



**ALLIED PROPERTIES REAL ESTATE INVESTMENT TRUST**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

**JUNE 30, 2006**

**DATED AUGUST 9, 2006**

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## PART I

### Forward-Looking Disclaimer

The terms “Allied Properties”, “the REIT”, “we”, “us” and “our” in the following Management’s Discussion and Analysis of Results of Operations and Financial Condition (“MD&A”) refer to Allied Properties Real Estate Investment Trust and its consolidated financial position and results of operations for the period ended June 30, 2006. This MD&A should be read in conjunction with our consolidated financial statements and notes thereto for the period ended June 30, 2006, and for the year ended December 31, 2005. Historical results and percentage relationships contained in our consolidated financial statements and MD&A, including trends which might appear, should not be taken as indicative of our future results, operations or performance. Unless otherwise indicated, dollar amounts in this MD&A are in thousands.

Certain information included in this MD&A contains forward-looking statements within the meaning of applicable securities laws, including, among other things, statements concerning our objectives and our strategies to achieve those objectives, statements with respect to Management’s beliefs, plans, estimates and intentions and statements concerning anticipated future events, circumstances, expectations, results, operations or performance that are not historical facts. Forward-looking statements can be identified generally by the use of forward-looking terminology, such as “indicators”, “outlook”, “objective”, “may”, “will”, “expect”, “intend”, “estimate”, “anticipate”, “believe”, “should”, “plans”, “continue” or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect Management’s current beliefs and are based on information currently available to Management.

The forward-looking statements in this MD&A are not guarantees of future results, operations or performance and are based on estimates and assumptions that are subject to risks and uncertainties, including those described below in this MD&A under “Risks and Uncertainties”, which could cause actual results, operations or performance to differ materially from the forward-looking statements in this MD&A. Those risks and uncertainties include risks associated with property ownership, geographic focus, asset-class focus, competition for real property investments, financing and interest rates, government regulations, environmental matters, construction liability and unitholder liability. Material assumptions that were made in formulating the forward-looking statements in this MD&A include the following: that the general economy remains stable; that the REIT’s current target markets remain stable; that interest rates and capitalization rates are stable; and that the equity and debt markets continue to provide access to capital. Although the forward-looking statements contained in this MD&A are based on what Management believes are reasonable assumptions, there can be no assurance that actual results, operations or performance will be consistent with these statements.

All forward-looking statements in this MD&A are qualified by this forward-looking disclaimer. These statements are made as of August 9, 2006, and, except as required by applicable law, we undertake no obligation to update publicly or revise any such statements to reflect new information or the occurrence of future events or circumstances.

**August 9, 2006**

## Business Overview and Strategy

The REIT is an unincorporated closed-end real estate investment trust created pursuant to the Declaration of Trust dated October 25, 2002, as amended and restated on February 6, 2003 (“Declaration”). The REIT is governed by the laws of Ontario. The units of the REIT are publicly traded on the Toronto Stock Exchange under the symbol AP.UN. Additional information relating to the REIT is available on SEDAR at [www.sedar.com](http://www.sedar.com).

The objectives of the REIT are to provide stable and growing cash distributions to its unitholders and to maximize unitholder value through the effective management and the accretive growth of its portfolio.

### Property Portfolio

The REIT completed its Initial Public Offering (“IPO”) on February 20, 2003. The REIT used the net proceeds of the IPO to acquire a portfolio of 14 predominantly Class I office properties in downtown Toronto with approximately 820,000 square feet of gross leasable area (“GLA”). By the end of 2005, the REIT had acquired another 20 office properties in downtown Toronto, 19 of them Class I office properties, bringing its total GLA in that market to just under two million square feet. The REIT had also acquired two Class I office properties in downtown Montreal and one in downtown Winnipeg, bringing its total portfolio at the end of 2005 to 37 properties with 2.32 million square feet of GLA.

The REIT has made the following acquisitions in 2006, bringing the portfolio to 41 properties with over 2.5 million square feet of GLA:

Class I Office Property	Acquired	Office GLA	Retail GLA	Total GLA
4446 Saint Laurent Boulevard, Montreal	April 5, 2006	72,613	10,000	82,613
364 Richmond Street West, Toronto	May 2, 2006	21,300	17,300	38,600
257 Adelaide Street West, Toronto	June 28, 2006	40,050	5,843	45,893
400 Atlantic Avenue, Montreal	July 14, 2006	86,034	0	86,034
Total		219,997	33,143	253,140

Class I office properties are created through the adaptive re-use of light industrial structures in urban areas. They typically feature high ceilings, abundant natural light, post and beam structural frames, exposed interior brick and hardwood floors. When restored and retrofitted to the standards of the REIT’s portfolio, Class I buildings can satisfy the needs of the most demanding office and retail tenants. When operated in the coordinated manner of REIT’s portfolio, these buildings become a vital part of the urban fabric and contribute meaningfully to a sense of community.

The REIT’s portfolio accommodates a diverse base of tenants. In 2005, business-service tenants represented 34% of the REIT’s gross revenue, retail tenants 20%, telecommunications and IT tenants 15%, media and entertainment tenants 13%, financial-service tenants 12%, government tenants 2% and other tenants 4%.

The REIT has become a leading provider of Class I office and ancillary retail space in Canada and intends to build on this advantage by continuing to make coherent office property acquisitions in its target markets. In doing so, the REIT will strive to enhance on an ongoing basis the quantity and quality of its net rental revenue.

Three Toronto properties, QRC South (103 Richmond Street East), 145 Berkeley Street and 257 Adelaide Street West, and one Montreal property, the land adjacent to 4446 Saint Laurent Boulevard, are properties under development (“Properties Under Development” or “PUD”), in that they are undergoing the development or redevelopment necessary to function as high quality, income-producing, Class I office properties. Properties Under Development are stated at the lower of cost and net recoverable value. Cost includes the cost of acquisition, other direct cost, realty tax, other operating expense and applicable financing expense during the development period, less the amount of operating revenue during the development period. The principal factors in determining when the redevelopment-period ends are (i) the achievement of positive cash flow after applicable interest expense and (ii) the passage of a predetermined period of time. Other criteria may be considered in determining when a redevelopment-period ends if warranted by circumstances relating to the relevant Property Under Development.

The REIT has an option agreement (“Option Agreement”) with Allied Canadian Development Corporation (“Developer”), a leading developer of Class I office properties, pursuant to which the Developer must offer to sell to the REIT at fair market value all developed or redeveloped office properties upon substantial completion. Three of the properties in the REIT’s portfolio were acquired pursuant to the Option Agreement.

The REIT’s portfolio has operated stably. The chart below summarizes the levels of GLA and leased area in the portfolio since the REIT’s IPO:

	IPO	Dec. 31, 2003	Dec. 31, 2004	Dec. 31, 2005	June 30, 2006
GLA (square feet)	820,120	984,856	1,636,343	2,321,507	2,488,613
% leased	96.9	97.5	99.2	97.0*	98.3*

\*not including Properties Under Development

Stable portfolio operations and manageable growth in assets have enabled the REIT to achieve its overriding objective of providing regular and growing cash distributions to its unitholders. The chart below summarizes the annualized cash distribution level and the total annual return for each fiscal year since the REIT’s IPO and for the period ended June 30, 2006:

	Dec. 31, 2003	Dec. 31, 2004	Dec. 31, 2005	June 30, 2006
Distribution level per unit annualized	\$1.10	\$1.14	\$1.18	\$1.22
Total return with reinvestment through DRIP	40.7%	17.6%	32.3%	8.2%
Total return without reinvestment	38.0%	16.2%	31.3%	8.1%

### ***Property Management***

Effective July 1, 2005, the REIT’s wholly owned subsidiary, Allied Properties Management Limited Partnership (“Property Manager”), completed the acquisition of the property management business of the Developer. In addition to providing property management and related services in connection with the REIT’s portfolio, the Property Manager provides property management and related services to third-party property owners on a fee-for-service basis.

### **Performance Indicators**

The REIT measures the long-term success of its strategies through key financial and operating performance indicators.

#### ***Financial Indicators***

##### **1. Distributions**

The REIT is focused on increasing distributions to its unitholders on a regular and prudent basis. During its first 12 months of operations, the REIT made regular monthly distributions of \$1.10 per unit on an annualized basis. In March of 2004, the REIT increased its monthly distributions by 3.6% to \$1.14 per unit on an annualized basis. In March of 2005, the REIT increased its monthly distributions by 3.5% to \$1.18 per unit on an annualized basis. In March of 2006, the REIT increased its monthly distributions by 3.4% to \$1.22 per unit on an annualized basis.

##### **2. Distributable Income**

Increasing distributions can be achieved prudently by increasing Distributable Income (“DI”), as defined in the Declaration. See “Distributable Income” below. In 2005, DI per unit (diluted) was \$1.339 per unit, up 2.2% from 2004. In the first half of 2006, DI per unit (diluted) was \$0.704, up 6.8% from the first half of 2005.

### 3. DI Pay-Out Ratio

To ensure it retains sufficient cash to meet its capital improvement and leasing objectives, the REIT will strive to maintain an appropriate DI pay-out ratio, the ratio of actual distributions to DI in a given period. In 2005, the REIT achieved a DI pay-out ratio of 87.9%. In the first half of 2006, the REIT achieved a DI pay-out ratio of 85.2%.

### 4. Adjusted Funds From Operations

Increasing distributions cannot be achieved prudently without reference to adjusted funds from operations ("AFFO"), as this financial indicator takes account of maintenance capital expenditures and regular leasing expenditures while ignoring the impact of step-rent revenue. See "Adjusted Funds from Operations" below. In 2005, AFFO per unit (diluted) was \$1.217 per unit, up 8.8% from 2004. In the first half of 2006, AFFO per unit (diluted) was \$0.626, up 6.6% from the first half of 2005.

### 5. AFFO Pay-Out Ratio

To ensure it retains sufficient cash to meet its capital improvement and leasing objectives, the REIT will strive to maintain an appropriate AFFO pay-out ratio, the ratio of actual distributions to AFFO in a given period. In 2005, the REIT achieved an AFFO pay-out ratio of 96.7%. In the first half of 2006, the REIT achieved an AFFO pay-out ratio of 95.7%.

### 6. Debt Ratio

Gross Book Value ("GBV") is defined as the book value of the assets of the REIT shown on the most recent balance sheet plus accumulated depreciation and amortization and an amount equal to the property management internalization expense recorded by the REIT in the year ended December 31, 2005. A conservative ratio of debt to GBV ("Debt Ratio") mitigates unitholder risk. At the end of 2005, the Debt Ratio was 51.0%. As at June 30, 2006, the Debt Ratio was 53.2%.

### 7. Interest Coverage Ratio

The ratio of EBITDA to interest expense ("Interest Coverage Ratio") is as important a financial indicator as the Debt Ratio. A high Interest Coverage Ratio mitigates unitholder risk. At the end of 2005, the Interest Coverage Ratio was 3.4:1. As at June 30, 2006, the Interest Coverage Ratio was 3.0:1.

## ***Operating Indicators***

### 1. Tenant Retention and Replacement

The REIT places a high value on tenant retention, as the cost of retention is typically lower than the cost of securing new tenancies. If retention is neither possible nor desirable, the REIT will strive for high-quality replacement tenants. Leases representing 272,103 square feet of GLA mature in 2006. By the end of the first half of 2006, the REIT had renewed leases representing 138,326 square feet of this GLA and re-leased another 86,541 square feet of this GLA, representing 82.4% of the GLA covered by the maturing leases. It had also renewed leases representing 32,877 square feet of GLA maturing in 2007 and 51,764 square feet of GLA maturing in 2009.

### 2. Occupancy

The REIT strives to maintain consistently high levels of occupancy. At the end of 2005, the REIT's leased area was 97.0% (not including Properties Under Development). By the end of the first half of 2006, the REIT's leased area was 98.3% (not including Properties Under Development).

### 3. Same-Asset Net Operating Income

The REIT strives to maintain or increase same-asset net operating income over time. Same-asset refers to those properties that were owned and operated by the REIT for the entire period in question and for the same period in the prior year. Ignoring the step-rent revenue and the amortization of the fair value assigned to above-market and below-market rents with respect to acquired properties (the marked-to-market rent adjustment), same-asset net operating income was \$15,068 in the first half of 2006, up 5.9% from the first half of 2005.

### 4. Leasing Expenditures

The REIT monitors leasing expenditures carefully. 188,959 square feet of the GLA leased by the end of the first half of 2006 involved (i) the lease of originally vacant space that commenced in the first half of

2006 and (ii) the renewal or replacement of leases that matured in the first half of 2006. \$1,032 of the leasing expenditures incurred or committed to by the end of the first half of 2006 relate to this space. This represents \$5.46 per leased square foot.

#### 5. Capital Expenditures

The REIT strives to maintain the properties in its portfolio in top physical condition. In the first half of 2006, the REIT incurred \$520 in maintenance capital expenditures. This represents \$0.23 per square foot of the REIT's portfolio at the outset of 2006.

#### Summary

The following table summarizes the key financial and operating performance indicators for the first half of 2006 and the first half of 2005, as well as the change between the two.

	First Half 2006	First Half 2005	Change
Period-end distribution level per unit annualized	\$1.22	\$1.18	\$0.04
DI per unit (diluted)	\$0.704	\$0.659	\$0.045
DI pay-out ratio	85.2%	89.6%	(4.4%)
AFFO per unit (diluted)	\$0.626	\$0.587	\$0.039
AFFO pay-out ratio	95.7%	100.7%	(5.0%)
Debt Ratio	53.2%	44.8%	8.4%
Interest Coverage Ratio	3.0:1	3.2:1	(0.2:1)
Renewal/replacement % of leases maturing in year	82.4%	49.0%	33.4%
Period-end leased area (not including PUD)	98.3%	97.9%	0.4%
Same-asset net operating income	\$15,068	\$14,235	\$833
Leasing expenditures	\$1,032	\$1,133	(\$101)
Leasing expenditures per leased square foot	\$5.46	\$11.37	(\$5.91)
Maintenance capital expenditures	\$520	\$182	\$338
Maintenance capital expenditures per portfolio square foot	\$0.23	\$0.11	\$0.12

#### Business Environment and Outlook

The REIT's target market in downtown Toronto includes 14 million square feet of office inventory in two sub-markets, Downtown East (2.1 million square feet), Downtown West (10 million square feet) and King West (1.9 million square feet). Approximately half of office inventory in the Toronto target market falls within the Class I category.

The REIT's target market in downtown Montreal includes 13.3 million square feet of office inventory in three sub-markets, Downtown East (5.8 million square feet) and Old Montreal (7.5 million square feet). Over half of the office inventory in the Montreal target market falls within the Class I category.

The REIT's target market in downtown Winnipeg includes 1.8 million square feet of office inventory, principally in the Exchange District. Most of the office inventory in the Winnipeg target market falls within the Class I category.

The downtown Toronto office market strengthened in 2005, with the overall vacancy rate declining to 9.2% and the Class I category recording positive absorption of 257,946 square feet.<sup>1</sup> The strengthening continued into the first half of 2006, with the overall vacancy rate declining to 9.0% and the Class I category recording positive absorption of 158,026 square feet.<sup>2</sup>

The downtown Montreal office market strengthened modestly in 2005, with the overall vacancy rate declining to 12.7% and the Old Montreal sub-market recording positive absorption of 15,215 square feet.<sup>3</sup> This strengthening continued into the first quarter of 2006, with the overall vacancy rate declining to 11.6% and the Old Montreal sub-market recording positive absorption of 100,237 square feet.<sup>4</sup>

The Winnipeg office market was stable in 2005, with a year-end vacancy rate of 7.8%.<sup>5</sup> While Class I office space is not tracked separately in Winnipeg, Colliers International observed that “businesses continue to be lured to renovated historic buildings in the Exchange area in downtown Winnipeg.”<sup>6</sup>

Demand for office space in the REIT’s principal target markets is strengthening. This is particularly pronounced in the REIT’s Toronto target market, where overall occupancy levels and rent levels are expected to rise over the remainder of 2006.<sup>7</sup> The state of the REIT’s target markets, the quality of the REIT’s portfolio and the capabilities of the REIT’s personnel afford Management a reasonable basis for confidence in the REIT’s near-term performance. The REIT intends to continue the acquisition of Class I and other office properties in its target markets.

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<sup>1</sup> Colliers International, *Greater Toronto Office Quarterly Update, Fourth Quarter 2005*.

<sup>2</sup> Colliers International, *Greater Toronto Office Quarterly Update, Second Quarter 2006*.

<sup>3</sup> Colliers International, *Greater Montreal Office Quarterly Update, Fourth Quarter 2005*.

<sup>4</sup> Colliers International, *Greater Montreal Office Quarterly Update, First Quarter 2006*.

<sup>5</sup> Colliers International, *Winnipeg Year-End Office Report, December 2005*.

<sup>6</sup> Colliers International, *Winnipeg Year-End Office Report, December 2005*.

<sup>7</sup> Colliers International, *Greater Toronto Office Quarterly Update, Second Quarter 2006*.

## PART II

### Summary Information and Performance for the Period ended June 30, 2006

The following sets out summary information and financial results for the period ended June 30, 2006, and the comparable period in 2005 and the change between the two.

(In thousands except for per unit and % amounts)	H1 2006	H1 2005	Change	%Change
Revenue from rental properties	30,410	24,057	6,353	26.4%
Rental property operating cost	10,928	8,677	2,251	25.9%
Net rental income	19,482	15,380	4,102	26.7%
Real estate service income	213	-	213	-
Financing expense				
Interest	6,265	4,690	1,575	33.6%
Amortization - Mortgage premium	(96)	(203)	107	(52.7%)
Depreciation and amortization				
Rental properties	3,613	2,830	783	27.7%
Deferred leasing cost and tenant improvements	525	252	273	108.3%
Origination cost and acquired tenant relationships	3,707	2,068	1,639	79.3%
Acquired contracts and customer relationships	48	-	48	-
Deferred financing cost	125	96	29	30.2%
Computer and office equipment	16	-	16	-
Income from operations	5,492	5,647	(155)	(2.7%)
Trust expense	1,285	966	319	33.0%
Property management internalization expense	-	-	-	-
Net income	4,207	4,681	(474)	(10.1%)
Amortization				
Rental properties	3,613	2,830	783	27.7%
Mortgage premium	(96)	(203)	107	(52.7%)
Acquired leases	1,271	914	357	39.1%
M-T-M acquired leases	156	48	108	225.0%
Acquired tenant relationships	2,435	1,154	1,281	110.0%
Acquired contracts and customer relationships	48	-	48	-
Step-rent adjustments	(564)	(755)	191	(25.3%)
Property management internalization expense	-	-	-	-
LTIP compensation expense	270	109	161	147.7%
DI	11,340	8,778	2,562	29.2%
Weighted average units outstanding (basic)	15,829	13,082	2,747	21.0%
Weighted average units outstanding (diluted)	16,116	13,314	2,802	21.0%
Distributions	9,659	7,866	1,793	22.8%
DI per unit (basic)	\$0.716	\$0.671	\$0.045	6.7%
DI per unit (diluted)	\$0.704	\$0.659	\$0.045	6.8%
DI pay-out ratio	85.2%	89.6%	(4.4%)	
FFO	12,052	9,831	2,221	22.6%
FFO per unit (basic)	\$0.761	\$0.751	\$0.010	1.3%
FFO per unit (diluted)	\$0.748	\$0.738	\$0.010	1.4%
FFO pay-out ratio	80.1%	80.0%	0.1%	
AFFO	10,092	7,809	2,283	29.2%
AFFO per unit (basic)	\$0.638	\$0.597	\$0.041	6.9%
AFFO per unit (diluted)	\$0.626	\$0.587	\$0.039	6.6%
AFFO pay-out ratio	95.7%	100.7%	(5.0%)	
Net operating income	19,074	14,673	4,401	30.0%
Same-asset net operating income	15,068	14,235	833	5.9%
Total assets	\$405,827	\$309,822	\$96,005	31.0%
Total debt (excludes premium on assumed debt)	\$224,498	\$144,596	\$79,902	55.3%
Debt to GBV	53.2%	44.8%	8.4%	
Total GLA (s.f., excluding PUD)	2,387	1,925	462	24.0%
Leased GLA (s.f., excluding PUD)	2,346	1,885	461	24.5%
Leased GLA (% total GLA)	98.3%	97.9%	0.4%	

Net income for the period ended June 30, 2006, was \$4,207, as compared to net income of \$4,681 in the period ended June 30, 2005. Net income per unit (diluted) for the period was \$0.261, as compared to net income per unit (diluted) of \$0.352 in the comparable period.

DI for the period ended June 30, 2006, increased by 29.2% to \$11,340 from \$8,778 for the period ended June 30, 2005. DI per unit (diluted) for the period was \$0.704, as compared to \$0.659 in the comparable period.

### **Net Rental Income**

Net rental income for the period ended June 30, 2006, increased by 26.7% to \$19,482 from \$15,380 in the period ended June 30, 2005, as follows:

- (i) \$3,392 due to net rental income from properties not owned for the entire period and the entire comparable period;
- (ii) \$855 due to the internalization of the property management function; and
- (iii) offset by \$145 due to the decrease in same-asset net rental income from properties owned for the entire period and the entire comparable period.

Net rental income per occupied square foot for the period ended June 30, 2006, was \$8.30 (\$16.60 annualized), as compared to \$8.16 (\$16.32 annualized) in the period ended June 30, 2005.

### **Real Estate Service Income**

The Property Manager provides real estate services to third-party property owners. Real estate service income for the period ended June 30, 2006, was \$213, as compared to nil in the period ended June 30, 2005.

### **Property Management Internalization**

The economic benefit of the property management internalization for the period ended June 30, 2006, is summarized in the following table:

(In thousands)	First Half 2006
Increase in net rental income	\$855
Real estate service income	213
Reduction in leasing expenditures payable as leasing fees	394
Reduction in capital expenditures payable as project management fees	70
<b>Total</b>	<b>\$1,532</b>

This exceeds Management's expectations for the period.

### **Financing Expense**

Financing expense includes interest cost on mortgage debt and other credit facilities and the amortization of the premiums and discounts on assumed mortgages. The amortization of the premiums and discounts on assumed mortgages reduced financing expense by \$96 in the period ended June 30, 2006.

Financing expense for the period ended June 30, 2006, increased by 37.5% to \$6,169 from \$4,487 in the period ended June 30, 2005, due to the increase in financing expense associated with additional properties acquired in 2005 and during the period ended June 30, 2006.

### **Depreciation and Amortization**

The REIT records depreciation on its buildings on a straight-line basis over their expected life. Depreciation recorded on buildings for the period ended June 30, 2006, increased by 27.7% to \$3,613 from \$2,830 in the period ended June 30, 2005.

The REIT records amortization of deferred leasing cost, tenant improvements and the assigned fair value of the origination cost and tenant relationships for in-place leases acquired on acquisition of a rental

property on a straight-line basis over the term of the corresponding lease. Deferred financing cost is amortized on a straight-line basis over the term of the corresponding debt.

### **Trust Expense**

Trust expense includes cost incurred by the REIT that is not directly attributable to rental property, such as officers' compensation, trustees' fees, professional fees for legal and audit services, trustees' and officers' insurance premiums and general administrative expenses.

Trust expense for the period ended June 30, 2006, increased by 33% to \$1,285 from \$966 in the period ended June 30, 2005, due to increased salary and occupancy costs and increased LTIP expense under the REIT's long-term incentive plan ("LTIP").

### **Leasing Activity**

Leasing activity as at June 30, 2006, is summarized in the following table:

	<b>Vacant or Maturing</b>	<b>Leased End H1</b>	<b>% Leased End H1</b>	<b>Vacant End H1*</b>
Vacant GLA on January 1, 2006*	68,666	39,569	56%	29,097
Vacant GLA on acquisition in 2006	3,136	-	-	3,136
GLA accessed through rationalization	19,706	19,706	100%	-
GLA maturing in first half of 2006	165,026	156,043	95%	8,983
Subtotal	256,534	215,318	84%	41,243
GLA maturing in remainder of 2006	107,977	68,824	64%	na
GLA maturing in 2007		32,877		na
GLA maturing in 2009		51,764		na
Total		153,465		

\*not including Properties Under Development

68,666 square feet of GLA were vacant at the beginning of 2006. By June 30, 2006, the REIT had leased 39,569 square feet of this originally vacant GLA, leaving 29,097 square feet vacant at the end of the period.

During the period ended June 30, 2006, the REIT acquired properties with 3,136 square feet of vacant GLA, not including Properties Under Development, of which none was leased by June 30, 2006.

6,653 square feet of the originally vacant GLA leased in the first half was in the Balfour Building in Montreal. This space, along with another 19,706 square feet of GLA in the Balfour Building that the REIT gained access to early in 2006, was leased to a single tenant for a term of 10 years commencing September 1, 2006.

Leases for 273,003 square feet of GLA mature in 2006, of which 165,026 square feet of GLA matured in the period ended June 30, 2006. By June 30, 2006, the REIT had

- (i) renewed or replaced leases representing 156,043 square feet of the GLA that matured in the period, leaving 8,983 square feet vacant at the end of the period,
- (ii) renewed or replaced leases representing 68,824 square feet of the GLA maturing in the remainder of 2006,
- (iii) renewed leases representing 32,877 square feet of GLA maturing in 2007 and
- (iv) replaced a portion of a lease representing 51,764 square feet of GLA maturing in 2009.

By June 30, 2006, the REIT had renewed or replaced leases representing 224,867 square feet of the GLA maturing in 2006. The REIT achieved rental rates

- (i) above in-place rental rates with respect to 63% of this GLA and

- (ii) equal to in-place rental rates with respect to the balance of this GLA.

### **Capital Expenditures**

The REIT's portfolio requires ongoing maintenance capital expenditures and leasing expenditures. Leasing expenditures include the cost of in-suite or base-building improvements made in connection with the leasing of vacant space or the renewal or replacement of tenants occupying space covered by maturing leases, as well as improvement allowances and commissions paid in connection with the leasing of vacant space and the renewal or replacement of tenants occupying space covered by maturing leases.

In the period ended June 30, 2006, the REIT incurred \$520 in maintenance capital expenditures (\$0.23 per portfolio square foot) and incurred or committed to \$1,032 in leasing expenditures (\$5.46 per leased square foot) in connection with (i) the lease of originally vacant space that commenced in the first half of 2006 and (ii) the renewal or replacement of leases that matured in the first half of 2006. (The REIT also committed to \$1,476 in leasing expenditures (\$9.20 per leased square foot) in connection with (i) the lease of originally vacant space that commences in the remainder of 2006 and (ii) the renewal or replacement of leases that mature in the remainder of 2006 or in 2007 or 2009.)

In the period ended June 30, 2006, the REIT incurred or committed to \$1,517 in revenue-enhancing capital expenditures in connection with base-building improvements to space that was significantly reconfigured and retrofitted to accommodate high-value new tenancies. The REIT also committed to \$492 in revenue-enhancing leasing expenditures in connection with the lease-up of space that was significantly reconfigured and retrofitted to accommodate high-value new tenancies.

### **Properties Under Development**

Management believes that the Properties Under Development represent risk-appropriate opportunities to enhance DI per unit and create value for unitholders. Management also believes that the Properties Under Development represent an opportunity to capitalize more fully on the experience and expertise of the REIT's personnel.

The REIT acquired 145 Berkeley Street, Toronto, in November of 2005 at a cost of approximately \$125 per square foot. At that time, 20% of the GLA in the property was occupied. The REIT has since increased the occupancy to 64% and is working on completing the lease-up of the remaining GLA.

The REIT acquired QRC South in November of 2005 at a cost of approximately \$95 per square foot. The property is a brick-and-beam structure that extends south from Richmond Street East through to Lombard Street and has entrances from both streets connected along the north-south axis by an open corridor. The REIT is redeveloping and marketing the property as an annex to The Queen Richmond Centre, a Class I office complex acquired by the REIT in 2004 and known as QRC. (QRC is a brick-and-beam complex that extends south from Queen Street East through to Richmond Street East and has entrances from both streets connected along the north-south axis by an open corridor.) The construction phase at QRC South is largely complete, and the re-leasing phase has commenced.

The REIT acquired 257 Adelaide Street West, Toronto, in June of 2006 at a cost of approximately \$127 per square foot. At that time, less than 60% of the GLA in the property was occupied. The REIT is working on the upgrade and lease-up of the property.

The REIT acquired approximately 5,500 square feet of land adjacent to 4446 Saint Laurent Boulevard, Montreal, in April of 2006 at a cost of \$118 per square foot. The REIT is evaluating the potential development of a 22,000 square foot building on the land to accommodate office and ancillary retail users.

### **Distributable Income**

The REIT defines DI as the net income of the REIT determined in accordance with Canadian generally accepted accounting principles ("GAAP") adjusted by adding back or deducting as required:

- (i) depreciation on rental properties;

- (ii) amortization of the premiums or discounts on assumed mortgages;
- (iii) non-cash rental revenue recorded to recognize rental income rateably over the life of each lease;
- (iv) non-cash compensation expense with respect to the LTIP;
- (v) amortization of values ascribed in a building acquisition to in-place leases and tenant relationships;
- (vi) amortization of values ascribed in a building acquisition to above-market and below-market leases;
- (vii) amortization of values ascribed in the property management internalization to acquired contracts and customer relationships; and
- (viii) property management internalization expense.

DI is a non-GAAP financial measure and should not be considered as an alternative to net income, cash flow from operations or any other measure prescribed under GAAP. The REIT considers DI to be a measure of its overall operating performance. Accordingly, DI is one of the REIT's key performance indicators.

Pursuant to the Ontario Securities Commission Revised CSA Staff Notice 52-306, the Commission recommends that distributable cash (which is synonymous with DI) be reconciled to cash flows from operating activities as presented in the consolidated financial statements. Set out below is this reconciliation.

(In thousands)	H1 2006	H1 2005
Cash from operating activities	\$11,692	\$6,922
Amortization of deferred leasing cost, tenant improvements and financing cost	(651)	(348)
Amortization of computer and office equipment	(16)	-
Amortization, other	(11)	-
Change in non-cash operating items	336	2,204
Property management internalization expense	-	-
DI	\$11,340	\$8,778

Distributions for the period ended June 30, 2006, were \$9,659, representing a DI pay-out ratio of 85.2%, as compared to distributions for the period ended June 30, 2005, of \$7,866, representing a DI pay-out ratio of 89.6%.

### Funds From Operations

Funds From Operations ("FFO") is a non-GAAP financial measure and should not be considered as an alternative to net income, cash flow from operations or any other measure prescribed under GAAP. The REIT considers FFO to be a measure of its overall operating performance, one for which there is a standardized definition. The following sets out FFO, calculated in accordance with recommendations of Real Property Association of Canada in its White Paper on Funds From Operations dated November 30, 2004.

(In thousands)	H1 2006	H1 2005
Net income	\$4,207	\$4,681
Amortization on rental properties	3,613	2,830
Amortization of deferred leasing cost and tenant improvements	525	252
Amortization of origination cost and acquired tenant relationships	3,707	2,068
FFO	\$12,052	\$9,831

Distributions for the period ended June 30, 2006, represented an FFO pay-out ratio of 80.1%, as compared to distributions for the period ended June 30, 2005, which represented an FFO pay-out ratio of 80.0%.

## Adjusted Funds From Operations

AFFO is a non-GAAP financial measure and should not be considered as an alternative to net income, cash flow from operations or any other measure prescribed under GAAP. The REIT considers AFFO to be a measure of its overall operating performance, one that is becoming more widely used by Canadian real estate investment trusts. Accordingly, AFFO is one of the REIT's key performance indicators. The principal advantage of AFFO is that it starts from the standardized definition of FFO and takes account of maintenance capital expenditures and regular leasing expenditures while ignoring the impact of step-rent revenue. Because maintenance capital expenditures and regular leasing expenditures are not incurred evenly throughout a fiscal year, there can be volatility in AFFO on a quarterly basis. The following sets out AFFO, calculated in accordance with what Management believes to be industry practice.

(In thousands)	H1 2006	H1 2005
FFO	\$12,052	\$9,831
Step-rent adjustments	(564)	(755)
M-T-M acquired leases	156	48
Leasing expenditures	(1,032)	(1,133)
Maintenance capital expenditures	(520)	(182)
AFFO	10,092	\$7,809

Distributions for the period ended June 30, 2006, represented an AFFO pay-out ratio of 95.7%, as compared to distributions for the period ended June 30, 2005, which represented an AFFO pay-out ratio of 100.7%.

## PART III

### Financial Condition

The REIT finances its operations through three sources of capital: (i) mortgage debt secured by the REIT's rental properties, (ii) secured short-term debt financing with two Canadian chartered banks and (iii) equity. As at June 30, 2006, the REIT had mortgage debt of \$224,497, bank indebtedness of \$9,398 and unitholders' equity of \$152,572.

#### **Unitholders' Equity**

As at December 31, 2005, the REIT had a market capitalization of approximately \$271,521 based on a closing unit price of \$16.95 on the Toronto Stock Exchange. As at June 30, 2006, the REIT had a market capitalization of approximately \$287,165 based on a closing unit price of \$17.72 on the Toronto Stock Exchange.

In the period ended June 30, 2006, the REIT issued a total of 186,750 units for equity contributions of \$3,925. Costs incurred to issue the units were \$118. Units were issued as follows:

- (i) 26,000 units at \$10.00 per unit for \$260 to certain officers and trustees who exercised options under the REIT's Unit Option Plan;
- (ii) 137,069 units at \$17.21 for \$2,359 to certain officers and trustees under the LTIP ;and
- (iii) 23,681 units under its distribution re-investment plan at an average price of \$17.13 per unit for \$406.

The REIT adopted a Unit Option Plan at the time of its IPO and granted at that time options to the trustees and officers of the REIT to acquire 345,000 units at an exercise price of \$10.00 per unit prior to February 19, 2008. In 2004, the maximum number of units reserved for the Unit Option Plan was reduced from 604,390 units to 345,000 units. In 2004, 2005 and the period ended June 30, 2006, the trustees and officers of the REIT exercised 289,500 options in accordance with their terms. As at June 30, 2006, 55,500 options were outstanding, all of which had vested.

In May of 2004, the REIT adopted the LTIP whereby trustees and officers of the REIT ("Participants") may from time to time, at the discretion of the Trustees and subject to regulatory approval, subscribe for units at a market price established in accordance with the provisions of the LTIP. The price for the units is payable as to 5% upon issuance and as to the balance ("LTIP Loan") over 10 years with interest on the LTIP Loan at an annual rate established in accordance with the provisions of the LTIP. The units issued pursuant to the LTIP are registered in the name of a Custodian on behalf of the Participants who are the beneficial owners. The units are pledged to the REIT as security for payment of the LTIP Loan, and all distributions paid on the units are forwarded by the Custodian to the REIT and applied first on account of interest on the LTIP Loan and then to reduce the outstanding balance of the LTIP loans. The maximum number of units authorized for issuance under the LTIP is equal to 5% of the issued and outstanding units from time to time. As at June 30, 2006, 441,965 were authorized for issuance under the LTIP.

#### **Mortgages Payable**

Mortgages payable as at June 30, 2006, consisted of mortgage debt of \$224,497 and premium on mortgages assumed (net of accumulated amortization) of \$784.

GAAP requires that the mortgages payable assumed on acquisition of properties be recorded at fair value. The fair value of the mortgages payable has been determined by discounting the cash flows of these financial obligations using market rates for debt of similar terms and credit risks.

The following sets out the maturity schedule of the REIT's mortgage debt, together with the weighted average interest on the mortgages that mature in the respective year.

	Periodic Principal Payments	Balance Due at Maturity	Total Principal	% of Total Principal	Weighted Average Interest Rate of Maturing Mortgages
2006	\$ 2,853	\$ -	\$ 2,853	1.3%	na
2007	5,761	19,408	25,169	11.2%	6.44%
2008	5,641	-	5,641	2.5%	na
2009	5,695	14,022	19,717	8.8%	6.40%
2010	5,897	1,926	7,823	3.5%	5.26%
Thereafter	28,290	135,004	163,294	72.7%	5.84%
Total	\$54,137	\$170,360	\$224,497		

Interest rates on the mortgage debt are between 4.94% and 8.10% with a weighted average interest rate of 5.95%. The weighted average term of the mortgage debt is 7.6 years.

Each individual mortgage loan of the REIT is secured by a mortgage registered on title of a rental property and by security agreements covering assignment of rents and personal property with respect to such property. The mortgage debt provides the holder with recourse to the assets of the REIT.

The REIT attempts to stagger the maturity of its mortgages and to have mortgages maturing each year to be in a position to upward finance the principal amount of maturing mortgages. Additionally, the REIT attempts to maintain 15 to 20% of its rental properties free from traditional long-term mortgage financing with a view to providing these assets as security for bank credit facilities.

#### **Bank Credit Facilities**

The REIT has a \$25,000 revolving credit facility with a Canadian chartered bank bearing interest at bank prime plus 1.0% and maturing on May 31, 2007, as well as a \$5,000 revolving credit facility with another Canadian chartered bank bearing interest at prime plus 1.0% and maturing on May 31, 2007. Each credit facility is secured by a combination of mortgage charges and security agreements on certain of the REIT's rental properties. In the period ended June 30, 2006, the average borrowings under the credit facilities were \$2,364. As at June 30, 2006, the borrowings under the credit facilities were \$10,241.

#### **Liquidity and Commitments**

Net operating income generated from the rental properties is the primary source of liquidity to fund the REIT's financing expense, trust expense and distributions to unitholders. The Declaration requires the REIT to declare distributions each year not less than the greater of (i) 75% of its DI or (ii) an amount to ensure that the REIT will not be subject to tax on its income and capital gains. The REIT intends to pay distributions of approximately 85% to 90% of DI.

The REIT expects that increased financing on maturing mortgages will provide sufficient cash flow to fund mortgage repayments. The REIT plans to fund anticipated ongoing commitments, obligations, capital expenditures and leasing expenditures using cash flow from operations retained by the REIT and through available borrowing capacity under the credit facilities.

The credit facilities, new mortgage financing and the access to the public equity markets will provide the necessary capital the REIT requires for acquisitions. The REIT's acquisition capacity, meaning the ability of the REIT to acquire rental properties using un-utilized borrowing capacity while not exceeding the 60% Debt Ratio, is \$74,000.

As at June 30, 2006, the REIT had future commitments as set out below.

(In thousands)	June 30, 2006
Leasing commissions	\$ 603
Tenant inducements	594
Revenue-enhancing capital expenditure and building renovations	1,504
Revenue-enhancing leasing expenditure	493
Properties Under Development	392
Expenses	207
Total	\$3,793

## PART IV

### Summary Information and Performance for the Quarter ended June 30, 2006

The following sets out summary information and financial results for the quarter ended June 30, 2006, and the comparable quarter in 2005 and the change between the two.

(In thousands except for per unit and % amounts)	Q2 2006	Q2 2005	Change	%Change
Revenue from rental properties	15,467	12,260	3,207	26.2%
Rental property operating cost	5,385	4,480	905	20.2%
Net rental income	10,082	7,780	2,302	29.6%
Real estate service income	103	-	103	-
Financing expense				
Interest	3,242	2,317	925	39.9%
Amortization - Mortgage premium	(54)	(99)	45	(45.5%)
Depreciation and amortization				
Rental properties	1,837	1,461	376	25.7%
Deferred leasing cost and tenant improvements	292	139	153	110.1%
Origination cost and acquired tenant relationships	1,827	1,262	565	44.8%
Acquired contracts and customer relationships	24	-	24	-
Deferred financing cost	59	48	11	22.9%
Computer and office equipment	8	-	8	-
Income from operations	2,950	2,652	298	11.2%
Trust expense	767	469	298	63.5%
Property management internalization expense	-	-	-	-
Net income	2,183	2,183	-	-
Amortization				
Rental properties	1,837	1,461	376	25.7%
Mortgage premium	(54)	(99)	45	(45.5%)
Acquired leases	635	501	134	26.7%
M-T-M acquired leases	68	24	44	183.3%
Acquired tenant relationships	1,191	761	430	56.5%
Acquired contracts and customer relationships	24	-	24	-
Step-rent adjustments	(209)	(350)	141	(40.3%)
Property management internalization expense	-	-	-	-
LTIP compensation expense	270	-	270	-
DI	5,945	4,481	1,464	32.7%
Weighted average units outstanding (basic)	15,848	14,036	1,812	12.9%
Weighted average units outstanding (diluted)	16,166	14,289	1,877	13.1%
Distributions	4,891	4,295	596	13.9%
DI per unit (basic)	\$0.375	\$0.319	\$0.056	17.5%
DI per unit (diluted)	\$0.368	\$0.314	\$0.054	17.3%
DI pay-out ratio	82.3%	95.8%	(13.5%)	
FFO	6,139	5,045	1,094	21.7%
FFO per unit (basic)	\$0.387	\$0.359	\$0.028	7.8%
FFO per unit (diluted)	\$0.380	\$0.353	\$0.027	7.5%
FFO pay-out ratio	79.7%	85.1%	(5.4%)	
AFFO	5,026	3,719	1,307	35.1%
AFFO per unit (basic)	\$0.317	\$0.265	\$0.052	19.6%
AFFO per unit (diluted)	\$0.311	\$0.260	\$0.051	19.6%
AFFO pay-out ratio	97.4%	115.9%	(18.6%)	
Net operating income	9,941	7,454	2,487	33.4%
Same-asset net operating income	7,749	7,016	733	10.4%
Total assets	\$405,827	\$309,822	\$96,005	31.0%
Total debt (excludes premium on assumed debt)	\$224,498	\$144,596	\$79,902	55.3%
Debt to GBV	53.2%	44.8%	8.4%	
Total GLA (s.f., excluding PUD)	2,387	1,925	462	24.0%
Leased GLA (s.f., excluding PUD)	2,346	1,885	461	24.5%
Leased GLA (% total GLA)	98.3%	97.9%	0.4%	

Net income for the quarter ended June 30, 2006, was \$2,183, as compared to net income of \$2,183 in the quarter ended June 30, 2005. Net income per unit (diluted) for the quarter was \$0.135, as compared to net income per unit (diluted) of \$0.153 in the comparable quarter.

DI for the quarter ended June 30, 2006, increased by 32.7% to \$5,945 from \$4,481 for the quarter ended June 30, 2005. DI per unit (diluted) for the quarter was \$0.368, as compared to \$0.314 in the comparable quarter.

### **Net Rental Income**

Net rental income for the quarter ended June 30, 2006, increased by 29.6% to \$10,082 from \$7,780 in the quarter ended June 30, 2005, as follows:

- (i) \$321 due to the increase in same-asset net rental income from properties owned for the entire quarter and the entire comparable quarter;
- (ii) \$1,575 due to net rental income from properties not owned for the entire quarter and the entire comparable quarter; and
- (iii) \$406 due to the internalization of the property management function.

Net rental income per occupied square foot for the quarter ended June 30, 2006, was \$4.30 (\$17.20 annualized), as compared to \$4.13 (\$16.52 annualized) in the quarter ended June 30, 2005.

### **Real Estate Service Income**

The Property Manager provides real estate services to third-party property owners. Real estate service income for the quarter ended June 30, 2006, was \$103, as compared to nil in the quarter ended June 30, 2005.

### **Property Management Internalization**

The economic benefit of the property management internalization for the quarter ended June 30, 2006, is summarized in the following table:

(In thousands)	Q2 2006
Increase in net rental income	\$406
Real estate service income	103
Reduction in leasing expenditures payable as leasing fees	227
Reduction in capital expenditures payable as project management fees	58
<b>Total</b>	<b>\$794</b>

This exceeds Management's expectations for the quarter.

### **Financing Expense**

Financing expense includes interest cost on mortgage debt and other credit facilities and the amortization of the premiums and discounts on assumed mortgages. The amortization of the premiums and discounts on assumed mortgages reduced financing expense by \$54 in the quarter ended June 30, 2006.

Financing expense for the quarter ended June 30, 2006, increased by 43.7% to \$3,188 from \$2,218 in the quarter ended June 30, 2005, due to the increase in financing expense associated with additional properties acquired in 2005 and during the period ended June 30, 2006.

### **Depreciation and Amortization**

The REIT records depreciation on its buildings on a straight-line basis over their expected life. Depreciation recorded on buildings for the quarter ended June 30, 2006, increased by 25.7% to \$1,837 from \$1,461 in the quarter ended June 30, 2005.

The REIT records amortization of deferred leasing cost, tenant improvements and the assigned fair value of the origination cost and tenant relationships for in-place leases acquired on acquisition of a rental

property on a straight-line basis over the term of the corresponding lease. Deferred financing cost is amortized on a straight-line basis over the term of the corresponding debt.

***Trust Expense***

Trust expense includes cost incurred by the REIT that is not directly attributable to rental property, such as officers' compensation, trustees' fees, professional fees for legal and audit services, trustees' and officers' insurance premiums and general administrative expenses.

Trust expense for the quarter ended June 30, 2006, increased by 63.5% to \$767 from \$469 in the quarter ended June 30, 2005, due to increased salary and occupancy costs and increased LTIP expense.

## PART V

### Summary Quarterly Information and Performance

The following sets out summary information and financial results for the most recently completed fiscal quarters.

(In thousands except for per unit and % amounts)	Q2 2006	Q1 2006	Q4 2005	Q3 2005	Q2 2005	Q1 2005	Q4 2004	Q3 2004
Revenue from rental properties	15,467	\$14,943	\$14,291	\$12,822	\$12,260	\$11,797	\$10,119	\$9,734
Rental property operating cost	5,385	5,543	5,145	4,442	4,480	4,197	3,664	3,369
Net rental income	10,082	9,400	9,146	8,380	7,780	7,600	6,455	6,365
Real estate service income	103	110	78	84	-	-	-	-
Financing expense	3,188	2,981	2,711	2,360	2,218	2,269	2,117	1,957
Depreciation and amortization	4,047	3,987	3,919	3,075	2,910	2,336	1,958	1,855
Income from operations	2,950	2,542	2,594	3,029	2,652	2,995	2,380	2,553
Trust expense	767	518	631	404	469	497	382	305
Property management internalization expense	-	-	-	7,877	-	-	-	-
Net income (loss)	2,183	2,024	1,963	(5,252)	2,183	2,498	1,998	2,248
Amortization								
Rental properties	1,837	1,776	1,692	1,549	1,461	1,369	1,194	1,175
Mortgage premium	(54)	(42)	(182)	(145)	(99)	(104)	(103)	(113)
Acquired leases	635	636	633	535	501	413	308	267
M-T-M acquired leases	68	88	181	-	24	24	31	38
Acquired tenant relationships	1,191	1,244	1,311	720	761	393	317	291
Acquired contracts and customer relationships	24	24	24	24	-	-	-	-
Step-rent adjustments	(209)	(355)	(339)	(287)	(350)	(405)	(276)	(375)
Property management internalization expense	-	-	-	7,877	-	-	-	-
LTIP compensation expense	270	-	-	-	-	109	26	-
DI	5,945	5,395	\$5,283	\$5,021	\$4,481	\$4,297	\$3,495	3,531
Weighted average units outstanding (basic)	15,848	15,809	15,350	14,471	14,036	12,118	10,226	10,200
Weighted average units outstanding (diluted)	16,166	16,064	15,606	14,727	14,289	12,329	10,389	10,348
Distributions	4,891	4,768	4,578	4,317	4,295	3,557	2,939	2,933
DI per unit (basic)	\$0.375	\$0.341	\$0.344	\$0.347	\$0.319	\$0.355	\$0.342	\$0.346
DI per unit (diluted)	\$0.368	\$0.336	\$0.339	\$0.341	\$0.314	\$0.348	\$0.336	\$0.341
DI pay-out ratio	82.3%	88.4%	86.7%	86.0%	95.8%	82.8%	84.1%	83.1%
FFO	6,139	5,913	5,782	5,616	5,045	4,786	3,912	4,062
FFO per unit (basic)	\$0.387	\$0.374	\$0.377	\$0.388	\$0.359	\$0.395	\$0.383	\$0.398
FFO per unit (diluted)	\$0.380	\$0.368	\$0.370	\$0.381	\$0.353	\$0.388	\$0.377	\$0.393
Net operating income	9,941	9,133	8,988	8,093	7,454	7,219	6,210	6,028
Net income (loss) per unit (basic)	\$0.138	\$0.128	\$0.128	\$(0.363)	\$0.156	\$0.206	\$0.195	\$0.220
Net income (loss) per unit (diluted)	\$0.135	\$0.126	\$0.126	\$(0.363)	\$0.153	\$0.203	\$0.192	\$0.217
Total assets	\$405,827	\$384,963	\$384,538	\$321,659	\$309,822	\$284,741	\$266,835	\$237,786
Total debt	\$224,498	\$212,226	\$210,093	\$163,182	\$144,596	\$147,418	\$154,273	\$125,514
Total debt to GBV	53.2%	51.2%	51.0%	47.7%	44.8%	50.0%	56.3%	52.1%
Total GLA (s.f., excluding PUD)	2,387	2,266	2,266	1,985	1,925	1,703	1,641	1,430
Leased GLA (s.f., excluding PUD)	2,346	2,202	2,197	1,933	1,885	1,687	1,627	1,410
Leased Area (%GLA)	98.3%	97.2%	97.0%	97.4%	97.3%	99.1%	99.2%	98.6%

## PART VI

### **Critical Accounting Estimates**

The significant accounting policies used in preparing the REIT's consolidated financial statements are described in Note 3 to those statements. The following is a discussion of Management's estimates that are most important to the presentation of the REIT's results of operations and financial condition and are most subjective as a result of matters that are inherently uncertain.

#### ***Fair Value of Assumed Mortgages Payable and Fair Value of Mortgages Payable***

Most of the mortgage indebtedness of the REIT was assumed in conjunction with rental property acquisitions. GAAP requires that the mortgages payable assumed on acquisition of properties be recorded at fair value. The fair value of the mortgages payable has been determined by discounting the cash flows of these financial obligations using market rates for debt of similar terms and credit risks. Market rates for debt are based on the yield of Canadian government bonds with similar maturity dates plus a credit spread based on Management's experience in obtaining financing and the current market conditions.

#### ***Impairment of Assets***

The REIT is required to write down to fair value any long-life assets that are determined to have been permanently impaired. The REIT's long-life assets consist of rental properties. The REIT's policy is to assess any potential impairment by making a comparison of the current and projected operating cash flow of a rental property over its remaining useful life, on an un-discounted basis, to the carrying amount of the rental property. If such carrying amount was in excess of the projected operating cash flow of the rental property, impairment in value would be recognized to adjust the carrying amount to its estimated fair market value. Current operating cash flows are based on leases in place and projected operating cash flows are based on Management's estimates of future rental rates. Prior to acquiring a rental property, the REIT commissions an appraisal and conducts due-diligence to satisfy itself that the acquisition price is representative of fair market value.

#### ***Depreciation***

A significant portion of the purchase price of rental properties is allocated to buildings. The depreciation recorded on buildings is based on the straight-line basis over their expected useful life. The allocation of purchase price to buildings and the estimated useful life are based on Management's estimates and, if these estimates prove incorrect, the depreciation will not be appropriately recorded.

## PART VII

### Related Party Transactions

At the time of its IPO, the REIT entered into an agreement (“Property Management Agreement”) with the Developer, a company owned in part and controlled by the President and CEO of the REIT and owned in part by the Executive Vice President of the REIT. Pursuant to the Property Management Agreement, the Developer provided property management and related services to the REIT. Effective July 1, 2005, the Property Manager, a wholly-owned subsidiary of the REIT, acquired the Developer’s property management business. Immediately prior to July 1, 2005, the Developer ceased to provide services to the REIT under the Property Management Agreement. Accordingly, the REIT made no payments to the Developer for property management and related services in the period ended June 30, 2006, as compared to payments of \$1,734 in the period ended June 30, 2005.

At the time of the REIT’s IPO, a subsidiary of the Developer leased 29,102 square feet of office space from the REIT pursuant to a lease expiring on September 30, 2010. Effective July 1, 2005, the REIT entered into a direct lease of this space with Loblaws Properties Limited for a term ending October 31, 2010, on the condition that the original indemnity of the Developer protecting the REIT from any revenue shortfall (on a cash basis) from the original lease remain in full force and effect.

## PART VIII

### Risk and Uncertainties

There are certain risk factors inherent in the investment and ownership of real estate. Real estate investments are capital intensive, and success from real estate investments depends upon maintaining occupancy levels and rental income flows to generate acceptable returns. These success factors are dependent on general economic conditions and local real estate markets, demand for leased premises and competition from other available properties.

The REIT's portfolio is focused on a particular asset class in the two largest metropolitan real estate markets in Canada. This focus enables management to capitalize on certain economies of scale and competitive advantages that would not otherwise be available.

#### **Financing and Interest Rate Risk**

The REIT is subject to risk associated with debt financing. The availability of debt to re-finance existing and maturing loans and the cost of servicing such debt will influence the success of the REIT. In order to minimize risk associated with debt financing, the REIT will attempt to re-finance maturing loans with long-term fixed-rate debt and to stagger the maturities over time.

Interest rates on the REIT's mortgage debt are between 4.94% and 8.10% with a weighted average interest rate of 5.95%. The weighted average term of the REIT's mortgage debt is 7.6 years. As at June 30, 2006, the borrowings under the REIT's credit facilities were \$10,241.

#### **Credit Risk**

The REIT is subject to credit risk. Credit risk arises from the possibility that tenants may not be able to fulfill their lease obligations. The REIT will strive to mitigate this risk by maintaining a diversified tenant-mix and limiting exposure to any single tenant. As at June 30, 2006, there were 275 tenants in the REIT's portfolio.

The following sets out the REIT's tenant-mix on the basis of percentage of rental revenue for the period ended June 30, 2006, and the year ended December 31, 2005.

<b>Category</b>	<b>% of Rental Revenue H1 2006</b>	<b>% of Rental Revenue 2005</b>
Service and professional	35	34
Retail (head office and storefront)	18	20
Telecommunications and information technology	17	15
Media and entertainment	13	13
Financial services	12	12
Government	2	2
Other	3	4

The following sets out the percentage of rental revenue from the REIT's top-10 tenants by rental revenue for the period ended June 30, 2006, as well as the percentage of rental revenue from those tenants for the year ended December 31, 2005.

<b>Tenant</b>	<b>% of Rental Revenue H1 2006</b>	<b>% of Rental Revenue 2005</b>
Desjardins	7.6	7.9
Cossette Communications	5.0	6.0
MTS Allstream	2.9	4.3
Publicis Toronto	2.8	3.2
St. Joseph Media	2.7	3.2
Algorithmics	2.3	2.7
Indigo Books & Music	2.0	2.4
Nelvana	2.0	2.3
Blast Radius	1.9	2.3
Veritprop	1.9	1.5

#### **Lease Roll-Over Risk**

The REIT is subject to lease roll-over risk. Lease roll-over risk arises from the possibility that the REIT may experience difficulty renewing or replacing tenants occupying space covered by leases that mature.

The REIT strives to stagger its lease maturity schedule so that it is not faced with a disproportionately large level of lease maturity in a given year.

98.3% of the GLA in the REIT's portfolio was leased as at June 30, 2006 (not including Properties Under Development). The following sets out the total GLA of the leases that mature during the period from January 1, 2006, to December 31, 2010, assuming tenants do not exercise renewal options, and the percentage of total GLA represented by the maturing leases.

<b>Year Ended</b>	<b>Square Feet</b>	<b>% of Total GLA</b>
December 31, 2006	273,003	11.6
December 31, 2007	297,773	12.7
December 31, 2008	224,237	9.6
December 31, 2009	364,148	15.5
December 31, 2010	254,032	10.8

Leases representing 224,867 of the GLA that matures in 2006, 32,877 of the GLA that matures in 2007 and 51,764 of the GLA that matures in 2009 were renewed or replaced by June 30, 2006.

The weighted average term to maturity of the REIT's leases is 4.8 years.

### ***Environmental Risk***

As an owner of real property, the REIT is subject to various federal, provincial and municipal laws relating to environmental matters. Such laws provide that the REIT could be liable for the costs of removal of certain hazardous substances and remediation of certain hazardous locations. The failure to remove or remediate such substances or locations, if any, could adversely affect the REIT's ability to sell such real estate or to borrow using such real estate as collateral and could potentially also result in claims against the REIT. The REIT is not aware of any material non-compliance with environmental laws at any of the properties in its portfolio. The REIT is also not aware of any pending or threatened investigations or actions by environmental regulatory authorities in connection with any of the properties in its portfolio or any pending or threatened claims relating to environmental conditions at the properties in its portfolio.

## PART IX

### Subsequent Events

On July 14, 2006, the REIT completed the acquisition of 400 Atlantic Avenue, an 86,034 square-foot Class I office property located in midtown Montreal, for a purchase price of \$5 million.

On July 26, 2006, the REIT announced the acquisition of a 183,870 square-foot portfolio of predominantly Class I office properties located in downtown Quebec City, for a purchase price of \$32.5 million.

On July 26, 2006, the REIT announced a public offering on a bought-deal basis of 1.9 million units from treasury at a price of \$17.00 per unit for gross proceeds of \$32.3 million.

## PART X

### Property Table

The following lists the properties owned by the REIT as at June 30, 2006:

Property	Office GLA	Retail GLA	Total GLA	% Total GLA	Office Vacant	Retail Vacant	Total Vacant	Vacancy Rate
<b>Toronto Total (including PUD)</b>	<b>1,609,542</b>	<b>368,753</b>	<b>1,978,295</b>	<b>79.49%</b>	<b>57,829</b>	<b>12,545</b>	<b>70,374</b>	<b>3.56%</b>
<b>King West Total</b>	162,056	26,394	188,450	7.57%	-	600	600	0.32%
<i>Phase I, The Castle</i>	59,002	16,562	75,564		-	-	-	0.00%
<i>905 King Street West</i>	103,054	9,832	112,886		-	600	600	0.53%
<b>King West Central Total</b>	538,839	119,617	658,456	26.46%	4,793	1,700	6,493	0.99%
<i>468 King Street West</i>	65,039	-	65,039		-	-	-	0.00%
<i>425-439 King Street West</i>	74,053	25,134	99,187		-	-	-	0.00%
<i>445-455 King Street West</i>	27,565	23,048	50,613		-	-	-	0.00%
<i>469 King Street West</i>	62,594	11,250	73,844		-	-	-	0.00%
<i>500-522 King Street West</i>	94,945	27,705	122,650		-	-	-	0.00%
<i>602-606 King Street West</i>	37,299	23,113	60,412		-	1,700	1,700	2.81%
<i>420 Wellington Street West</i>	33,813	3,137	36,950		-	-	-	0.00%
<i>425 Adelaide Street West</i>	74,008	4,104	78,112		3,008	-	3,008	3.85%
<i>579 Richmond Street West</i>	29,311	-	29,311		-	-	-	0.00%
<i>141 Bathurst Street</i>	10,521	-	10,521		-	-	-	0.00%
<i>662 King Street West</i>	29,691	2,126	31,817		1,785	-	1,785	5.61%
<b>Entertainment District Total</b>	426,642	120,816	547,458	22.00%	10,765	4,402	15,167	2.77%
<i>116 Simcoe Street</i>	13,819	-	13,819		-	-	-	0.00%
<i>200 Adelaide Street West</i>	28,024	-	28,024		-	-	-	0.00%
<i>208-210 Adelaide Street West</i>	12,330	-	12,330		-	-	-	0.00%
<i>312 Adelaide Street West</i>	63,904	7,891	71,795		-	4,402	4,402	6.13%
<i>331-333 Adelaide Street West</i>	20,951	3,209	24,160		-	-	-	0.00%
<i>358-360 Adelaide Street West</i>	35,986	18,263	54,249		8,983	-	8,983	16.56%
<i>134 Peter Street</i>	29,218	19,804	49,022		-	-	-	0.00%
<i>82 Peter Street</i>	38,623	8,287	46,910		-	-	-	0.00%
<i>364 Richmond Street West</i>	21,300	17,300	38,600		1,782	-	1,782	4.62%
<i>388 King Street West</i>	32,529	11,765	44,294		-	-	-	0.00%
<i>99 Spadina Avenue</i>	39,267	12,613	51,880		-	-	-	0.00%
<i>185 Spadina Avenue</i>	55,814	-	55,814		-	-	-	0.00%
<i>217-225 Richmond Street West</i>	34,877	21,684	56,561		-	-	-	0.00%
<b>Downtown Total</b>	44,870	5,794	50,664	2.04%	2,339	-	2,339	4.62%
<i>67 Richmond Street West</i>	44,870	5,794	50,664		2,339	-	2,339	4.62%
<b>St. Lawrence Market Total</b>	71,754	41,390	113,144	4.55%	3,225	-	3,225	2.85%
<i>35-39 Front Street East</i>	30,811	16,606	47,417		-	-	-	0.00%
<i>41-45 Front Street East</i>	19,799	13,735	33,534		-	-	-	0.00%
<i>50 Wellington Street East</i>	21,144	11,049	32,193		3,225	-	3,225	10.02%
<b>Queen Richmond Total</b>	270,106	48,899	319,005	12.82%	2,976	-	2,976	0.93%
<i>Queen Richmond Centre</i>	175,000	48,899	223,899		2,976	-	2,976	1.33%
<i>230 Richmond Street East</i>	62,514	-	62,514		-	-	-	0.00%
<i>489 Queen Street East</i>	32,592	-	32,592		-	-	-	0.00%
<b>Properties Under Development</b>	95,275	5,843	101,118	4.06%	33,731	5,843	39,574	39.14%
<i>QRC South, 103 Richmond Street East</i>	44,600	-	44,600		17,363	-	17,363	38.93%
<i>145 Berkeley Street</i>	10,625	-	10,625		3,838	-	3,838	36.12%
<i>257 Adelaide Street West</i>	40,050	5,843	45,893		12,530	5,843	18,373	40.03%
<b>Montreal Total</b>	<b>442,724</b>	<b>28,284</b>	<b>471,008</b>	<b>18.93%</b>	<b>5,628</b>	<b>-</b>	<b>5,628</b>	<b>1.19%</b>
<i>425 Viger Avenue West</i>	205,314	820	206,134		-	-	-	0.00%
<i>3575 Saint-Laurent Boulevard</i>	164,797	17,464	182,261		4,274	-	4,274	2.34%
<i>4446 Saint-Laurent Boulevard</i>	72,613	10,000	82,613		1,354	-	1,354	1.64%
<b>Winnipeg Total</b>	<b>34,495</b>	<b>4,815</b>	<b>39,310</b>	<b>1.58%</b>	<b>-</b>	<b>4,815</b>	<b>4,815</b>	<b>12.25%</b>
<i>115 Bannatyne Avenue</i>	34,495	4,815	39,310		-	4,815	4,815	12.25%
<b>Total (including PUD)</b>	<b>2,086,761</b>	<b>401,852</b>	<b>2,488,613</b>	<b>100.00%</b>	<b>63,457</b>	<b>17,360</b>	<b>80,817</b>	<b>3.25%</b>
<b>Total (not including PUD)</b>	<b>1,991,486</b>	<b>396,009</b>	<b>2,387,495</b>	<b>95.94%</b>	<b>29,726</b>	<b>11,517</b>	<b>41,243</b>	<b>1.73%</b>