required by the adoption of AcG-15 during 2005, the Keg Rights are recorded at their historical cost. Partnership units received by KRL on sale of the Keg Rights are eliminated on consolidation. The adoption of AcG-15 does not affect the contractual obligations between KRL, the Partnership and the Fund or the legal ownership of the Keg Rights.

### 6. INCOME TAXES:

Income tax recovery as reported differs from the amount that would be computed by applying the combined Federal and Provincial statutory income tax rates to the loss before income taxes. The reason for the differences is as follows:

	52 weeks ended October 1, <u>2006</u>	52 weeks ended October 2, <u>2005</u>
Earnings (loss) before income taxes .....	\$ 647	\$ (3,578)
Combined Canadian federal and provincial rates .....	<u>34.60%</u>	<u>34.98%</u>
Computed "expected" tax expense (recovery) .....	224	(1,252)
Increased (reduced) by:		
Amounts not deductible for tax .....	313	115
Foreign exchange translation .....	468	1,067
Non-taxable portion of capital gains .....	(123)	(565)
Realization of previously unrecognized tax assets .....	342	(366)
Expiration of non-capital losses .....	1,114	-
Change in valuation allowance .....	(1,517)	(169)
Foreign tax rate differences .....	9	29
Adjustment to future tax assets and liabilities for enacted changes in tax laws and rates .....	-	72
Other items .....	<u>(77)</u>	<u>176</u>
Total income tax expense (recovery) per the statement of operations .....	<u>\$ 753</u>	<u>\$ (893)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 6. INCOME TAXES (CONTINUED):

The tax effects of temporary differences that give rise to the future tax assets and liabilities are:

	October 1, <u>2006</u>	October 2, <u>2005</u>
Future tax assets:		
Property, plant and equipment .....	\$ 1,631	\$ 1,039
Non-capital losses .....	11,900	15,016
Deferred gain and non-controlling interest .....	7,101	6,618
Long-term debt settlement expenses .....	239	712
Unearned revenue and other accruals deductible in future periods for income tax purposes .....	<u>4,388</u>	<u>3,941</u>
Total gross future tax assets .....	25,259	27,326
Valuation allowance .....	<u>(10,977)</u>	<u>(12,494)</u>
Total future tax assets .....	14,282	14,832
Future tax liabilities:		
Intangible assets and Partnership earnings .....	<u>(7,144)</u>	<u>(6,949)</u>
Net future tax assets .....	<u>\$ 7,138</u>	<u>\$ 7,883</u>

KRL has loss carryforwards remaining of approximately \$35.1 million (\$23.3 million from its U.S. operations) which may be applied against future operating income. The amount of these loss carryforwards is subject to reassessment by Canada Revenue Agency and the Internal Revenue Service and is subject to certain restrictions with respect to their use. These losses begin to expire in 2007.

### 7. NOTE PAYABLE TO THE KEG ROYALTIES INCOME FUND:

On May 31, 2002, KRL issued a note payable to the Fund in exchange for cash of \$57,000,000. KRL has the option at any time to transfer its 5,700,000 Class C Partnership units ("Class C units") to The Keg Holdings Trust ("KHT"), a subsidiary of the Fund, in consideration for the assumption by KHT of an amount of the note payable equal to \$10.00 for each Class C unit transferred. The Class C units are entitled to a preferential monthly distribution equal to \$0.0625 per Class C unit issued and outstanding. KRL's investment in Class C units is eliminated on consolidation of the Partnership.

Interest accrues at 7.5% per annum and is payable monthly, on the third business day immediately prior to the end of the month following the month for which such interest has accrued. Included in interest expense is \$4,263,288 (52 weeks ended October 2, 2005 - \$4,260,376) relating to this note of which \$3,900,206 (52 weeks ended October 2, 2005 - \$3,885,581) had been paid as at October 1, 2006 and \$363,082 (October 2, 2005 - \$374,795) is included in accounts payable and accrued liabilities.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 7. NOTE PAYABLE TO THE KEG ROYALTIES INCOME FUND (CONTINUED):

The principal amount matures on May 31, 2042 and is subject to extension by the mutual agreement of KRL and the Fund.

The note is secured by a general security agreement, including accounts receivable and inventories, that is subordinated to primary bank debt obligations and may not be assigned without the prior consent of KRL.

### 8. LONG-TERM DEBT:

	October 1, 2006	October 2, 2005
Canadian bank debt (a).....	\$ 16,000	\$ 15,695
GE Capital (U.S. \$10.603 million) (b) .....	11,825	8,426
	27,825	24,121
Current portion .....	(1,081)	(2,215)
	<u>\$ 26,744</u>	<u>\$ 21,906</u>

#### (a) Canadian bank debt:

On September 26, 2006, KRL amended its existing credit facility and entered into an expanded \$30,000,000 multi-option credit facility with a syndicate of two Canadian banks for the expansion of restaurant operations.

The amended facility is comprised of the following three components:

- i. A \$16,000,000 term facility for KRL's existing Canadian debt. Interest only payments are required monthly on the outstanding principal balance until December 30, 2007, when principal payments are also required according to the following schedule:

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October 2007 – September 2008 .....	\$ 2,000
October 2008 – September 2009 .....	4,000
October 2009 – September 2009 .....	6,000
October 2010 – March 2011 .....	4,000

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- ii. An available \$12,000,000 revolving facility for future restaurant expansion which is subject to annual repayment based on 25% of excess operating cash flow beginning in KRL's financial year ending in 2008. Excess operating cash flow is defined as operating cash flow for the financial year plus extraordinary or non-recurring items and any net decrease in working capital less interest paid, debt principal repayments, unfunded capital expenditures, income taxes paid and any net increase in working capital. Operating cash flow is defined as the sum of net income for the financial year, adjusted for gains or losses from dispositions not in the ordinary course of business, extraordinary or non-recurring items and equity income or losses from subsidiaries plus interest expense, income tax expense and depreciation and amortization.

Any remaining outstanding principal balance is due when the facility is scheduled to mature on April 3, 2011.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars, except unit amounts)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 8. LONG-TERM DEBT (CONTINUED):

(a) Canadian bank debt (continued):

iii. A revolving demand operating facility of up to \$2,000,000 available for general corporate purposes, including working capital, overdrafts and letters of credit.

All of the above facilities bear interest at a rate between bank prime to bank prime plus 1.50% based on certain financial criteria. As at October 1, 2006, KRL meets the criteria for interest at bank prime.

The above credit facilities are secured by a general security agreement and hypothecation over KRL's Canadian assets, a limited recourse personal guarantee from the sole shareholder of KRL and a pledge of all equity interests in the Partnership.

(b) G.E. Capital Debt:

The G.E. Capital debt is repayable in fixed monthly installments, including interest at rates varying from 7.43% to 9.25%, is secured by certain property, plant and equipment in the states of Washington, Texas, Colorado and Arizona and continues to be used for the expansion of restaurant operations in the United States.

Future minimum principal payments as at October 1, 2006, under the long-term debt agreements, are as follows:

2007 .....	\$	1,081
2008 .....		3,280
2009 .....		5,240
2010 .....		7,246
2011 .....		5,269
Thereafter .....		<u>5,709</u>
	\$	<u>27,825</u>

### 9. EXCHANGEABLE UNITS:

KRL holds the following Partnership units which are exchangeable for Fund units:

	October 1, <u>2006</u>	October 2, <u>2005</u>
Class A units (a) .....	905,944	905,944
Entitled Class B units (b) .....	<u>1,395,982</u>	<u>1,196,710</u>
	<u>2,301,926</u>	<u>2,102,654</u>

(a) Class A units:

The Class A units are entitled to a preferential proportionate distribution equal to the distribution on the Class C units (note 7), multiplied by the number of Class A units, divided by the number of Limited Partnership units issued and outstanding. The Keg Holdings Trust ("KHT"), a wholly-owned subsidiary of the Fund, holds all of the 8,153,500 Limited Partnership units issued and outstanding at October 1, 2006.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 9. EXCHANGEABLE UNITS (CONTINUED):

(a) Class A units (continued):

In addition, the Class A units receive a residual distribution proportionately with the Class B units, Limited Partnership units and General Partnership units relative to the aggregate number of each class issued and outstanding (or in the case of Class B units, the number issued and outstanding multiplied by the Class B current distribution entitlement). Class A units are exchangeable for units of the Fund on the basis of one Fund unit for one Class A unit.

(b) Entitled Class B units:

The Class B units are entitled to a preferential proportionate distribution and a residual distribution based on the amount of incremental royalties paid to the Partnership from new Keg restaurants. The distribution entitlements of the Class B units are adjusted annually on January 1. Class B units are exchangeable for Fund units based upon a defined calculation that itself is based on net sales from new restaurants and approximates one Fund unit for one Class B unit (note 10).

KRL also holds 1,080,718 Class B units which are not yet entitled to receive distributions from the Partnership.

KRL's investment in Class A and Class B units are eliminated on consolidation of the Partnership.

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

	October 1, <u>2006</u>	October 2, <u>2005</u>
Cash proceeds received on sale of Keg Rights .....	\$ 30,487	\$ 30,487
Fund units received on exchange of Class B Partnership units .....	9,912	2,548
Disposition costs .....	<u>(322)</u>	<u>(322)</u>
	40,077	32,713
The Fund's 79.73% ownership interest (October 2, 2005 – 79.99%) .....	<u>(16,280)</u>	<u>(16,333)</u>
	23,797	16,380
Accumulated amortization .....	<u>(674)</u>	<u>(446)</u>
	<u>\$ 23,123</u>	<u>\$ 15,934</u>

The deferred gain on sale of intangible assets is adjusted to reflect changes in the Fund's ownership interest in the Keg Rights held by the Partnership resulting from the entitlement of certain Partnership units held by KRL as consideration for the addition of new restaurants to the Royalty Pool and the exchange of certain Partnership units by KRL for Fund units.

Annually, on January 1, the Royalty Pool is adjusted to include the gross sales from new Keg restaurants that have opened on or before October 2 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 each year when the actual full year performance of the new restaurants is known with certainty.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 10. DEFERRED GAIN ON SALE OF INTANGIBLE ASSETS (CONTINUED):

The total number of Keg restaurants included in the Royalty Pool increased from the 80 Keg restaurants in existence on March 31, 2002, to 86 as of December 31, 2005. Fourteen new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2004, with annual gross sales of \$66.1 million, have been added to the Royalty Pool. Eight permanently closed Keg restaurants with annual sales of \$18.8 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$47.3 million annually and KRL receiving a cumulative Additional Entitlement equivalent to 1,621,730 Fund units as of December 31, 2005.

On January 1, 2006, seven new Keg restaurants that opened during the period from October 3, 2004 to October 2, 2005 were added to the Royalty Pool. The gross sales of these seven new restaurants have been estimated at \$30.7 million annually. Two permanently closed Keg restaurants with annual sales of \$6.0 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$24.7 million annually. The total number of restaurants in the Royalty Pool has increased to 91. The yield of the Fund Units was determined to be 8.19% calculated using a weighted average unit price of \$13.21.

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 842,815 Fund units, being 7.31% of the Fund units on a fully diluted basis. On January 1, 2006, KRL received 80% of this entitlement representing the equivalent of 674,252 Fund units, being 5.94% 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 Additional Entitlement described above, KRL has the right to exchange its units in the capital of the Partnership for 2,301,926 Fund units, representing 20.27% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted on December 31, 2006 to be effective January 1, 2006 once the actual performance of the new restaurants has been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2006, it would have the right to exchange its Partnership Units for 2,470,489 Fund units, representing 21.44% of the Fund units on a fully diluted basis.

On March 9, 2006, KRL exchanged 650,000 Class B units of the Partnership (July 4, 2005 – 250,000) for an equal amount of Fund units. Thereafter, on March 14, 2006, KRL sold these 650,000 Fund units (July 6, 2005 – 250,000) through the facilities of the Toronto Stock Exchange.

A gain on the sale of the Fund units was realized as follows:

	52 weeks ended October 1, <u>2006</u>	52 weeks ended October 2, <u>2005</u>
Gross proceeds .....	\$ 8,126	\$ 3,280
Weighted average cost .....	(7,364)	(2,548)
Transaction costs .....	<u>(49)</u>	<u>(46)</u>
	<u>\$ 713</u>	<u>\$ 686</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 11. NON-CONTROLLING INTEREST:

	October 1, <u>2006</u>	October 2, <u>2005</u>
The Fund's ownership interest in the Keg Rights (note 10) .....	\$ 16,280	\$ 16,333
Non-controlling interest in earnings of the Partnership, net of distributions declared, beginning of the period .....	334	408
Non-controlling interest in earnings of the Partnership .....	6,883	5,534
Distributions declared on Partnership units held by non-controlling interest .....	<u>(6,723)</u>	<u>(5,608)</u>
	<u>\$ 16,774</u>	<u>\$ 16,667</u>

  

	52 weeks ended October 1, <u>2006</u>	52 weeks ended October 2, <u>2005</u>
Partnership royalty income .....	\$ 14,508	\$ 12,785
Partnership expenses .....	<u>(440)</u>	<u>(445)</u>
Net earnings of the Partnership for the period .....	14,068	12,340
KRL's interest .....	<u>(7,185)</u>	<u>(6,806)</u>
Non-controlling interest in Partnership earnings .....	<u>\$ 6,883</u>	<u>\$ 5,534</u>

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. KRL's interest includes its entitlement on Class C units. The non-controlling interest in Partnership earnings does not include the interest paid to the Fund by KRL on the \$57,000,000 note payable (note 7).

### 12. RELATED PARTY TRANSACTIONS:

KRL provided services to Hy's of Canada Ltd. ("Hy's"), a company partially owned by the sole shareholder of KRL, under the terms of a management agreement. The charge for these services for the 52 weeks ended October 1, 2006, which amounted to \$200,000 (52 weeks ended October 2, 2005 - \$200,000), is recorded as a reduction in general and administrative expenses. The \$622,398 total amount owing from Hy's as at October 1, 2006 (\$1,360,038 - October 2, 2005) is included in accounts receivable.

The amounts due to related parties are working capital items owing to the Fund or its subsidiaries and are in the normal course of operations.

At October 1, 2006, \$275,000 (October 2, 2005 - \$368,000) due to the shareholder of KRL is included in accounts payable and accrued liabilities.

The prior year amount due to a related company controlled by the shareholder of KRL is a result of advances received for the expansion of restaurant operations and is without interest or fixed terms of repayment. KRL also provides services to this company under the terms of a management agreement. The charge for these services for the 52 weeks ended October 1, 2006, which amounted to \$100,000 (52 weeks ended October 2, 2005 - \$100,000), is recorded as a reduction in general and administrative expenses.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 13. SHARE CAPITAL:

Authorized:

1,000 common shares with a par value of \$1 per share.

October 1,	October 2,
<u>2006</u>	<u>2005</u>

Issued:

100 common shares .....	\$ <u>1</u>	\$ <u>1</u>
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### 14. COMMITMENTS AND CONTINGENT LIABILITIES:

(a) Operating leases:

Minimum rentals under head leases extending to the year 2023 (excluding CPI adjustment factors and rentals based on sales) are approximately as follows:

	<u>Total</u>	<u>Sub-lease reimbursement</u>	<u>Net</u>
2007 .....	\$ 11,169	\$ (1,908)	\$ 9,261
2008 .....	11,426	(1,709)	9,717
2009 .....	9,906	(1,195)	8,711
2010 .....	7,894	(714)	7,180
2011 .....	6,911	(540)	6,371
Thereafter .....	39,730	(628)	39,102

Under the terms of certain lease agreements, KRL is contingently liable to the landlord for any default in payment by sub-lessees. At October 1, 2006, substantially all sub-lease accounts were current.

(b) Contingent liabilities:

- i. KRL has been named as a defendant in various lawsuits that are currently pending. In those cases where an unfavourable outcome is likely, a provision for anticipated costs has been accrued. In determining the estimated exposure for pending lawsuits, KRL relies upon their understanding of the claim, including activities undertaken by the other party, as well as discussions with legal counsel. In the opinion of management, the remaining lawsuits are without substantial merit and no provision has been made for them.
- ii. KRL has issued letters of credit, in the normal course of business, totalling Cdn\$353,000 and US\$15,000. At October 1, 2006 these amounts are covered by the \$2,000,000 operating credit facility described in note 8(a)(iii).
- iii. As of October 1, 2006, KRL has guaranteed lease obligations of certain franchises in the amount of \$7,928,766 with lease terms extending until 2021. The principals of these franchises have given KRL personal guarantees and full indemnities for any and all costs related to the leases.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 15. JOINT VENTURE:

KRL has a 50% investment in an incorporated joint venture, Sedan (Coquitlam) Enterprises Ltd. Earnings and distributions to the participants are based on their proportionate interest in the joint venture. KRL's share of income from the joint venture for the 52 weeks ended October 2, 2005 was \$110,000 (52 weeks ended October 2, 2005 – \$70,000); KRL's share of sales was \$1,497,000 (52 weeks ended October 2, 2005 – \$1,548,000).

### 16. FINANCIAL INSTRUMENTS:

(a) Fair value:

KRL's financial instruments include cash, accounts receivable, notes receivable, accounts payable and accrued liabilities and long-term debt. The carrying values of these instruments approximate their fair values. Due to the interrelationship between the note payable to Fund and the Class C units described in note 7, it is not practical to estimate the fair value of the note payable with sufficient reliability.

(b) Interest rate risk:

Interest on KRL's long-term debt is based on both fixed and variable rates and exposes KRL to interest rate risk. KRL has not entered into any derivative agreements to mitigate this risk.

(c) Concentration of credit risk:

KRL's revenues are generated from restaurant sales, which are not significantly exposed to credit risk due to their immediate or short-term nature of collection. In addition, as these sales are from restaurants that are geographically dispersed and to a large number of individual customers, concentration of credit risk is considered to be limited.

(d) Exchange risk:

KRL is exposed to currency exchange risk as a result of its operations in the United States. To manage its exchange risk, KRL's subsidiary in the United States, Keg Restaurants U.S., Inc., has entered into financing arrangements in United States dollars. KRL has not entered into any derivative agreements to further mitigate this risk.

### 17. 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)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### 18. SEGMENT DISCLOSURES:

KRL's principal business activity is the operation and franchising of Keg steakhouse restaurants and bars in Canada and the United States; as a result, KRL is considered to operate in only one reportable segment.

Geographic information:	52 weeks ended October 1, 2006	52 weeks ended October 2, 2005
Restaurant sales:		
Canada .....	\$ 131,162	\$ 117,845
United States .....	<u>60,033</u>	<u>60,604</u>
	<u>\$ 191,195</u>	<u>\$ 178,449</u>
Franchise fee revenue:		
Canada .....	\$ 9,026	\$ 7,851
United States .....	<u>82</u>	<u>86</u>
	<u>\$ 9,108</u>	<u>\$ 7,937</u>
	October 1, 2006	October 2, 2005
Property, plant and equipment:		
Canada .....	\$ 30,489	\$ 30,374
United States .....	<u>19,212</u>	<u>18,989</u>
	<u>\$ 49,701</u>	<u>\$ 49,363</u>

### 19. SUPPLEMENTARY CASH FLOW INFORMATION:

	52 weeks ended October 1, 2006	52 weeks ended October 2, 2005
(a) Change in non-cash operating working capital:		
Accounts receivable .....	\$ 651	\$ (505)
Inventories .....	(50)	(236)
Prepaid expense and deposits .....	876	(345)
Due to related parties .....	50	341
Accounts payable and accrued liabilities .....	1,284	(826)
Unearned revenue .....	1,646	494
Cumulative translation adjustment .....	<u>206</u>	<u>520</u>
	<u>\$ 4,663</u>	<u>\$ (557)</u>
(b) Supplementary information:		
Interest received .....	\$ 352	\$ 86
Interest paid .....	6,466	5770
Income taxes paid .....	13	12
Non-cash transactions:		
Exchange of Class B units for Fund units .....	7,364	2,548

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Tabular amounts expressed in thousands of dollars)

52 weeks ended October 1, 2006

52 weeks ended October 2, 2005

### **20. COMPARATIVE FIGURES:**

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