

# THE KEG ROYALTIES INCOME FUND

## THIRD QUARTER REPORT

For the three and nine months ended September 30, 2008

## 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, 2008.

### 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 96 Keg restaurants in the Royalty Pool were \$108,035,000, an increase of \$5,041,000 or 4.9% from the comparable quarter of the prior year. These higher gross sales reflect the very successful new Keg restaurants which opened during the period from October 3, 2006 through October 2, 2007, which were added to the Royalty Pool on January 1, 2008.

The Fund generated earnings before income taxes of \$3,066,000 or 31.6 cents/Fund unit compared with \$2,946,000 or 30.4 cents/Fund unit during the same quarter of the prior year, an increase of \$120,000 or 1.2 cents/Fund unit. Distributable cash available to pay distributions to public Unitholders decreased by \$63,000 to \$3,120,000 or 32.2 cents/Fund unit, from \$3,183,000 or 32.8 cents/Fund unit for the third quarter of the prior year, due entirely to changes in working capital balances.

### OUTLOOK

The Canadian Restaurant and Foodservice Association (CRFA) has projected growth in the full-service restaurant category, the category in which the Keg operates, of 2.7% in 2008, although this projection may very well be reduced in the coming months. Notwithstanding the current turbulence in the financial markets, and consumer concerns about an economic slowdown, Management of KRL believes that The Keg will continue to outperform the full-service restaurant category with respect to same store sales growth.

The Trustees believe the Fund's financial stability is not being accurately reflected in the Fund's unit price, which is currently trading at historically low levels. KRL has consistently demonstrated its ability to deliver growth in both system sales and same store sales, which has provided not only stability but also growth in distributable cash and distributions to the Fund's unitholders. The Keg remains an industry leader in the full-service restaurant category in Canada; a fact confirmed by an independent research report from Angus Reid Strategies in July 2008 that identified The Keg as having a market share of well over 60% for diners choosing a steak dinner. KRL's management remains committed to maintaining and improving the legendary high standards that have come to define the brand throughout North America including The Keg's high quality menu, knowledgeable service and marketing innovation.

Sincerely,



C.C. Woodward  
Chairman, The Keg Royalties Income Fund  
on behalf of the Board of Trustees  
November 14, 2008

*This letter may contain certain "forward looking statements" reflecting the Fund's current and future expectations with respect to, among other things, the casual dining segment of the restaurant industry and the economy in general. Readers should therefore familiarize themselves with the "Forward Looking Information" section of the Management Discussion and Analysis on page 19.*

## FINANCIAL HIGHLIGHTS

(\$000's except per unit amounts)	Jul. 1 to Sept. 30, 2008	Jul. 1 to Sept. 30, 2007	Jan. 1 to Sept. 30, 2008	Jan. 1 to Sept. 30, 2007
<b>Restaurants in the Royalty Pool</b>	<b>96</b>	<b>95</b>	<b>96</b>	<b>95</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool.....</b>	<b>\$ 108,035</b>	<b>\$ 102,994</b>	<b>\$ 327,275</b>	<b>\$ 309,218</b>
Royalty income <sup>(1)</sup> .....	\$ 4,383	\$ 4,211	\$ 13,205	\$ 12,581
Partnership expenses <sup>(2)</sup> .....	(93)	(97)	(273)	(292)
Partnership earnings .....	4,290	4,114	12,932	12,289
KRL's interest <sup>(3)</sup> .....	(2,118)	(2,016)	(6,208)	(5,776)
<b>Equity income <sup>(4)</sup> .....</b>	<b>2,172</b>	<b>2,098</b>	<b>6,724</b>	<b>6,513</b>
Interest income <sup>(5)</sup> .....	1,084	1,090	3,236	3,226
<b>Total income .....</b>	<b>3,256</b>	<b>3,188</b>	<b>9,960</b>	<b>9,739</b>
Interest and financing expenses <sup>(6)</sup> .....	(190)	(242)	(602)	(702)
<b>Earnings before income taxes .....</b>	<b>\$ 3,066</b>	<b>\$ 2,946</b>	<b>\$ 9,358</b>	<b>\$ 9,037</b>
<b>Net earnings <sup>(7)</sup> .....</b>	<b>\$ 3,066</b>	<b>\$ 2,871</b>	<b>\$ 9,508</b>	<b>\$ 7,187</b>
<b>Distributable cash <sup>(8)</sup> .....</b>	<b>\$ 3,120</b>	<b>\$ 3,183</b>	<b>\$ 9,384</b>	<b>\$ 9,258</b>
<b>Distributions paid .....</b>	<b>\$ 3,100</b>	<b>\$ 2,937</b>	<b>\$ 9,242</b>	<b>\$ 8,500</b>
<b>Earnings before income taxes per Fund unit <sup>(9)</sup> .....</b>	<b>\$ .316</b>	<b>\$ .304</b>	<b>\$ .964</b>	<b>\$ .943</b>
<b>Earnings per Fund unit <sup>(9)</sup> .....</b>	<b>\$ .316</b>	<b>\$ .296</b>	<b>\$ .980</b>	<b>\$ .750</b>
<b>Distributable cash per Fund unit <sup>(8)(9)</sup> .....</b>	<b>\$ .322</b>	<b>\$ .328</b>	<b>\$ .967</b>	<b>\$ .967</b>
<b>Distributions paid per Fund unit <sup>(9)</sup> .....</b>	<b>\$ .320</b>	<b>\$ .303</b>	<b>\$ .953</b>	<b>\$ .887</b>
<b>Payout Ratio <sup>(10)</sup> .....</b>	<b>99.4%</b>	<b>92.3%</b>	<b>98.5%</b>	<b>91.8%</b>

Notes:

- <sup>(1)</sup> The Fund, indirectly through the Partnership, earns royalty income equal to 4% of gross sales of Keg restaurants 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, Class C and Class D Partnership units. The Class A, entitled Class B and Class D 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. The amount is calculated as the royalty income, less the Partnership's operating expenses, less earnings attributable to KRL.
- <sup>(5)</sup> The Fund directly earns interest income on the \$57.0 million Keg Loan, accruing at 7.5% per annum, payable monthly.
- <sup>(6)</sup> The Fund directly incurs interest expense on the long-term debt and amortization of deferred financing charges.
- <sup>(7)</sup> Net earnings for the three months ended September 30, 2008 reflect the non-cash future income tax expense of \$nil and for the nine months ended September 30, 2008 the non-cash future income tax recovery of \$150,000.
- <sup>(8)</sup> Distributable cash is defined as Standardized Distributable Cash which is the periodic cash flows from operating activities as reported in the GAAP financial statements, including the effects of changes in non-cash working capital.
- <sup>(9)</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, 2008 was 9,703,500 (three months ended September 30, 2007 – 9,703,500) and for the nine months ended September 30, 2008 was 9,703,500 (nine months ended September 30, 2007 – 9,579,690).
- <sup>(10)</sup> Payout ratio is computed as the ratio of aggregate cash distributions paid during the period (numerator) to the aggregate Standardized Distributable Cash of the period (denominator).
- <sup>(11)</sup> Same Store Sales Growth ("SSSG") is the overall increase in gross sales from Keg restaurants (that operated during the entire period of both the current and the prior year) as compared to gross sales for the same period of the prior year.

## SUMMARY OF QUARTERLY RESULTS

	Q3	Q2	Q1	Q4
(\$000's except per unit amounts)	2008	2008	2008	2007
<b>Restaurants in the Royalty Pool</b>	<b>96</b>	<b>96</b>	<b>96</b>	<b>95</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool</b>	<b>\$ <u>108,035</u></b>	<b>\$ <u>107,690</u></b>	<b>\$ <u>111,550</u></b>	<b>\$ <u>103,541</u></b>
Royalty income <sup>(1)</sup>	\$ 4,383	\$ 4,334	\$ 4,488	\$ 4,246
Partnership expenses <sup>(2)</sup>	(93)	(81)	(99)	(77)
Partnership earnings	4,290	4,253	4,389	4,169
KRL's interest <sup>(3)</sup>	(2,118)	(2,033)	(2,057)	(1,919)
<b>Equity income <sup>(4)</sup></b>	<b>2,172</b>	<b>2,220</b>	<b>2,332</b>	<b>2,250</b>
Interest income <sup>(5)</sup>	1,084	1,075	1,077	1,090
<b>Total income</b>	<b>3,256</b>	<b>3,295</b>	<b>3,409</b>	<b>3,340</b>
Interest and financing expenses <sup>(6)</sup>	(190)	(192)	(220)	(240)
<b>Earnings before income taxes</b>	<b>\$ <u>3,066</u></b>	<b>\$ <u>3,103</u></b>	<b>\$ <u>3,189</u></b>	<b>\$ <u>3,100</u></b>
<b>Net earnings <sup>(7)</sup></b>	<b>\$ <u>3,066</u></b>	<b>\$ <u>2,903</u></b>	<b>\$ <u>3,539</u></b>	<b>\$ <u>3,200</u></b>
<b>Distributable cash <sup>(8)</sup></b>	<b>\$ <u>3,120</u></b>	<b>\$ <u>3,065</u></b>	<b>\$ <u>3,199</u></b>	<b>\$ <u>2,940</u></b>
<b>Distributions paid</b>	<b>\$ <u>3,100</u></b>	<b>\$ <u>3,100</u></b>	<b>\$ <u>3,042</u></b>	<b>\$ <u>2,962</u></b>
<b>Earnings before income taxes per Fund unit <sup>(9)</sup></b>	<b>\$ <u>.316</u></b>	<b>\$ <u>.320</u></b>	<b>\$ <u>.329</u></b>	<b>\$ <u>.319</u></b>
<b>Earnings per Fund unit <sup>(9)</sup></b>	<b>\$ <u>.316</u></b>	<b>\$ <u>.299</u></b>	<b>\$ <u>.365</u></b>	<b>\$ <u>.330</u></b>
<b>Distributable cash per Fund unit <sup>(8)(9)</sup></b>	<b>\$ <u>.322</u></b>	<b>\$ <u>.316</u></b>	<b>\$ <u>.330</u></b>	<b>\$ <u>.303</u></b>
<b>Distributions paid per Fund unit <sup>(9)</sup></b>	<b>\$ <u>.320</u></b>	<b>\$ <u>.320</u></b>	<b>\$ <u>.314</u></b>	<b>\$ <u>.305</u></b>
<b>Payout Ratio <sup>(10)</sup></b>	<b><u>99.4%</u></b>	<b><u>101.2%</u></b>	<b><u>95.1%</u></b>	<b><u>100.8%</u></b>
<b>SSSG Canada <sup>(11)</sup></b>	<b>1.1%</b>	<b>4.7%</b>	<b>6.2%</b>	<b>2.8%</b>
<b>SSSG United States <sup>(11)</sup></b>	<b>(8.3)%</b>	<b>(7.5)%</b>	<b>(3.6)%</b>	<b>(2.2)%</b>
<b>SSSG Consolidated <sup>(11)</sup></b>	<b>0.0%</b>	<b>1.7%</b>	<b>2.2%</b>	<b>(0.4)%</b>
<b>Restaurants Opened</b>	<b>3</b>	<b>4</b>	<b>1</b>	<b>--</b>
<b>Restaurants Closed</b>	<b>1</b>	<b>--</b>	<b>1</b>	<b>--</b>
<b>Restaurants Relocated</b>	<b>--</b>	<b>--</b>	<b>--</b>	<b>--</b>
<b>Net Restaurants Opened (Closed)</b>	<b>2</b>	<b>4</b>	<b>--</b>	<b>--</b>
			Sept. 30,	Dec. 31,
			2008	2007
Total assets			\$ 116,374	\$ 116,261
Total liabilities			15,613	16,770

## SUMMARY OF QUARTERLY RESULTS

	Q3	Q2	Q1	Q4
(\$000's except per unit amounts)	2007	2007	2007	2006
<b>Restaurants in the Royalty Pool</b>	<b>95</b>	<b>95</b>	<b>95</b>	<b>91</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool</b>	<b><u>\$ 102,994</u></b>	<b><u>\$ 100,984</u></b>	<b><u>105,239</u></b>	<b><u>\$ 98,684</u></b>
Royalty income <sup>(1)</sup>	\$ 4,211	\$ 4,110	\$ 4,260	\$ 4,038
Partnership expenses <sup>(2)</sup>	(97)	(93)	(102)	(105)
Partnership earnings	4,114	4,017	4,158	3,933
KRL's interest <sup>(3)</sup>	(2,016)	(1,835)	(1,926)	(1,876)
<b>Equity income <sup>(4)</sup></b>	<b>2,098</b>	<b>2,182</b>	<b>2,232</b>	<b>2,057</b>
Interest income <sup>(5)</sup>	1,090	1,077	1,061	1,083
<b>Total income</b>	<b>3,188</b>	<b>3,259</b>	<b>3,293</b>	<b>3,140</b>
Interest and financing expenses <sup>(6)</sup>	(242)	(232)	(229)	(234)
<b>Earnings before income taxes</b>	<b><u>\$ 2,946</u></b>	<b><u>\$ 3,027</u></b>	<b><u>\$ 3,064</u></b>	<b><u>\$ 2,906</u></b>
<b>Net earnings <sup>(7)</sup></b>	<b><u>\$ 2,871</u></b>	<b><u>\$ 1,252</u></b>	<b><u>\$ 3,064</u></b>	<b><u>\$ 2,906</u></b>
<b>Distributable cash <sup>(8)</sup></b>	<b><u>\$ 3,183</u></b>	<b><u>\$ 3,022</u></b>	<b><u>\$ 3,055</u></b>	<b><u>\$ 2,636</u></b>
<b>Distributions paid</b>	<b><u>\$ 2,937</u></b>	<b><u>\$ 2,881</u></b>	<b><u>\$ 2,682</u></b>	<b><u>\$ 2,597</u></b>
<b>Earnings before income taxes per Fund unit <sup>(9)</sup></b>	<b><u>\$ .304</u></b>	<b><u>\$ .312</u></b>	<b><u>\$ .328</u></b>	<b><u>\$ .321</u></b>
<b>Earnings per Fund unit <sup>(9)</sup></b>	<b><u>\$ .296</u></b>	<b><u>\$ .129</u></b>	<b><u>\$ .328</u></b>	<b><u>\$ .321</u></b>
<b>Distributable cash per Fund unit <sup>(8)(9)</sup></b>	<b><u>\$ .328</u></b>	<b><u>\$ .311</u></b>	<b><u>\$ .328</u></b>	<b><u>\$ .291</u></b>
<b>Distributions paid per Fund unit <sup>(9)</sup></b>	<b><u>\$ .303</u></b>	<b><u>\$ .297</u></b>	<b><u>\$ .289</u></b>	<b><u>\$ .287</u></b>
<b>Payout Ratio <sup>(10)</sup></b>	<b><u>92.3%</u></b>	<b><u>95.3%</u></b>	<b><u>87.8%</u></b>	<b><u>98.5%</u></b>
<b>SSSG Canada <sup>(11)</sup></b>	<b>9.5%</b>	<b>11.0%</b>	<b>8.1%</b>	<b>10.5%</b>
<b>SSSG United States <sup>(11)</sup></b>	<b>1.9%</b>	<b>5.4%</b>	<b>3.8%</b>	<b>7.9%</b>
<b>SSSG Consolidated <sup>(11)</sup></b>	<b>7.2%</b>	<b>9.7%</b>	<b>7.6%</b>	<b>9.6%</b>
<b>Restaurants Opened</b>	<b>--</b>	<b>--</b>	<b>1</b>	<b>--</b>
<b>Restaurants Closed</b>	<b>--</b>	<b>--</b>	<b>--</b>	<b>--</b>
<b>Restaurants Relocated</b>	<b>1</b>	<b>--</b>	<b>2</b>	<b>--</b>
<b>Net Restaurants Opened (Closed)</b>	<b>--</b>	<b>--</b>	<b>1</b>	<b>--</b>

## SELECTED ANNUAL INFORMATION

	Year Ended Dec. 31, 2007	Year Ended Dec. 31, 2006	Year Ended Dec. 31, 2005
(\$000's except per unit amounts)			
<b>Restaurants in the Royalty Pool</b>	<b>95</b>	<b>91</b>	<b>86</b>
<b>Gross sales reported by Keg restaurants in the Royalty Pool</b>	<b>\$ 412,759</b>	<b>\$ 372,472</b>	<b>\$ 325,717</b>
Royalty income <sup>(1)</sup>	\$ 16,827	\$ 15,097	\$ 13,138
Partnership expenses <sup>(2)</sup>	(369)	(456)	(441)
Partnership earnings	16,458	14,641	12,697
KRL's interest <sup>(3)</sup>	(7,696)	(7,306)	(6,965)
<b>Equity income <sup>(4)</sup></b>	<b>8,762</b>	<b>7,335</b>	<b>5,732</b>
Interest income <sup>(5)</sup>	4,318	4,289	4,281
<b>Total income</b>	<b>13,080</b>	<b>11,624</b>	<b>10,013</b>
Interest and financing expenses <sup>(6)</sup>	(943)	(900)	(711)
<b>Earnings before income taxes</b>	<b>\$ 12,137</b>	<b>\$ 10,724</b>	<b>\$ 9,302</b>
<b>Net earnings <sup>(7)</sup></b>	<b>\$ 10,387</b>	<b>\$ 10,724</b>	<b>\$ 9,302</b>
<b>Distributable cash <sup>(8)</sup></b>	<b>\$ 12,199</b>	<b>\$ 10,510</b>	<b>\$ 8,799</b>
<b>Distributions paid</b>	<b>\$ 11,463</b>	<b>\$ 10,078</b>	<b>\$ 9,001</b>
<b>Earnings before income taxes per Fund unit <sup>(9)</sup></b>	<b>\$ 1.263</b>	<b>\$ 1.200</b>	<b>\$ 1.124</b>
<b>Earnings per Fund unit <sup>(9)</sup></b>	<b>\$ 1.081</b>	<b>\$ 1.200</b>	<b>\$ 1.124</b>
<b>Distributable cash per Fund unit <sup>(8)(9)</sup></b>	<b>\$ 1.269</b>	<b>\$ 1.176</b>	<b>\$ 1.063</b>
<b>Distributions paid per Fund unit <sup>(9)</sup></b>	<b>\$ 1.193</b>	<b>\$ 1.128</b>	<b>\$ 1.087</b>
<b>Payout Ratio <sup>(10)</sup></b>	<b>94.0%</b>	<b>95.9%</b>	<b>102.3%</b>
<b>SSSG Canada <sup>(11)</sup></b>	<b>7.3%</b>	<b>8.3%</b>	<b>3.4%</b>
<b>SSSG United States <sup>(11)</sup></b>	<b>2.1%</b>	<b>7.2%</b>	<b>9.2%</b>
<b>SSSG Consolidated <sup>(11)</sup></b>	<b>5.5%</b>	<b>6.9%</b>	<b>3.1%</b>
<b>Restaurants Opened</b>	<b>1</b>	<b>5</b>	<b>3</b>
<b>Restaurants Closed</b>	<b>--</b>	<b>2</b>	<b>1</b>
<b>Restaurants Relocated</b>	<b>3</b>	<b>--</b>	<b>--</b>
<b>Net Restaurants Opened (Closed)</b>	<b>1</b>	<b>3</b>	<b>2</b>
	Dec. 31, 2007	Dec. 31, 2006	Dec. 31, 2005
Total assets	\$ 116,261	\$ 106,500	\$ 97,671
Total liabilities	16,770	14,863	14,836

# MANAGEMENT DISCUSSION AND ANALYSIS

**For the Three and Nine Months Ended September 30, 2008  
As of November 14, 2008**

## OVERVIEW

### KEY ATTRIBUTES OF THE FUND

The Keg Royalties Income Fund (the “Fund”) is a limited purpose, open-ended trust which trades on the Toronto Stock Exchange under the symbol KEG.UN. On May 31, 2002, as part of the Initial Public Offering (the “IPO”), the Fund, through its subsidiary The Keg Rights Limited Partnership (the “Partnership”), purchased The Keg trademarks and other related intellectual 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 equal to 4% of gross sales of Keg restaurants included in a specific royalty pool (the “Royalty Pool”).

The key feature of the Fund is that royalty income is based on the top-line, gross sales of Keg restaurants in the Royalty Pool and not on the profitability of either KRL or the Keg restaurants in the Royalty Pool. Moreover, the Fund is not subject to the variability of earnings or expenses associated with an operating business. The Fund’s only expenses are nominal administrative expenses and interest on non-amortizing term debt. Thus, the success of the Fund depends primarily on the ability of KRL to maintain and increase the gross sales of the Keg restaurants in the Royalty Pool.

Increases in gross sales are derived from both same store sales growth from existing restaurants (“SSSG”) and from the addition of new Keg restaurants. SSSG is the key driver of growth in royalty income and, since the Fund’s expenses are relatively fixed in nature, SSSG results in growth in distributable cash which allows for higher distributions to the Fund’s unitholders. KRL has consistently generated SSSG through a combination of increased guest counts and increased guest average cheque. SSSG has been achieved by maintaining operational excellence within each Keg restaurant, innovative marketing and promotional programs, and pricing. Over the past decade, KRL’s SSSG has averaged 5.5% annually, a figure that compares very favourably against the restaurant industry as a whole. This consistent sales growth is one of the primary reasons that monthly cash distributions to the Fund’s unitholders have been increased 7 times since the Fund’s inception, most recently in March 2008.

### KRL’S INTEREST IN THE FUND

KRL’s interest in the earnings of the Partnership is from its ownership of Class A, entitled Class B, Class C and Class D Partnership units. The Class A, entitled Class B and Class D Partnership units are exchangeable into Fund units on a one-for-one basis in certain circumstances. KRL’s effective ownership of the Fund and its interest in the earnings of the Partnership has grown from 10.00% at the time of the IPO to 23.60% as of January 1, 2008. The change in KRL’s effective ownership of the Fund was the result of adding net sales to the Royalty Pool on an annual basis, in return for which KRL received the right to indirectly acquire additional Fund units (see “The Royalty Pool”). The total number of restaurants included in the Royalty Pool has increased from 80 Keg restaurants in existence at the time of the IPO to 96 as of January 1, 2008. This has resulted in a net increase in Royalty Pool sales of \$110.6 million and the issuance of 3,642,220 exchangeable units to KRL, as of the date hereof. KRL has exchanged a total of 1,550,000 Class B units for an equal number of Fund units (increasing the number of issued and outstanding Fund units from 8,153,500 at the time of the IPO to 9,703,500 as of February 23, 2007) and sold these units through the facilities of the Toronto Stock Exchange.

## **OVERVIEW (CONTINUED)**

### **VARIABLE INTEREST ENTITY**

During 2005, the Partnership was determined to be a variable interest entity in accordance with the criteria established in the Canadian Institute of Chartered Accountants' ("CICA") 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.

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

On June 12, 2007, the Canadian federal government's legislation to tax publicly traded income trusts passed third reading in the House of Commons and thus the associated income tax became substantively enacted for accounting purposes. The legislation imposes a tax of 29.5% on distributions from Canadian public income trusts. The new tax is not expected to apply to the Fund until January 1, 2011 as a transition period applies to publicly traded trusts that existed prior to November 1, 2006. This rate was subsequently reduced to 26% for 2012 and later taxation years. Historically, the Fund had been exempt from recognizing future income tax assets and liabilities associated with temporary differences arising in the Fund and its equity accounted investment, The Keg Rights Limited Partnership. As a result of the substantive enactment of the new tax legislation, the Fund has recognized future income tax assets and liabilities that are expected to reverse subsequent to January 1, 2011. Future income tax expense is a non-cash item that does not affect cash flow.

### **DISTRIBUTABLE CASH**

The Canadian Institute of Chartered Accountants and the Canadian Securities Administrators have recently released a guideline on the measurement and reporting of distributable cash for income trusts and other flow through entities in Management's Discussion and Analysis. This guidance attempts to provide comparable measures of distributable cash among income trusts. As a result of the Fund adopting this guidance, distributable cash is now defined as the periodic cash flows from operating activities as reported in the GAAP financial statements including the change in non-cash working capital balances, less adjustments for capital expenditures and restrictions on distributions arising from compliance with financial covenants. Distributable cash may not be comparable to other issuers who have adopted this guidance. Previously, distributable cash was computed as earnings for the period plus non-cash items such as amortization and future income taxes; a non-GAAP measure which was also not necessarily comparable to similar measures presented by other issuers. Given the Fund has no capital expenditures and no expected restriction on distributions arising from compliance with financial covenants, the only significant difference that may arise in any particular reporting period between the two definitions is due to the inclusion of changes in non-cash working capital balances.

The Trustees are of the opinion that the inclusion of changes in non-cash working capital balances in the determination of distributable cash will provide less meaningful information for Unitholders as the Fund's working capital requirements are not permanent in nature and are primarily due to the timing of payments between related parties. Readers are advised that this is a reporting change only, and that earnings and actual cash available for distribution to the Fund's unitholders are not impacted, nor are the contractual obligations between the Fund, the Partnership, and KRL.



## 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.

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 95 as of December 31, 2007. Twenty-seven new Keg restaurants that opened during the period from April 1, 2002, through October 2, 2006, with annual gross sales of \$128.0 million have been added to the Royalty Pool. Twelve permanently closed Keg restaurants with annual sales of \$30.5 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$97.5 million annually, and KRL receiving a cumulative Additional Entitlement equivalent to 3,311,525 Fund units as of December 31, 2007.

On January 1, 2008, four new Keg restaurants that opened during the period from October 3, 2006 through October 2, 2007 were added to the Royalty Pool. The gross sales of these four new restaurants have been estimated at \$20.5 million annually. Three permanently closed Keg restaurants with annual sales of \$7.4 million were removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$13.1 million annually. The total number of restaurants in the Royalty Pool increased to 96. The yield of the Fund units was determined to be 8.54% calculated using a weighted average unit price of \$13.78. 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 413,367 Fund units, being 3.23% of the Fund units on a fully diluted basis. On January 1, 2008, KRL received 80% of this entitlement representing the equivalent of 330,694 Fund units, being 2.60% 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 will have the right to exchange its units in the capital of the Partnership for 2,998,164 Fund units representing 23.60% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2008 once the actual performance of the new restaurants has been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2008, it would have the right to exchange its Partnership units for 3,080,837 Fund units representing 24.10% of the Fund units on a fully diluted basis.

## DISTRIBUTIONS TO UNITHOLDERS

The Fund's objective is to provide consistent monthly distributions to unitholders at the highest sustainable level, and the Trustees of the Fund continue to review distribution levels on an ongoing basis to fulfill that objective. Since the inception of the Fund, monthly distributions to unitholders have been increased seven times from the original level of \$0.09 per unit at the time of the IPO, to the current level of \$0.1065 per unit, an increase of 18.3%.

Year-to-date distributions were as follows:

<b>Period</b>	<b>Payment Date</b>	<b>Per/Unit</b>
January 1-31, 2008	February 29, 2008	10.35¢
February 1-29, 2008	March 31, 2008	10.65¢
March 1-31, 2008	April 30, 2008	10.65¢
April 1-30, 2008	May 30, 2008	10.65¢
May 1-31, 2008	June 30, 2008	10.65¢
June 1-30, 2008	July 31, 2008	10.65¢
July 1-31, 2008	August 29, 2008	10.65¢
August 1-31, 2008	September 30, 2008	10.65¢
September 1-30, 2008	October 31, 2008*	10.65¢

*\*Paid subsequent to the period*

Distributions paid during the year were funded entirely by cash flow from operations and no debt was incurred at any point during the year to fund distributions.

Since inception, the Fund has generated \$63,375,000 of distributable cash and has paid cumulative distributions of \$62,532,000, which resulted in a cumulative surplus of \$843,000. The cumulative payout ratio (the ratio of cumulative cash distributions paid since inception to the cumulative standardized distributable cash generated since inception) is 98.7%.

## OWNERSHIP OF THE FUND

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

	September 30, 2008 <sup>(1)</sup>		September 30, 2007	
	#	%	#	%
Fund units held by public unitholders <sup>(2)</sup> .....	9,703,500	76.40	9,703,500	79.93
Exchangeable Partnership units held by KRL: <sup>(3)</sup>				
Class A units <sup>(4)</sup> .....	905,944	7.13	905,944	7.46
Class B units <sup>(5)</sup> .....	1,826,700	14.38	1,530,840	12.61
Class D units <sup>(5)</sup> .....	<u>265,520</u>	<u>2.09</u>	-	-
Total Exchangeable Partnership units <sup>(6)</sup> .....	<u>2,998,164</u>	<u>23.60</u>	<u>2,436,784</u>	<u>20.07</u>
Total Fund and Exchangeable Partnership units .....	<u>12,701,664</u>	<u>100.00</u>	<u>12,140,284</u>	<u>100.00</u>

Notes:

<sup>(1)</sup> Information is current as of September 30, 2008.

<sup>(2)</sup> Represents the public's total effective ownership of the Fund as of September 30, 2008 and 2007. The public's average effective ownership of the Fund (based on the weighted average number of Fund units held by public unitholders during the respective period) was 76.40% during the three months ended September 30, 2008 (three months ended September 30, 2007 – 79.93%) and 76.40% during the nine months ended September 30, 2008 (nine months ended September 30, 2007 – 78.91%). The weighted average number of Fund units outstanding for the three months ended September 30, 2008 was 9,703,500 (three months ended September 30, 2007 – 9,703,500) and for the nine months ended September 30, 2008 was 9,703,500 (nine months ended September 30, 2007 – 9,579,690). On February 22, 2007, 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 9,703,500 and on February 23, 2007, sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange.

<sup>(3)</sup> Exchangeable into Fund units on a one-for-one basis.

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

<sup>(5)</sup> These exchangeable Partnership units are issued to KRL in return for adding net sales to the Royalty Pool on an annual basis. Class D units may only be issued to KRL after all Class B units have become fully entitled to proportionate distributions from the Partnership (which occurred on January 1, 2008). As of September 30, 2008, KRL is the registered holder of 1,826,700 Class B units and 265,520 Class D units (September 30, 2007 – 1,530,840 Class B units and nil Class D units). Also included in these figures is 80% of the Additional Entitlement estimated at the beginning of each year, pursuant to which KRL received a proportionate increase in monthly distributions from the Partnership. The remaining 20% of KRL's Additional Entitlement to Class B or Class D 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, 2008 and 2007. KRL's average effective ownership of the Fund (based on the weighted average number of Fund and exchangeable units held by KRL during the respective period) was 23.60% during the three months ended September 30, 2008 (three months ended September 30, 2007 – 20.07%) and 23.60% during the nine months ended September 30, 2008 (nine months ended September 30, 2007 – 21.09%).

## 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	
	Sept. 28, <u>2008</u>	Sept. 30, <u>2007</u>	Sept. 28, <u>2008</u>	Sept. 30, <u>2007</u>
Corporate Keg restaurants <sup>(1)</sup> .....	\$ 56,332	\$ 51,851	\$ 167,479	\$ 158,888
Franchised Keg restaurants <sup>(2)</sup> .....	<u>60,466</u>	<u>55,575</u>	<u>173,069</u>	<u>160,436</u>
Total system sales .....	<u>\$ 116,798</u>	<u>\$ 107,426</u>	<u>\$ 340,548</u>	<u>\$ 319,324</u>

Notes:

<sup>(1)</sup> The amount of system sales for the corporate Keg restaurants is the amount of gross sales from corporate Keg restaurants only and excludes its proportionate share of gross sales from a joint venture restaurant located in Coquitlam, British Columbia.

## THIRD QUARTER

System sales for the 13 weeks ended September 28, 2008 were \$116.8 million compared to \$107.4 million for the 13 weeks ended September 30, 2007, an increase of \$9.4 million or 8.7%. During the 13 weeks ended September 28, 2008, one new corporate and two new franchised restaurants were opened, and one corporate restaurant was closed. The closed corporate restaurant, located in Puyallup, Washington, closed due to a lease expiry which had been planned as part of ongoing property rationalization. During the 13 weeks ended September 30, 2007, one corporate restaurant was relocated and no restaurants were closed. As of September 28, 2008, there were a total of 102 Keg restaurants as compared with 96 Keg restaurants at September 30, 2007.

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 1.1% in Canada and decreased by 8.3% 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 were flat. The average exchange rate remained the same at 1.04 in both KRL's fourth quarter of fiscal 2007 and KRL's fourth quarter of fiscal 2008, and therefore there was no exchange rate impact on same store sales during the quarter.

## YEAR TO DATE

System sales for the 39 weeks ended September 28, 2008 were \$340.5 million compared to \$319.3 million for the 39 weeks ended September 30, 2007, an increase of \$21.2 million or 6.6%. During the 39 weeks ended September 28, 2008, five new corporate and three new franchised restaurants were opened, and one corporate and one joint venture restaurant were closed. The closed joint venture restaurant, located in Coquitlam, British Columbia, was substantially damaged by fire in the prior year. The company has elected not to rebuild at the existing location given the short remaining life of the lease, but will relocate to a far superior site within the year. The closed corporate restaurant, located in Puyallup, Washington, closed due to a lease expiry which had been planned as part of ongoing property rationalization. During the 39 weeks ended September 30, 2007, one new corporate restaurant was opened, and two corporate and one franchised restaurant were relocated.

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 3.9% in Canada and decreased by 6.6% 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 1.2%. The average exchange rate moved from 1.11 in KRL's 39-week period of fiscal 2007 to 1.02 in KRL's 39-week period of fiscal 2008, 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 \$102,994,000 to \$108,035,000 for the comparable quarter. The increase of \$5,041,000 or 4.9% was due to the addition of net new sales to the Royalty Pool at the beginning of the year.

#### **ROYALTY INCOME**

Royalty income earned by the Partnership increased by \$172,000 from \$4,211,000 in the third quarter of 2007, to \$4,383,000 in the third quarter of 2008, 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, 2008 were \$93,000 and included general and administrative expenses of \$94,000, and interest income on the surplus cash balances of \$1,000. The decrease of \$4,000 over the comparable quarter in 2007 was due to a decrease in general and administrative expenses of \$4,000 due to the timing of certain expenditures.

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

KRL's interest in the earnings of the Partnership from the Class A, entitled Class B, Class C and Class D Partnership units increased from \$2,016,000 for the three months ended September 30, 2007, to \$2,118,000 for the three months ended September 30, 2008. The increase of \$102,000 was partly 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 20.07% during the three-month period ended September 30, 2007, to 23.60% during the three-month period ended September 30, 2008. The change in the average effective ownership of the Partnership during the period was a result of the Additional Entitlement received by KRL on January 1, 2008.

#### **EQUITY INCOME**

The Fund's equity income from its investment in the Partnership increased from \$2,098,000 during the third quarter of 2007, to \$2,172,000 during the third quarter of 2008. The increase of \$74,000 is due to the net impact of the increase in royalty income of \$172,000, the decrease in Partnership expenses of \$4,000, and the increase in KRL's interest in the earnings of the Partnership of \$102,000.

#### **INTEREST INCOME**

Interest income earned by the Fund for the quarter was \$1,084,000 and included interest income on the Keg Loan of \$1,075,000 and other interest income of \$9,000. Interest income earned by the Fund on the Keg loan decreased by \$3,000 during the quarter. Interest income for the quarter is calculated based on 92 days of a 366 day year, as 2008 is a leap year, rather than on 92 days of a 365 day year, as in the comparable quarter of the prior year. Other interest income decreased by \$3,000 due to lower effective interest rates applied to surplus cash balances during the quarter.

## **INTEREST AND FINANCING EXPENSES**

Interest and financing expenses incurred by the Fund were \$190,000 for the three months ended September 30, 2008, and included interest on the long-term debt of \$185,000 and amortization of deferred financing charges of \$5,000. Interest costs decreased by \$52,000 in the quarter as a result of a decrease in the average interest rate on the long-term debt from 6.72% in the third quarter of 2007 to 5.25% in the third quarter of 2008.

## **EARNINGS BEFORE INCOME TAXES**

Earnings before income taxes increased by \$120,000 from \$2,946,000 (30.4 cents/Fund unit) in the third quarter of 2007, to \$3,066,000 (31.6 cents/Fund unit) in the third quarter of 2008.

## **FUTURE TAX RECOVERY (EXPENSE)**

The future tax expense decreased by \$75,000 from \$75,000 for the three months ended September 30, 2007, to \$nil for the three months ended September 30, 2008. The new tax legislation was substantively enacted in June 2007 and so the Fund was required to recognize the cumulative future income tax liability in the second quarter of 2007.

## **NET EARNINGS AND COMPREHENSIVE INCOME**

Net earnings increased by \$195,000 from \$2,871,000 (29.6 cents/Fund unit) in the third quarter of 2007, to \$3,066,000 (31.6 cents/Fund unit) in the third quarter of 2008, primarily due to the decrease in future tax expense discussed previously.

## **DISTRIBUTABLE CASH**

Cash available for distribution to Fund unitholders decreased by \$63,000 from \$3,183,000 (32.8 cents/Fund unit) to \$3,120,000 (32.2 cents/Fund unit) during the quarter. The difference between the Fund's earnings and distributable cash is due to non-cash items such as amortization and future income tax expense included in the Fund's net earnings, as well as changes in non-cash working capital balances.

## **DISTRIBUTIONS**

Distributions of \$2,937,000 (30.3 cents/ Fund unit) were paid in the third quarter of 2007, and \$3,100,000 (32.0 cents/ Fund unit) in the third quarter of 2008.

## **YEAR TO DATE**

### **GROSS SALES**

Gross sales reported by the restaurants in the Royalty Pool increased from \$309,218,000 to \$327,275,000 for the comparable nine-month period. The increase of \$18,057,000 or 5.8% 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 \$624,000 from \$12,581,000 in the first nine months of 2007, to \$13,205,000 in the first nine months of 2008, 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, 2008 were \$273,000 and included general and administrative expenses of \$276,000 and interest income on the surplus cash balances of \$3,000. The decrease of \$19,000 over the comparable nine-month period in 2007 was due to a decrease in general and administrative expenses of \$19,000 primarily due to a permanent reduction in legal and printing costs associated with the publication of the Fund's Annual Report.

## 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 \$5,776,000 for the nine months ended September 30, 2007, to \$6,208,000 for the nine months ended September 30, 2008. The increase of \$432,000 was partly 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 21.61% during the nine-month period ended September 30, 2007, to 23.60% during the nine-month period ended September 30, 2008. The change in the average effective ownership of the Partnership during the period was a result of the sale of 650,000 Fund units owned by KRL on February 23, 2007, and the Additional Entitlement received by KRL on January 1, 2008.

## EQUITY INCOME

The Fund's equity income from its investment in the Partnership increased from \$6,513,000 during the first nine months of 2007, to \$6,724,000 during the first nine months of 2008. The increase of \$211,000 is due to the net impact of the increase in royalty income of \$624,000, the decrease in Partnership expenses of \$19,000, and the increase in KRL's income in the earnings of the Partnership of \$432,000.

## INTEREST INCOME

Interest income earned by the Fund for the nine-month period was \$3,236,000 and included interest income on the Keg Loan of \$3,200,000, and other interest income of \$36,000. Interest income on the Keg Loan increased by \$3,000 during the period. Interest income for the period is calculated based on 274 days of a 366 day year, as 2008 is a leap year, rather than on 273 days of a 365 day year, as in the comparable period of the prior year. Other interest income increased by \$6,000 due to the net effect of larger surplus cash balances on hand, partially offset by lower effective interest rates applied to these surplus cash balances during the period.

## INTEREST AND FINANCING EXPENSES

Interest and financing expenses incurred by the Fund were \$602,000 for the nine months ended September 30, 2008, and included interest on the long-term debt of \$588,000, and amortization of deferred financing charges of \$14,000. Interest costs decreased by \$100,000 in the nine-month period as a result of a reduction in the average interest rate on the long-term debt from 6.58% in the first nine months of 2007, to 5.59% in the first nine months of 2008.

## EARNINGS BEFORE INCOME TAXES

Earnings before income taxes increased by \$321,000 from \$9,037,000 (94.3 cents/Fund unit) in the first nine months of 2007, to \$9,358,000 (96.4 cents/Fund unit) in the first nine months of 2008.

### **FUTURE TAX RECOVERY (EXPENSE)**

The future tax expense decreased by \$2,000,000 from \$1,875,000 for the nine months ended September 30, 2007, to a future tax recovery of \$150,000 for nine months ended September 30, 2008. The new tax legislation was substantively enacted in June 2007 and so the Fund was required to recognize the cumulative future income tax liability in the second quarter of 2007.

### **NET EARNINGS AND COMPREHENSIVE INCOME**

Net earnings increased by \$2,126,000 from \$7,187,000 (75.0 cents/Fund unit) in the first nine months of 2007, to \$9,508,000 (98.0 cents/Fund unit) in the first nine months of 2008, partly due to the decrease in future tax expense discussed previously.

### **DISTRIBUTABLE CASH**

Cash available for distribution to Fund unitholders increased by \$187,000 from \$9,258,000 (96.7 cents/Fund unit) to \$9,384,000 (96.7 cents/Fund unit) during the period. The difference between the Fund's earnings and distributable cash is due to the non-cash items such as amortization and future tax expense included in the Fund's net earnings, as well as changes in non-cash working capital balances.

### **DISTRIBUTIONS**

Distributions of \$8,500,000 (88.7 cents/Fund unit) were paid in the first nine months of 2007 and \$9,242,000 (95.3 cents Fund/unit) in the first nine months of 2008.

### **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.



## **CONTROLS AND PROCEDURES**

The CEO and CFO have designed or caused to be designed under their supervision, internal controls over financial reporting to provide reliable assurance regarding the reliability of the Fund's financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. There have been no changes in the Fund's internal control over financial reporting during the period covered by this Management Discussion and Analysis that has materially affected, or is reasonably likely to materially affect, the Fund's internal control over financial reporting.

## **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, 2008.

## **NEW ACCOUNTING STANDARDS AND ACCOUNTING POLICY CHANGES**

Effective January 1, 2008, the Fund has adopted the following new accounting standards that were issued by the CICA:

### GENERAL STANDARDS ON FINANCIAL STATEMENT PRESENTATION

Handbook Section 1400, *General Standards on Financial Statement Presentation*, requires the Fund to assess and disclose its ability to continue as a going concern. The Fund's adoption of this standard did not have a material impact on the Fund's consolidated financial statements.

### CAPITAL DISCLOSURE

Handbook Section 1535, *Capital Disclosures*, specifies requirements for the disclosure of: (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any established capital requirements; and (iv) if it has not complied, the consequences of such non-compliance. The required disclosure is in note 10 of the Fund's interim consolidated financial statements.

### FINANCIAL INSTRUMENTS

Handbook Sections 3862 and 3863, *Financial Instruments – Disclosures* and *Financial Instruments – Presentation*, replace Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, revise and enhance its disclosure requirements and carries forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from the financial instruments and how the entity manages those risks. The required disclosure is in notes 11 and 12 of the Fund's interim consolidated financial statements.

## **FUTURE CHANGES IN ACCOUNTING POLICY**

### **INTERNATIONAL FINANCIAL REPORTING STANDARDS**

The CICA plans to amalgamate Canadian GAAP with International Financial Reporting Standards (“IFRS”) over a transition period expected to end in 2011. The impact of the transition to IFRS on the Fund’s financial statements is not yet determinable.

### **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.

### **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.

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 advised the Trustees that it has revised the number of restaurants it expects to open prior to October 2, 2008, primarily due to the late turnover of sites by landlords. Management of KRL has advised that it currently expects to open eight restaurants consisting of four corporate and two franchised restaurants in Canada, as well as one corporate and one franchised restaurant in the United States. 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 several 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 18 restaurants located in the United States, 16 of which are corporately owned through its wholly owned subsidiaries, and two of which are 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).

# THE KEG ROYALTIES INCOME FUND

## CONSOLIDATED FINANCIAL STATEMENTS

For the three and nine months ended September 30, 2008 and 2007

## CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of dollars)

	September 30, 2008 (unaudited)	December 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash .....	\$ 1,440	\$ 1,298
Due from Keg Restaurants Ltd. (note 6) .....	350	363
Due from The Keg Rights Limited Partnership (note 7) .....	<u>133</u>	<u>1,097</u>
	1,923	2,758
Note receivable from Keg Restaurants Ltd. ....	57,000	57,000
Investment in The Keg Rights Limited Partnership (note 3) .....	<u>57,451</u>	<u>56,503</u>
	<u>\$ 116,374</u>	<u>\$ 116,261</u>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
Current liabilities:		
Interest payable on term loan .....	\$ 60	\$ 77
Distributions payable to Fund unitholders .....	<u>-</u>	<u>1,004</u>
	60	1,081
Term loan, net of deferred financing charges .....	13,953	13,939
Future income taxes .....	1,600	1,750
Unitholders' equity:		
Capital contributions .....	100,014	100,014
Retained earnings (deficit) .....	<u>747</u>	<u>(523)</u>
	<u>100,761</u>	<u>99,491</u>
	<u>\$ 116,374</u>	<u>\$ 116,261</u>

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 AND COMPREHENSIVE INCOME

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

	July 1 to Sept 30, <u>2008</u>	July 1 to Sept 30, <u>2007</u>	January 1 to Sept 30, <u>2008</u>	January 1 to Sept 30, <u>2007</u>
Revenue:				
Equity income (note 3) .....	\$ 2,172	\$ 2,098	\$ 6,724	\$ 6,513
Interest income .....	<u>1,084</u>	<u>1,090</u>	<u>3,236</u>	<u>3,226</u>
	3,256	3,188	9,960	9,739
Expenses:				
Interest and financing fees .....	(185)	(237)	(588)	(688)
Amortization of deferred financing charges .....	<u>(5)</u>	<u>(5)</u>	<u>(14)</u>	<u>(14)</u>
	<u>(190)</u>	<u>(242)</u>	<u>(602)</u>	<u>(702)</u>
Earnings before income taxes .....	3,066	2,946	9,358	9,037
Future income tax recovery (expense) .....	-	<u>(75)</u>	<u>150</u>	<u>(1,850)</u>
Net earnings and comprehensive income for the period ..	<u>\$ 3,066</u>	<u>\$ 2,871</u>	<u>\$ 9,508</u>	<u>\$ 7,187</u>
Weighted average units outstanding (note 8) .....	<u>9,703,500</u>	<u>9,703,500</u>	<u>9,703,500</u>	<u>9,579,690</u>
Basic and diluted earnings per unit .....	<u>\$ 0.32</u>	<u>\$ 0.30</u>	<u>\$ 0.98</u>	<u>\$ 0.75</u>

## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

(Expressed in thousands of dollars - unaudited)

	July 1 to Sept 30, <u>2008</u>	July 1 to Sept 30, <u>2007</u>	January 1 to Sept 30, <u>2008</u>	January 1, to Sept 30, <u>2007</u>
Retained earnings (deficit), beginning of period .....	\$ 781	\$ 307	\$ (523)	\$ 691
Net earnings .....	3,066	2,871	9,508	7,187
Distributions declared to Fund unitholders .....	<u>(3,100)</u>	<u>(2,935)</u>	<u>(8,238)</u>	<u>(7,635)</u>
Retained earnings, end of period .....	<u>\$ 747</u>	<u>\$ 243</u>	<u>\$ 747</u>	<u>\$ 243</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars - unaudited)

	<u>July 1 to Sept 30, 2008</u>	<u>July 1 to Sept 30, 2007</u>	<u>January 1 to Sept 30, 2008</u>	<u>January 1 to Sept 30, 2007</u>
<b>Cash provided by (used for):</b>				
<b>OPERATIONS:</b>				
Net earnings for the period .....	\$ 3,066	\$ 2,871	\$ 9,508	\$ 7,187
Items not involving cash:				
Amortization of deferred financing charges .....	5	5	14	14
Equity income (note 3) .....	(2,172)	(2,098)	(6,724)	(6,513)
Future income tax expense (recovery) .....	-	75	(150)	1,850
Distributions from The Keg Rights Limited Partnership	2,192	2,122	5,776	5,548
Change in non-cash operating working capital				
(note 13(a)) .....	<u>29</u>	<u>208</u>	<u>960</u>	<u>1,172</u>
	3,120	3,183	9,384	9,258
<b>FINANCING:</b>				
Distributions paid to Fund unitholders .....	<u>(3,100)</u>	<u>(2,937)</u>	<u>(9,242)</u>	<u>(8,500)</u>
Increase in cash .....	20	246	142	758
Cash, beginning of period .....	<u>1,420</u>	<u>1,074</u>	<u>1,298</u>	<u>562</u>
Cash, end of period .....	<u>\$ 1,440</u>	<u>\$ 1,320</u>	<u>\$ 1,440</u>	<u>\$ 1,320</u>

See note 13(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, 2008 and 2007

### 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 (“GAAP”) on a basis consistent with those used and described in the annual consolidated financial statements for the year ended December 31, 2007, except as described below in note 2. The disclosures contained in these interim consolidated financial statements do not include all the requirements of Canadian GAAP 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, 2007.

### 2. NEW ACCOUNTING STANDARDS AND ACCOUNTING POLICIES:

Effective January 1, 2008, the Fund has adopted the following new accounting standards that were issued by the Canadian Institute of Chartered Accountants:

(a) General standards on financial statement presentation:

Handbook Section 1400, *General Standards on Financial Statement Presentation*, requires the Fund to assess and disclose its ability to continue as a going concern. The Fund’s adoption of this standard did not have a material impact on disclosure in the Fund’s consolidated financial statements.

(b) Capital disclosure:

Handbook Section 1535, *Capital Disclosures*, specifies requirements for the disclosure of: (i) an entity’s objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any established capital requirements; and (iv) if it has not complied, the consequences of such non-compliance (note 10).

(c) Financial instruments:

Handbook Sections 3862 and 3863, *Financial Instruments – Disclosures* and *Financial Instruments – Presentation*, replace Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, revise and enhance its disclosure requirements and carries forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks (notes 11 and 12).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

### 3. EQUITY INVESTMENT:

	September 30, <u>2008</u>	December 31, <u>2007</u>
Investment in the Partnership, at cost .....	\$ 56,669	\$ 56,669
Accumulated equity earnings less distributions received, beginning of period .....	(166)	(242)
Equity income in the Partnership .....	6,724	8,762
Distributions from the Partnership .....	<u>(5,776)</u>	<u>(8,686)</u>
Equity investment in the Partnership .....	<u>\$ 57,451</u>	<u>\$ 56,503</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"), 1,550,000 Class B units and 99% of the General Partnership units ("GP units") of the Partnership through its 90% interest in The Keg GP Ltd.

Summarized financial information of the Partnership is as follows:

	September 30, <u>2008</u>	December 31, <u>2007</u>
Current assets .....	\$ 2,005	\$ 2,112
Long-term assets, being Keg Rights .....	<u>140,156</u>	<u>135,927</u>
Total assets .....	<u>\$ 142,161</u>	<u>\$ 138,039</u>
Current liabilities .....	\$ 485	\$ 2,290
Partners' equity .....	<u>141,676</u>	<u>135,749</u>
Total liabilities and equity .....	<u>\$ 142,161</u>	<u>\$ 138,039</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

### 3. EQUITY INVESTMENT (CONTINUED):

	July 1 to Sept 30, <u>2008</u>	July 1 to Sept 30, <u>2007</u>	January 1 to Sept 30, <u>2008</u>	January 1 to Sept 30, <u>2007</u>
System sales reported by Keg restaurants in the Royalty Pool .....	\$ <u>108,035</u>	\$ <u>102,994</u>	\$ <u>327,275</u>	\$ <u>309,218</u>
Royalty income at 4% of system sales reported above .....	\$ 4,321	\$ 4,120	\$ 13,091	\$ 12,369
Make-whole payment, based on 4% of lost system sales .....	<u>62</u>	<u>91</u>	<u>114</u>	<u>212</u>
Total royalty income .....	4,383	4,211	13,205	12,581
Expenses .....	<u>(93)</u>	<u>(97)</u>	<u>(273)</u>	<u>(292)</u>
Net earnings of the Partnership for the period .....	4,290	4,114	12,932	12,289
KRL's interest in the net earnings of the Partnership .....	<u>(2,118)</u>	<u>(2,016)</u>	<u>(6,208)</u>	<u>(5,776)</u>
Equity income for the period .....	<u>\$ 2,172</u>	<u>\$ 2,098</u>	<u>\$ 6,724</u>	<u>\$ 6,513</u>

### 4. ROYALTY POOL:

Annually, on January 1, the 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 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 of each year when the actual full year performance of the new restaurants is known with certainty.

The gross sales reported by the 96 Keg restaurants in the Royalty Pool are from January 1 to September 30, 2008 (January 1 to September 30, 2007 – 95 Keg restaurants).

The royalty payment from KRL to the Partnership is four percent of system sales for such period reported by Keg restaurants in the Royalty Pool plus a make-whole payment, if required by a restaurant closure, based on four percent of lost system sales. System sales for any period and for any Keg restaurant located in Canada and the United States, as defined in the Licence and Royalty Agreement, means the gross sales by such Keg restaurants for such period. The make-whole payment is based on two restaurant closures for the period from January 1 to September 30, 2008 (January 1 to September 30, 2007 – three restaurant closures).

## 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, 2008 and 2007

### 4. ROYALTY POOL (CONTINUED):

On January 1, 2008, four new Keg restaurants that opened during the period from October 3, 2006 to October 2, 2007 were added to the Royalty Pool. The gross sales of these four new restaurants have been estimated at \$20.5 million annually. Three permanently closed Keg restaurants with annual sales of \$7.4 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$13.1 million annually. The yield of the Fund Units was determined to be 8.54% calculated using a weighted average unit price of \$13.78.

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 413,367 Fund units, being 3.23% of the Fund units on a fully diluted basis. On January 1, 2008, KRL received 80% of this entitlement representing the equivalent of 330,694 Fund units, being 2.60% 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 2,998,164 Fund units, representing 23.60% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2008 once the actual performance of the new restaurants have been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2008, it would have the right to exchange its Partnership Units for 3,080,837 Fund units, representing 24.10% of the Fund units on a fully diluted basis.

### 5. UNITHOLDER DISTRIBUTIONS:

	July 1 to Sept 30, <u>2008</u>	July 1 to Sept 30, <u>2007</u>	January 1 to Sept 30, <u>2008</u>	January 1 to Sept 30, <u>2007</u>
Distributions declared to Fund unitholders .....	\$ <u>3,100</u>	\$ <u>2,935</u>	\$ <u>8,238</u>	\$ <u>7,635</u>
Weighted average Fund units outstanding (note 8)...	<u>9,703,500</u>	<u>9,703,500</u>	<u>9,703,500</u>	<u>9,579,690</u>
Weighted average distributions declared per unit ....	\$ <u>0.32</u>	\$ <u>0.30</u>	\$ <u>0.85</u>	\$ <u>0.80</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. The determination to declare and make payable distributions from the Fund are at the discretion of the board of Trustees of the Fund and until declared payable, the Fund has no requirement to pay cash distributions to Fund unitholders.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

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

	September 30, <u>2008</u>	December 31, <u>2007</u>
Interest on note receivable from Keg Restaurants Ltd. ....	<u>\$ 350</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.

### 7. 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.

### 8. UNITHOLDERS' EQUITY:

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.

On February 22, 2007, 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 \$13.95 which resulted in an additional \$9,067,500 recorded as unitholders' equity. Thereafter, on February 23, 2007, 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

For the three and nine months ended September 30, 2008 and 2007

### 9. EXCHANGEABLE UNITS:

In return for adding net sales to the Royalty Pool, KRL has received the following Partnership units that are exchangeable into Fund units:

	September 30, <u>2008</u>	December 31, <u>2007</u>
Class A Partnership units (a) .....	905,944	905,944
Class B Partnership units (b) .....	1,826,700	1,761,525
Class D Partnership units (c) .....	<u>265,520</u>	<u>-</u>
	<u>2,998,164</u>	<u>2,667,469</u>

Pursuant to the declaration of trust, the holders (other than the Fund or its subsidiaries) of the Class A Partnership units ("Class A units"), Class B Partnership units ("Class B units") and Class D Partnership units ("Class D units") 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, entitled Class B and Class D 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.

- (a) The Class A units are entitled to a preferential proportionate distribution equal to the distribution on the Class C Partnership units ("Class C units"), multiplied by the number of Class A units divided by the number of LP Partnership units ("LP units") issued and outstanding. KHT holds all of the 8,153,500 LP units issued and outstanding at September 30, 2008. 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 and Class D units, the number issued and outstanding multiplied by the Class B and Class D current distribution entitlement, respectively). Class A units are exchangeable for Fund units on the basis of one Fund unit for one Class A unit.
- (b) 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 until such date that all Class B units have received entitlement (the "Class B Termination Date"). Concurrent with the January 1, 2008 roll-in, the Class B Termination Date was reached and the last of the Class B units became entitled. 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, 2008, 1,826,700 (December 31, 2007 – 1,761,525) Class B units held by KRL receive a distribution entitlement.
- (c) The Class D 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 D units are adjusted annually on January 1. Class D 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, 2008, 265,520 (December 31, 2007 – nil) Class D units held by KRL receive a distribution entitlement. Class D units are issued subsequent to the Class B Termination Date and are identical to Class B units except that the Trustees of KHT can require KRL to surrender any or all of the issued Class D units for a price that is equal to the one originally used in the formula to calculate the number of units issued.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

### 10. CAPITAL DISCLOSURES:

The Fund's objectives in managing its capital, which it defines as unitholders' equity, are:

- To safeguard the Fund's ability to continue as a going concern;
- To provide financial capacity and flexibility to meet its strategic objectives;
- To provide adequate return to unitholders commensurate with the level of risk; and
- To distribute excess cash through distributions.

The Fund maintains financial policies and manages its liquidity and capital structure and makes adjustments to it in light of changes to economic conditions, the underlying risks inherent in its operations and capital requirement to maintain and grow its operations.

The Fund is not subject to any statutory capital requirements and has no commitments to sell or otherwise issue units, other than the commitment to exchange Class A, Class B and Class D units held by KRL for Fund units (note 9).

### 11. FINANCIAL INSTRUMENTS:

The Fund classified its financial instruments as follows:

- Cash as *held-for-trading*, which is measured at fair value.
- Amounts due from KRL and the Partnership and the note receivable from KRL as *loans and receivables*, which are initially measured at fair value and subsequently at amortized cost.
- Interest payable on term loan and distributions payable to Fund unitholders as *other financial liabilities*, which are measured at amortized cost.

The requirement for the Fund to settle its note receivable from KRL in exchange for Class C units is classified as a *derivative instrument*. The Fund has reviewed the net impact of this potential exchange requirement on its cash flows and has determined there is no significant value applicable to this feature.

The fair values of the amounts due from KRL and the Partnership, interest payable on term loan and distributions payable to Fund unitholders approximate their carrying amounts largely due to the short-term maturities of these instruments.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

### 12. FINANCIAL RISK MANAGEMENT:

The Fund is exposed to credit risk, liquidity risk, interest rate risk and foreign currency exchange rate risk as they relate to the Fund's identified financial instruments.

(a) Credit risk:

Credit risk is defined by the Fund as an unexpected loss in cash and earnings if the other party is unable to pay its obligations in due time. The Fund's exposure to credit risk arises from its amounts due from KRL and the Partnership and the note receivable from KRL, which are consolidated in KRL's financial statements. The Fund monitors this risk through its regular review of the operating and financing activities of KRL. Since its inception, the Fund has never failed to collect its receivables on a timely basis.

The performance of the Fund is directly dependent upon the royalty and interest payments received from KRL. The amount of the royalty received from KRL is dependent on various factors that may affect the casual dining sector of the restaurant industry. The restaurant industry generally, and in particular the casual dining sector, is intensely competitive with respect to price, service, location and food quality. If KRL and the Keg franchisees are unable to successfully compete in the casual dining sector, sales may be adversely affected, the amount of royalty reduced and the ability of KRL to pay the royalty or interest on the loan from KRL to the Fund may be impacted.

(b) Liquidity risk:

Liquidity risk results from the Fund's potential inability to meet its financial liabilities. Beyond effective net working capital and cash management, the Fund constantly monitors the operations and cash flows of the Partnership to ensure that current and future distributions to unitholders will be met.

The Fund's capital resources are compromised of cash and cash flow from operating activities.

The Fund is subject to certain guarantor covenants and reporting requirements arising from the Partnership's undrawn \$1 million operating line of credit and KHT's \$14 million term loan.

(c) Interest rate risk:

The Fund's interest rate risk exposure is mainly related to an interest-bearing note receivable from KRL and the \$14 million term loan. As the note receivable from KRL has a fixed rate of 7.5%, is from a related party and is due on May 31, 2042, the Fund does not perform interest rate risk management to minimize the overall financial interest rate risk on this financial instrument. The term loan requires interest payments at bank prime plus 0.5% and net earnings would change by approximately \$17,500 during the quarter if the prime rate changed by 0.5%.

(d) Foreign currency exchange rate risk:

The Fund is exposed to foreign currency exchange rate risk as a result of the translation of KRL's US dollar sales into Canadian dollars for the purposes of calculating the monthly royalty. Based on the US dollar sales of Keg restaurants included in the Royalty Pool for the three months ended September 30, 2008, a 100 basis point change in the US dollar exchange rate would result in an approximate \$125,000 and \$5,000 change in Royalty Pool sales and royalty revenue, respectively.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars - unaudited)

For the three and nine months ended September 30, 2008 and 2007

### 13. SUPPLEMENTARY CASH FLOW INFORMATION:

	July 1 to Sept 30, <u>2008</u>	July 1 to Sept 30, <u>2007</u>	January 1 to Sept 30, <u>2008</u>	January 1 to Sept 30, <u>2007</u>
(a) Change in non-cash operating working capital:				
Due from Keg Restaurants Ltd. ....	\$ -	\$ -	\$ 13	\$ 12
Due from The Keg Rights Limited Partnership .....	29	205	964	1,159
Interest payable on term loan .....	<u>-</u>	<u>3</u>	<u>(17)</u>	<u>1</u>
	<u>\$ 29</u>	<u>\$ 208</u>	<u>\$ 960</u>	<u>\$ 1,172</u>
(b) Supplementary information:				
Interest received .....	\$ 1,084	\$ 1,090	\$ 3,249	\$ 3,238
Interest paid .....	185	234	605	687
Non-cash transactions:				
Issuance of Fund units to acquire additional interest in the Partnership .....	-	-	-	9,068

## 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  
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# KEG RESTAURANTS LTD.

YEAR END REPORT  
For the 13 and 52 weeks ended September 28, 2008

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 September 28, 2008.

### SELECTED FINANCIAL INFORMATION OF KRL

	13 weeks ended Sept. 28, 2008	13 weeks ended Sept. 30, 2007	52 weeks ended Sept. 28, 2008	52 weeks ended Sept. 30, 2007
	(in thousands of dollars)			
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 116,798</b>	<b>\$ 107,426</b>	<b>\$ 449,443</b>	<b>\$ 425,681</b>
Corporate restaurant sales <sup>(2)</sup> .....	\$ 56,344	\$ 51,851	\$ 222,215	\$ 212,355
Corporate restaurant costs <sup>(3)</sup> .....	(48,878)	(43,979)	(186,054)	(175,254)
Corporate restaurant profit .....	7,466	7,872	36,161	37,101
Retail operating contribution (loss) <sup>(4)</sup> .....	(116)	48	(124)	23
Franchise fee income .....	2,947	2,697	11,069	10,399
General and administrative expenses <sup>(5)</sup> .....	(4,688)	(4,775)	(20,330)	(19,390)
<b>Operating earnings</b> .....	<b>5,609</b>	<b>5,842</b>	<b>26,776</b>	<b>28,133</b>
Partnership expenses <sup>(6)</sup> .....	(93)	(97)	(350)	(397)
Non-controlling interest <sup>(7)</sup> .....	(2,172)	(2,098)	(8,974)	(8,569)
Gain on sale of Class B units <sup>(8)</sup> .....	-	-	-	964
Executive bonus <sup>(9)</sup> .....	(200)	(500)	(200)	(500)
<b>EBITDA</b> <sup>(10)</sup> .....	<b>3,144</b>	<b>3,147</b>	<b>17,252</b>	<b>19,631</b>
Non-cash expenses <sup>(11)</sup> .....	(3,970)	(1,898)	(11,928)	(9,121)
Interest <sup>(12)</sup> .....	(1,581)	(1,394)	(5,975)	(5,637)
<b>Earnings (loss) before income taxes</b> .....	<b>(2,407)</b>	<b>(145)</b>	<b>(651)</b>	<b>4,873</b>
Income tax recovery (expense) .....	301	(325)	(477)	(1,420)
<b>Net earnings (loss)</b> .....	<b>\$ (2,106)</b>	<b>\$ (470)</b>	<b>\$ (1,128)</b>	<b>\$ 3,453</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) Includes food and beverage costs, staff and management labour costs, as well as premises costs for all restaurants owned by KRL and its proportionate share of restaurant costs from a joint venture located in Coquitlam, B.C.
- (4) Represents the revenue net of related expenses of a wholly owned subsidiary, which sells Keg branded food and liquor products.
- (5) Includes marketing and advertising expenses, net of franchise contributions, as well as general and administrative costs associated with the operation of KRL in providing services to the corporate and franchised Keg restaurants.
- (6) 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").
- (7) 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, Class C and Class D Partnership units.
- (8) On February 22, 2007, KRL exchanged 650,000 Class B units of the Partnership for an equal number of Fund units and on February 23, 2007, sold those Fund units. A gain on sale was realized as the net proceeds received from the sale of those Fund units exceeded the weighted average cost of the units sold.
- (9) 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.
- (10) 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.
- (11) Includes amortization, net of amortization on the deferred gain, as well as gains or losses on the disposal of property, plant and equipment.
- (12) Includes interest paid to third parties, net of interest earned, and interest paid on the \$57.0 million note payable to the Fund.
- (13) The interim financial results for all periods presented herein have not been reviewed by our auditors.

## SUMMARY OF QUARTERLY FINANCIAL RESULTS

	Q4 2008	Q3 2008	Q2 2008	Q1 2008
	(in thousands of dollars)			
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 116,798</b>	<b>\$ 112,150</b>	<b>\$ 111,600</b>	<b>\$ 108,895</b>
Corporate restaurant sales <sup>(2)</sup> .....	\$ 56,344	\$ 56,218	\$ 54,920	\$ 54,732
Corporate restaurant costs <sup>(3)</sup> .....	(48,878)	(47,995)	(45,046)	(44,135)
Corporate restaurant profit .....	7,466	8,223	9,874	10,597
Retail operating contribution (loss) <sup>(4)</sup> .....	(116)	22	10	(40)
Franchise fee income .....	2,947	2,740	2,746	2,637
General and administrative expenses <sup>(5)</sup> .....	(4,688)	(5,325)	(5,409)	(4,908)
<b>Operating earnings</b> .....	<b>5,609</b>	<b>5,660</b>	<b>7,221</b>	<b>8,286</b>
Partnership expenses <sup>(6)</sup> .....	(93)	(81)	(99)	(77)
Non-controlling interest <sup>(7)</sup> .....	(2,172)	(2,220)	(2,332)	(2,250)
Gain on sale of Class B units <sup>(8)</sup> .....	-	-	-	-
Executive bonus <sup>(9)</sup> .....	(200)	-	-	-
<b>EBITDA</b> <sup>(10)</sup> .....	<b>3,144</b>	<b>3,359</b>	<b>4,790</b>	<b>5,959</b>
Non-cash expenses <sup>(11)</sup> .....	(3,970)	(2,892)	(2,560)	(2,506)
Interest <sup>(12)</sup> .....	(1,581)	(1,542)	(1,408)	(1,444)
<b>Earnings (loss) before income taxes</b> .....	<b>(2,407)</b>	<b>(1,075)</b>	<b>822</b>	<b>2,009</b>
Income tax recovery (expense) .....	301	(122)	(59)	(594)
<b>Net earnings (loss)</b> .....	<b>\$ (2,106)</b>	<b>\$ (1,197)</b>	<b>\$ 763</b>	<b>\$ 1,415</b>
	Q4 2007	Q3 2007	Q2 2007	Q1 2007
	(in thousands of dollars)			
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 107,426</b>	<b>\$ 104,941</b>	<b>\$ 106,960</b>	<b>\$ 106,354</b>
Corporate restaurant sales <sup>(2)</sup> .....	\$ 51,851	\$ 52,593	\$ 54,445	\$ 53,466
Corporate restaurant costs <sup>(3)</sup> .....	(43,979)	(44,302)	(44,247)	(42,739)
Corporate restaurant profit .....	7,872	8,291	10,198	10,727
Retail operating contribution (loss) <sup>(4)</sup> .....	48	37	(24)	(39)
Franchise fee income .....	2,697	2,539	2,607	2,556
General and administrative expenses <sup>(5)</sup> .....	(4,775)	(5,195)	(4,628)	(4,779)
<b>Operating earnings</b> .....	<b>5,842</b>	<b>5,672</b>	<b>8,153</b>	<b>8,465</b>
Partnership expenses <sup>(6)</sup> .....	(97)	(93)	(102)	(105)
Non-controlling interest <sup>(7)</sup> .....	(2,098)	(2,182)	(2,232)	(2,057)
Gain on sale of Class B units <sup>(8)</sup> .....	-	-	964	-
Executive bonus <sup>(9)</sup> .....	(500)	-	-	-
<b>EBITDA</b> <sup>(10)</sup> .....	<b>3,147</b>	<b>3,397</b>	<b>6,783</b>	<b>6,303</b>
Non-cash expenses <sup>(11)</sup> .....	(1,898)	(2,533)	(2,425)	(2,265)
Interest <sup>(12)</sup> .....	(1,394)	(1,384)	(1,409)	(1,450)
<b>Earnings (loss) before income taxes</b> .....	<b>(145)</b>	<b>(520)</b>	<b>2,949</b>	<b>2,588</b>
Income tax recovery (expense) .....	(325)	(159)	(1,788)	852
<b>Net earnings (loss)</b> .....	<b>\$ (470)</b>	<b>\$ (679)</b>	<b>\$ 1,161</b>	<b>\$ 3,440</b>

SELECTED ANNUAL FINANCIAL INFORMATION OF KRL

	52 weeks ended Sept. 28, 2008	52 weeks ended Sept. 30, 2007	52 weeks ended Oct. 1, 2006
(in thousands of dollars)			
<b>System sales</b> <sup>(1)</sup> .....	<b>\$ 449,443</b>	<b>\$ 425,681</b>	<b>\$ 380,181</b>
Corporate restaurant sales <sup>(2)</sup> .....	\$ 222,215	\$ 212,355	\$ 191,195
Corporate restaurant costs <sup>(3)</sup> .....	<u>(186,054)</u>	<u>(175,254)</u>	<u>(160,550)</u>
Corporate restaurant profit .....	36,161	37,101	30,645
Retail operating contribution (loss) <sup>(4)</sup> .....	(124)	23	42
Franchise fee income .....	11,069	10,399	9,108
General and administrative expenses <sup>(5)</sup> .....	<u>(20,330)</u>	<u>(19,390)</u>	<u>(16,354)</u>
<b>Operating earnings</b> .....	<b>26,776</b>	<b>28,133</b>	<b>23,441</b>
Partnership expenses <sup>(6)</sup> .....	(350)	(397)	(440)
Non-controlling interest <sup>(7)</sup> .....	(8,974)	(8,569)	(6,883)
Gain on sale of Class B units <sup>(8)</sup> .....	-	964	713
Executive Bonus <sup>(9)</sup> .....	<u>(200)</u>	<u>(500)</u>	<u>(500)</u>
<b>EBITDA</b> <sup>(10)</sup> .....	<b>17,252</b>	<b>19,631</b>	<b>16,331</b>
Non-cash expenses <sup>(11)</sup> .....	(11,928)	(9,121)	(9,512)
Interest <sup>(12)</sup> .....	<u>(5,975)</u>	<u>(5,637)</u>	<u>(6,172)</u>
<b>Earnings (loss) before income taxes</b> .....	<b>(651)</b>	<b>4,873</b>	<b>647</b>
Income tax recovery (expense) .....	<u>(477)</u>	<u>(1,420)</u>	<u>(753)</u>
<b>Net earnings (loss)</b> .....	<b>\$ (1,128)</b>	<b>\$ 3,453</b>	<b>\$ (106)</b>
<hr/>			
	Sept. 28, 2008	Sept. 30, 2007	Oct. 1, 2006
Total assets .....	\$ 134,151	\$ 113,125	\$ 104,126
Total long-term liabilities .....	141,132	129,651	125,345

## MANAGEMENT DISCUSSION AND ANALYSIS

For the 13 and 52 Weeks Ended September 28, 2008  
As of December 29, 2008

### 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 other related intellectual 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, 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 equal to 4% of gross sales of Keg restaurants included in a specific royalty pool (the “Royalty Pool”).

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, labour costs, and premises 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, Class C, and Class D Partnership units.



## **THE ROYALTY POOL**

Annually, on January 1st, the Royalty Pool is adjusted to include the gross sales from new Keg restaurants that have opened on or before October 2nd 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 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 31st 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 95 as of December 31, 2007. Twenty-seven new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2006, with annual gross sales of \$128.0 million, have been added to the Royalty Pool. Twelve permanently closed Keg restaurants with annual sales of \$30.5 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$97.5 million annually and KRL receiving a cumulative Additional Entitlement equivalent to 3,311,525 Fund units as of December 31, 2007.

On January 1, 2008, four new Keg restaurants that opened during the period from October 3, 2006 through October 2, 2007 were added to the Royalty Pool. The gross sales of these four new restaurants have been estimated at \$20.5 million annually. Three permanently closed Keg restaurants with annual sales of \$7.4 million were removed from the Royalty Pool resulting in an estimated net increase in Royalty Pool sales of \$13.1 million annually. The total number of restaurants in the Royalty Pool increased to 96. The yield of the Fund units was determined to be 8.54% calculated using a weighted average unit price of \$13.78.

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 413,367 Fund units, being 3.23% of the Fund units on a fully diluted basis. On January 1, 2008, KRL received 80% of this entitlement representing the equivalent of 330,694 Fund units, being 2.60% 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 2,998,164 Fund units representing 23.60% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted on December 31, 2008, to be effective January 1, 2008, once the actual performance of the new restaurants has been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2008, it would have the right to exchange its Partnership units for 3,080,837 Fund units representing 24.10% 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 28, 2008 <sup>(1)</sup>		September 30, 2007	
	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>
Fund units held by public unitholders <sup>(2)</sup> .....	9,703,500	76.40	9,703,500	79.93
Exchangeable Partnership units held by KRL: <sup>(3)</sup>				
Class A units <sup>(4)</sup> .....	905,944	7.13	905,944	7.46
Class B units <sup>(5)</sup> .....	1,826,700	14.38	1,530,840	12.61
Class D units <sup>(5)</sup> .....	<u>265,520</u>	<u>2.09</u>	-	-
Total Exchangeable Partnership units <sup>(6)</sup> .....	<u>2,998,164</u>	<u>23.60</u>	<u>2,436,784</u>	<u>20.07</u>
Total Fund and Exchangeable Partnership units.....	<u>12,701,664</u>	<u>100.00</u>	<u>12,140,284</u>	<u>100.00</u>

Notes:

<sup>(1)</sup> Information is current as of September 28, 2008.

<sup>(2)</sup> Represents the public's total effective ownership of the Fund as of September 28, 2008 and September 30, 2007. The public's average effective ownership of the Fund (based on the weighted average number of Fund units held by public unitholders during the respective period) was 76.40% during the 13 weeks ended September 28, 2008 (13 weeks ended September 30, 2007 – 79.93%) and for the 52 weeks ended September 28, 2008 was 76.90% (52 weeks ended September 30, 2007 – 78.78%). The weighted average number of Fund units outstanding for the 13-week period ended September 28, 2008 were 9,703,500 (13-week period ended September 30, 2007 – 9,703,500) and for the 52-week period ended September 28, 2008 were 9,703,500 (52-week period ended September 30, 2007 – 9,447,061). On February 22, 2007, 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 9,703,500 and on February 23, 2007, sold these 650,000 Fund units through the facilities of the Toronto Stock Exchange.

<sup>(3)</sup> Exchangeable into Fund units on a one-for-one basis.

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

<sup>(5)</sup> These exchangeable Partnership units are issued to KRL in return for adding net sales to the Royalty Pool on an annual basis. Class D units may only be issued to KRL after all Class B units have become fully entitled to proportionate distributions from the Partnership (which occurred on January 1, 2008). As of September 28, 2008, KRL is the registered holder of 1,826,700 Class B units and 265,520 Class D units (September 30, 2007 – 1,530,840 Class B units and Nil Class D units). 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 or Class D units is adjusted retroactively to January 1st 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 28, 2008 and September 30, 2007. KRL's average effective ownership of the Fund (based on the weighted average number of Fund and exchangeable units held by KRL during the respective period) was 23.60% during the 13 weeks ended September 28, 2008 (13 weeks ended September 30, 2007 – 20.07%) and 23.10% during the 52 weeks ended September 28, 2008 (52 weeks ended September 30, 2007 - 21.22%).

## 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, Class C and Class D Partnership units.

(\$000's)	13 weeks ended Sept. 28, <u>2008</u>	13 weeks ended Sept. 30, <u>2007</u>	52 weeks ended Sept. 28, <u>2008</u>	52 weeks ended Sept. 30, <u>2007</u>
Royalty income <sup>(1)</sup> .....	\$ 4,383	\$ 4,211	\$ 17,451	\$ 16,619
Partnership expenses <sup>(2)</sup> .....	<u>(93)</u>	<u>(97)</u>	<u>(350)</u>	<u>(397)</u>
Partnership earnings .....	4,290	4,114	17,101	16,222
KRL's interest <sup>(3)</sup> .....	<u>(2,118)</u>	<u>(2,016)</u>	<u>(8,127)</u>	<u>(7,653)</u>
Non-controlling interest <sup>(4)</sup> .....	<u>\$ 2,172</u>	<u>\$ 2,098</u>	<u>\$ 8,974</u>	<u>\$ 8,569</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, Class C and Class D Partnership units. The Class A, entitled Class B and Class D 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.

## SYSTEM SALES

The operating earnings of KRL are derived from the profits from corporate-owned Keg restaurants, its 50% share of the profits from a joint venture restaurant, franchise fee income, and revenue (net of related expenses) from sales of food and liquor products marketed under The Keg brand name. Profits from corporate-owned restaurants are directly affected by the gross sales from these restaurants and franchise fee income is directly affected by the gross sales from the joint venture and franchised restaurants. The total system sales of The Keg chain are of interest to readers as these sales best reflect the chain's overall performance. The following table sets out The Keg's total systems sales for the periods indicated below:

(\$000's)	13 weeks ended Sept. 28, <u>2008</u>	13 weeks ended Sept. 30, <u>2007</u>	52 weeks ended Sept. 28, <u>2008</u>	52 weeks ended Sept. 30, <u>2007</u>
Corporate Keg restaurants <sup>(1)</sup> .....	\$ 56,344	\$ 51,851	\$ 222,215	\$ 212,355
Franchised Keg restaurants <sup>(2)</sup> .....	<u>60,454</u>	<u>55,575</u>	<u>227,228</u>	<u>213,326</u>
Total system sales .....	<u>\$ 116,798</u>	<u>\$ 107,426</u>	<u>\$ 449,443</u>	<u>\$ 425,681</u>

Notes:

<sup>(1)</sup> The amount of system sales for the corporate Keg restaurants is the amount of gross sales from the corporate Keg restaurants only and excludes its proportionate share of gross sales from a joint venture restaurant located in Coquitlam, British Columbia.

<sup>(2)</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.

## **FOURTH QUARTER**

System sales for the 13 weeks ended September 28, 2008 were \$116,798,000 compared to \$107,426,000 for the 13 weeks ended September 30, 2007, an increase of \$9,372,000 or 8.7%. During the 13 weeks ended September 28, 2008, one new corporate and two new franchised restaurants were opened, and one corporate restaurant was closed. The closed corporate restaurant, located in Puyallup, Washington, closed due to a lease expiry which had been planned as part of an ongoing property rationalization. During the 13 weeks ended September 30, 2007, one corporate restaurant was relocated and no restaurants were closed. As of September 28, 2008, there were a total of 102 Keg restaurants as compared with 96 restaurants at September 30, 2007.

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 1.1% in Canada and decreased by 8.3% 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 were flat. The average exchange rate remained the same at 1.04 in both the fourth quarter of fiscal 2007, and the fourth quarter of fiscal 2008, and therefore there was no exchange rate impact on same store sales during the quarter.

## **YEAR END**

System sales for the 52 weeks ended September 28, 2008 were \$449,443,000 compared to \$425,681,000 for the 52 weeks ended September 30, 2007, an increase of \$23,762,000 or 5.6%. During the 52 weeks ended September 28, 2008, five new corporate and three new franchised restaurants were opened, and one corporate and one joint venture restaurant were closed. The closed corporate restaurant, located in Puyallup, Washington, closed due to a lease expiry which had been planned as part of an ongoing property rationalization. The closed joint venture restaurant, located in Coquitlam, British Columbia was substantially damaged by fire in the prior year. The company has elected not to re-build at the existing location given the short remaining life of the lease, and instead relocate to a far superior site within the year. During the 52 weeks ended September 30, 2007, one new corporate restaurant was opened, and two corporate and one franchised restaurant were relocated.

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 3.6% in Canada and decreased by 5.4% 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 0.9%. The average exchange rate moved from 1.11 for fiscal 2007, to 1.01 for fiscal 2008, significantly reducing the Canadian dollar equivalent of the U.S. restaurant sales.

## **OPERATING RESULTS**

### **FOURTH QUARTER**

#### **CORPORATE RESTAURANT SALES**

Gross sales from corporate-owned restaurants increased from \$51,851,000 to \$56,344,000 for the comparable 13-week period. The increase of \$4,493,000 or 8.7% was due to the net impact of same store sales increases discussed previously, and the sales of the net new corporate restaurants that operated during the quarter (56 incremental trading weeks).

## CORPORATE RESTAURANT COSTS

Corporate restaurant operating costs and expenses increased from \$43,979,000 for the 13-week period ended September 30, 2007, to \$48,878,000 for the 13-week period ended September 28, 2008. The increase of \$4,899,000 was primarily due to six expense categories. Restaurant variable operating costs increased by \$2,724,000 due to the increased sales for the period. Food costs increased by \$386,000 due to unfavourable beef prices and other commodity costs relative to the same quarter of the prior year. Staff labour costs increased by \$435,000 due to general wage pressures in Canada, particularly in British Columbia and Alberta as well as significant minimum wage increases in Alberta, Ontario and Quebec in the spring of 2008. Restaurant management costs increased by \$203,000 due to the management costs of the net new corporate restaurants that operated during the quarter, but were partially offset by lower management bonuses resulting from reduced restaurant profitability. Restaurant trade costs grew by \$460,000 entirely due to the trade costs of the net new corporate restaurants that operated during the quarter. Restaurant facility costs increased by \$629,000 directly as a result of the net new corporate restaurants that operated during the quarter.

## 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 \$48,000 during the 13-week period ended September 30, 2007, to a loss of \$116,000 during the 13-week period ended September 28, 2008. The decrease of \$164,000 resulted primarily from additional marketing and advertising expenses related to the promotion of two new Keg branded liquor products and other adjustments of the retail product portfolio.

## FRANCHISE FEE INCOME

Franchise fee income climbed from \$2,697,000 for the fourth quarter of the prior year to \$2,947,000 for the fourth quarter of the current year, an increase of \$250,000 or 9.3%. The net increase in franchise fees earned was due to the combination of same store sales growth at existing franchised restaurants during the quarter and the sales of the net new franchised restaurants that operated during the quarter (30 incremental trading weeks).

## GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses decreased by \$87,000 from \$4,775,000 for the 13-week period ended September 30, 2007, to \$4,688,000 for the 13-week period ended September 28, 2008. Marketing and advertising expenses decreased by \$260,000 primarily due to the timing of certain expenditures. Corporate administrative expenses increased by \$173,000 due to the addition of new corporate personnel, and increased travel costs incurred as a result of accelerated new restaurant development. The total increase in corporate administrative expenses was partially offset by lower corporate bonuses resulting from reduced corporate profitability.

## OPERATING EARNINGS

Operating earnings decreased by \$233,000 from \$5,842,000 for the 13 weeks ended September 30, 2007, to \$5,609,000 for the 13 weeks ended September 28, 2008. 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 September 28, 2008 were \$93,000 and included general and administrative expenses of \$94,000 and interest income on the surplus cash balances of \$1,000. The decrease of \$4,000 in Partnership expenses over the comparable quarter in fiscal 2007 was due to a decrease in general and administrative expenses of \$4,000 due to the timing of certain expenditures.

## **NON-CONTROLLING INTEREST**

The non-controlling interest increased from \$2,098,000 for the 13-week period of the prior year to \$2,172,000 for the 13-week period of the current year. The increase in non-controlling interest of \$74,000 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 79.93% during the 13-week period of the prior year to 76.40% during the 13-week period of the current year. The change in effective ownership of the Partnership during the quarter was the result of the Additional Entitlement received by KRL on January 1, 2008.

## **EXECUTIVE BONUS**

The executive bonus decreased from \$500,000 for the fourth quarter of the prior year to \$200,000 for the fourth quarter of the current year. The decrease in executive bonus expense of \$300,000 was primarily due to the reduced profitability of KRL during the year.

## **EBITDA**

EBITDA for the 13-week period of the current year was \$3,144,000 compared to \$3,147,000 for the 13-week period of the prior year. The decrease in EBITDA of \$3,000 for the quarter was due to the net impact of the decrease in operating earnings of \$233,000, the decrease in Partnership expenses of \$4,000, the increase in non-controlling interest of \$74,000, and the decrease in the executive bonus of \$300,000.

## **EARNINGS (LOSS) BEFORE INCOME TAXES**

The loss before income taxes for the 13 weeks ended September 28, 2008 amounted to \$2,407,000 compared to a loss before income taxes of \$145,000 for the 13 weeks ended September 30, 2007.

## **YEAR END**

### **CORPORATE RESTAURANT SALES**

Gross sales from corporate-owned restaurants increased from \$212,355,000 to \$222,215,000 for the year. The increase of \$9,860,000 or 4.6% was due to the net impact of same store sales increases discussed previously, the sales of the net new corporate restaurants that operated during the year (117 incremental trading weeks), and the negative effect of the exchange rate decline on the translation of the U.S. corporate restaurants sales into their Canadian dollar equivalent.

## CORPORATE RESTAURANT COSTS

Restaurant operating costs and expenses increased from \$175,254,000 for the 52-week period ended September 30, 2007 to \$186,054,000 for the 52-week period ended September 28, 2008. The increase of \$10,800,000 was primarily due to six expense categories. Restaurant variable operating costs increased by \$5,809,000 due to increased sales for the year. Food costs decreased by \$264,000 relative to the prior year as a result of menu pricing and favourable beef prices. Restaurant staff labour costs increased by \$2,079,000 due to the combination of general wage pressures in Canada, particularly in British Columbia and Alberta, and significant minimum wage increases in Alberta, Ontario and Quebec in the spring of 2008. Restaurant management costs increased by \$746,000 due to the combination of increased management salaries resulting from competitive pressures, and management costs of the net new corporate restaurants that operated during the year which were partially offset by lower management bonuses resulting from reduced restaurant profitability. Restaurant trade costs grew by \$1,143,000 mostly due to the trade costs of the net new corporate restaurants that operated during the year, but also due to increased utility costs as well as increased repair and maintenance expenses. Restaurant facility costs increased by \$1,071,000 directly as a result of the net new corporate restaurants that operated during the year.

## 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 \$23,000 during fiscal 2007 to a loss of \$124,000 during fiscal 2008. The decrease of \$147,000 resulted primarily from additional marketing and advertising expense related to the promotion of two new Keg branded liquor products and other adjustments to the retail product portfolio.

## FRANCHISE FEE REVENUE

Franchise fee revenue climbed from \$10,399,000 during the prior year to \$11,069,000 for the current year, an increase of \$670,000 or 6.4%. The net increase in franchise fees earned was due to the combination of same store sales growth at existing restaurants during the year and the sales of the net new franchised restaurants that operated during the year (34 incremental trading weeks).

## GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased by \$940,000 from \$19,390,000 for the 52-week period ended September 30, 2007 to \$20,330,000 for the 52-week period ended September 28, 2008. Marketing and advertising expenses increased by \$65,000 primarily 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 \$875,000 due to the addition of new corporate personnel, increased travel costs incurred as a result of accelerated new restaurant development, and start-up costs associated with franchise expansion in a number of new markets. The total increase in corporate administrative expenses was partially offset by non-recurring reorganization expenses which the company incurred in the prior year and lower corporate bonuses resulting from reduced corporate profitability.

## OPERATING EARNINGS

Operating earnings decreased by \$1,357,000 from \$28,133,000 for the year ended September 30, 2007 to \$26,776,000 for the year ended September 28, 2008. 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 September 28, 2008 were \$350,000 and included general and administrative expenses of \$355,000, and interest income on the surplus cash balances of \$5,000. The decrease in Partnership expenses of \$47,000 was due to a decrease in general and administrative expenses of \$47,000 over the comparable period in fiscal 2007 primarily due to a permanent reduction in legal and printing costs associated with the publication of the Fund's Annual Report.

## NON-CONTROLLING INTEREST

The non-controlling interest increased from \$8,569,000 for the 52-week period of the prior year to \$8,974,000 for the 52-week period of the current year. The increase in non-controlling interest of \$405,000 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 78.78% during the 52-week period of the prior year, to 76.90% 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 sale of 650,000 Fund units owned by KRL on February 23, 2007, and the Additional Entitlement received by KRL on January 1, 2008.

## GAIN ON SALE OF CLASS B UNITS

On February 22, 2007, 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 9,703,500. Thereafter, on February 23, 2007, 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 prior year, as the net proceeds received exceeded the weighted average cost of these units by \$964,000.

## EXECUTIVE BONUS

The executive bonus decreased from \$500,000 for the prior year to \$200,000 for the current year. The decrease in executive bonus expense of \$300,000 was primarily due to the reduced profitability of KRL during the year.

## EBITDA

EBITDA for the current year was \$17,252,000 compared to \$19,631,000 for the prior year. The decrease in EBITDA of \$2,379,000 for the year was due to the net impact of the decrease in operating earnings of \$1,357,000, the decrease in Partnership expenses of \$47,000, the increase in non-controlling interest of \$405,000, the decrease in the gain on sale of Class B units of \$964,000, and the decrease in executive bonus of \$300,000.

## EARNINGS (LOSS) BEFORE INCOME TAXES

The loss before income taxes for the year ended September 28, 2008 amounted to \$651,000 compared to earnings before income taxes of \$4,873,000 for the year ended September 30, 2007.



## 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 \$3,000,000 per annum. KRL will use cash flow from operations to fund seasonal fluctuations in working capital and maintenance capital expenditures. As substantially all of the restaurant sales are for cash or cash equivalents and accounts payable are generally due in fifteen to thirty days, KRL is able to carry current liabilities in excess of current assets. In addition to cash flow from operations, KRL uses a combination of long-term and short-term borrowings to fund its capital expenditures incurred to build new corporate restaurants.

## LONG-TERM DEBT OBLIGATIONS

KRL has a CDN\$26,500,000 revolving credit/term loan facility with a syndicate of two Canadian banks which is available to finance the construction of certain new corporate restaurants and major renovations in Canada. The facility is comprised of a \$14,500,000 term facility and a \$12,000,000 revolving facility and is scheduled to mature on April 3, 2011. The term facility required 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\$12,684,208. 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.

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

2009 .....	\$ 6,065,496
2010 .....	7,644,598
2011 .....	17,708,063
2012 .....	1,775,863
2013 .....	1,296,512
Thereafter .....	5,136,356

## 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. As at September 28, 2008, KRL meets the criteria for interest at bank prime.

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 September 28, 2008, substantially all sub-lease accounts were current.

## **RELATED PARTY TRANSACTIONS**

On November 22, 2007, KRL loaned \$6,000,000 to The Charles F. White Corporation, a company wholly owned by the sole shareholder of KRL. The loan is unsecured, non-interest bearing and payable on demand with repayment due on or before the maturity date of May 31, 2009.

KRL has an amount owing from Hy's of Canada Ltd. ("Hy's"), a company partially owned by the sole shareholder of KRL. The total amount owing from Hy's as at September 28, 2008 was \$850,324 (September 30, 2007 - \$655,170) and is included in accounts receivable. KRL also provided services to another company wholly owned by its sole shareholder under the terms of a management agreement. The charge for these services for the 52 weeks ended September 28, 2008, was \$Nil as compared with \$100,000 for the 52 weeks ended September 30, 2007. The charge for these management services are recorded as a reduction of general and administrative expenses. Also included in accounts receivable as at September 28, 2008 is a \$52,000 non-interest bearing demand note from an employee (September 30, 2007 - \$332,000).

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 September 28, 2008, \$1,877,000 due from the sole shareholder of KRL is included in accounts receivable (September 30, 2007 - \$167,000 due to the shareholder of KRL was included in accounts payable and accrued liabilities). This amount is non-interest bearing, due on demand and was repaid subsequent to year end in accordance with KRL's banking requirements.

## **CRITICAL ACCOUNTING ESTIMATES**

KRL's critical accounting estimates are those that 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. Management of KRL believes these amounts are appropriately valued at September 28, 2008.

## **NEW ACCOUNTING STANDARDS AND ACCOUNTING POLICY CHANGES**

Effective October 1, 2007, KRL has adopted the following new accounting standards that were issued by the CICA:

### **GENERAL STANDARDS ON FINANCIAL STATEMENT PRESENTATION**

Handbook Section 1400, *General Standards on Financial Statement Presentation*, requires KRL to assess and disclose its ability to continue as a going concern. The adoption of this standard did not have a material impact in KRL's annual audited consolidated financial statements.

### **CAPITAL DISCLOSURES**

Handbook Section 1535, *Capital Disclosures*, specifies requirements for the disclosure of: (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any established capital requirements; and (iv) if it has not complied, the consequences of such non-compliance. The required disclosure is in note 16 of KRL's annual audited consolidated financial statements.

### **FINANCIAL INSTRUMENTS**

Handbook Sections 3862 and 3863, *Financial Instruments – Disclosures* and *Financial Instruments – Presentation*, replace Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, revise and enhance its disclosure requirements and carries forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from the financial instruments and how the entity manages those risks. The required disclosure is in notes 17 and 18 of KRL's annual audited consolidated financial statements.

### **INVENTORIES**

Handbook Section 3031, *Inventories*, replaces Handbook Section 3030, *Inventories*, and provides more guidance on the measurement and disclosure requirements for inventories. The new standard allows the reversal of previous write-downs to net realize value when there is a subsequent increase in the value of inventories. KRL's adoption of this standard did not have a material impact on KRL's annual audited consolidated financial statements.

## **FUTURE CHANGES IN ACCOUNTING POLICY**

### **INTERNATIONAL FINANCIAL REPORTING STANDARDS**

The CICA plans to converge Canadian GAAP with International Financial Reporting Standards ("IFRS") over a transition period expected to end in 2011. The impact of the transition to IFRS on the KRL's financial statements is not yet determinable.

### **FINANCIAL INSTRUMENTS**

KRL's financial instruments consist of cash, accounts receivable, prepaid expenses and other assets, 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 the Fund and the Class C Partnership units held by KRL, it is not practicable to estimate the fair value of the note payable with sufficient reliability. It is management's opinion that KRL is not exposed to significant interest rate or credit risk arising from these financial statements.

## **OUTLOOK**

The Canadian Restaurant and Foodservice Association (CRFA) has projected sales in the full-service restaurant category, the category in which The Keg operates, of -3.1% in 2009. Relatively weaker economic conditions experienced during 2008 had a negative impact on both the sales and profits of Keg restaurants. While management of KRL does not expect a significant improvement in economic conditions in North America in the near term, management believes that The Keg will continue to outperform the full-service restaurant category with respect to same store sales growth. Management of KRL continues to monitor the global economy and evaluate its potential impact on the North American business environment, particularly the effect on consumer confidence and discretionary spending.

Management of KRL continues to focus on growing same store sales and to selectively 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 over thirty-five years.

Management of KRL currently expects to open eleven restaurants during fiscal 2009, consisting of four corporate and four franchised restaurants in Canada, as well as two corporate and one franchised restaurant in the United States. The scheduled opening of these new restaurants is conditional upon the timely receipt of municipal approvals, construction permits, and ongoing evaluation of the current economic environment. Management of KRL continues to monitor economic conditions and intends to regularly review the timing of its scheduled restaurant openings and adjust these as necessary.

## **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 an 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 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 several 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 September 28, 2008

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 September 28, 2008 and September 30, 2007 and the consolidated statements of operations and deficit, comprehensive income (loss), accumulated other comprehensive income (loss) 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 September 28, 2008 and September 30, 2007 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 28, 2008  
except note 14(c), which is as of December 11, 2008

## CONSOLIDATED BALANCE SHEETS

(Expressed in thousands of dollars)

	September 28, <u>2008</u>	September 30, <u>2007</u>
<b>ASSETS</b>		
Current assets:		
Cash .....	\$ 5,370	\$ 18,860
Accounts receivable (note 14) .....	7,864	4,592
Inventories .....	4,585	3,789
Prepaid expenses and other assets .....	6,729	3,023
Note receivable from The Charles F. White Corporation (note 4) .....	<u>6,000</u>	<u>-</u>
	30,548	30,264
Property, plant and equipment (note 5) .....	75,218	55,648
Deferred charges .....	2,686	1,074
Intangible assets (note 6) .....	20,423	20,423
Future income taxes (note 8) .....	<u>5,276</u>	<u>5,716</u>
	<u>\$ 134,151</u>	<u>\$ 113,125</u>
<b>LIABILITIES AND SHAREHOLDER'S DEFICIENCY</b>		
Current liabilities:		
Accounts payable and accrued liabilities .....	\$ 21,479	\$ 19,313
Due to related parties (note 14).....	133	57
Distributions due to non-controlling interest .....	685	-
Unearned revenue .....	17,531	12,933
Current portion of long-term debt (note 10) .....	<u>6,065</u>	<u>3,143</u>
	45,893	35,446
Unearned revenue .....	3,619	2,959
Note payable to The Keg Royalties Income Fund (note 9) .....	57,000	57,000
Long-term debt, net of deferred financing charges (note 10) .....	33,178	22,085
Deferred gain on sale of intangible assets (note 12) .....	30,951	30,560
Non-controlling interest (note 13) .....	16,384	17,047
Shareholder's deficiency:		
Share capital (note 15) .....	1	1
Accumulated other comprehensive income (loss) .....	(4,304)	(4,530)
Deficit .....	<u>(48,571)</u>	<u>(47,443)</u>
	<u>(52,874)</u>	<u>(51,972)</u>
	<u>\$ 134,151</u>	<u>\$ 113,125</u>

Commitments and contingent liabilities (note 19)

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 September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
Revenue:		
Restaurant sales .....	\$ 222,215	\$ 212,355
Retail sales .....	<u>2,153</u>	<u>2,148</u>
	224,368	214,503
Operating costs:		
Restaurant operating costs .....	(186,054)	(175,254)
Retail operations .....	<u>(2,277)</u>	<u>(2,125)</u>
	<u>(188,331)</u>	<u>(177,379)</u>
Earnings from operations .....	36,037	37,124
Franchise fee revenue .....	11,069	10,399
General and administrative expenses (note 14) .....	(20,330)	(19,390)
Partnership expenses .....	(350)	(397)
Non-controlling interest (note 13) .....	(8,974)	(8,569)
Gain on sale of marketable securities .....	-	964
Executive bonus .....	<u>(200)</u>	<u>(500)</u>
Earnings before undernoted items .....	17,252	19,631
Amortization .....	(12,080)	(9,993)
Amortization of deferred gain (note 12) .....	332	306
Interest .....	(5,975)	(5,637)
Gain (loss) on disposal of property, plant and equipment .....	<u>(180)</u>	<u>566</u>
Earnings (loss) before income taxes .....	(651)	4,873
Income taxes (note 8):		
Current .....	(37)	2
Future .....	<u>(440)</u>	<u>(1,422)</u>
	<u>(477)</u>	<u>(1,420)</u>
Net earnings (loss) for the period .....	(1,128)	3,453
Deficit, beginning of period .....	(47,443)	(45,615)
Dividends .....	-	(5,000)
Deficit adjustment (note 10) .....	<u>-</u>	<u>(281)</u>
Deficit, end of period .....	<u>\$ (48,571)</u>	<u>\$ (47,443)</u>

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Expressed in thousands of dollars)

	52 weeks ended September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
Net earnings (loss) for the period .....	\$ (1,128)	\$ 3,453
Change in foreign currency translation on self-sustaining foreign operations .....	<u>226</u>	<u>(716)</u>
Comprehensive income (loss) for the period .....	<u>\$ (902)</u>	<u>\$ 2,737</u>

## CONSOLIDATED STATEMENTS OF ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

(Expressed in thousands of dollars)

	52 weeks ended September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
Accumulated other comprehensive income (loss), beginning of period .....	\$ (4,530)	\$ (3,814)
Change in foreign currency translation on self-sustaining foreign operations .....	<u>226</u>	<u>(716)</u>
Accumulated other comprehensive income (loss), end of period .....	<u>\$ (4,304)</u>	<u>\$ (4,530)</u>

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Expressed in thousands of dollars)

	52 weeks ended September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
<b>Cash provided by (used for):</b>		
<b>OPERATIONS:</b>		
Net earnings (loss) for the period .....	\$ (1,128)	\$ 3,453
Items not involving cash:		
Amortization .....	12,080	9,993
Amortization of deferred gain .....	(332)	(306)
Non-controlling interest (note 13) .....	8,974	8,569
Loss (gain) on disposition of property, plant and equipment .....	180	(566)
Gain on sale of marketable securities .....	-	(964)
Future income tax expense .....	440	1,422
Distributions declared to non-controlling interest (note 13) .....	(8,914)	(8,338)
Change in non-cash operating working capital (note 21(a)) .....	<u>2,199</u>	<u>4,884</u>
	13,499	18,147
<b>INVESTMENTS:</b>		
Additions to property, plant and equipment and deferred charges .....	(32,575)	(17,978)
Distributions from long-term investment .....	-	2
Net proceeds (costs) from disposition of property, plant and equipment .....	(21)	959
Note receivable from The Charles F. White Corporation (note 4) .....	(6,000)	-
Net proceeds from sale of marketable securities .....	<u>-</u>	<u>8,749</u>
	(38,596)	(8,268)
<b>FINANCING:</b>		
Dividends paid .....	-	(5,000)
Due to related company .....	76	-
Shareholder loan (note 14) .....	(2,045)	-
Issuance of long-term debt (note 10) .....	16,269	-
Repayment of long-term debt (note 10).....	<u>(2,693)</u>	<u>(1,079)</u>
	<u>11,607</u>	<u>(6,079)</u>
Increase (decrease) in cash .....	(13,490)	3,800
Cash, beginning of period .....	<u>18,860</u>	<u>15,060</u>
Cash, end of period .....	<u>\$ 5,370</u>	<u>\$ 18,860</u>

Cash is defined as cash less bank indebtedness.

See note 21(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 September 28, 2008

52 weeks ended September 30, 2007

### 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. NEW ACCOUNTING STANDARDS AND ACCOUNTING POLICY CHANGES:

Effective January 1, 2008, KRL has adopted the following new accounting standards that were issued by the Canadian Institute of Chartered Accountants (“CICA”):

(a) General standards on financial statement presentation:

Handbook Section 1400, *General Standards on Financial Statement Presentation*, requires KRL to assess and disclose its ability to continue as a going concern. KRL’s adoption of this standard did not have a material impact on disclosure in KRL’s consolidated financial statements.

(b) Capital disclosure:

Handbook Section 1535, *Capital Disclosures*, specifies requirements for the disclosure of: (i) an entity’s objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any established capital requirements; and (iv) if it has not complied, the consequences of such non-compliance (note 16).

(c) Financial instruments:

Handbook Sections 3862 and 3863, *Financial Instruments – Disclosures* and *Financial Instruments – Presentation*, replace Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, revise and enhance its disclosure requirements and carries forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks (notes 17 and 18).

(d) Inventories:

Handbook Section 3031, *Inventories*, replaces Handbook Section 3030, *Inventories*, and provides more guidance on the measurement and disclosure requirements for inventories. The new standard allows the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. KRL’s adoption of this standard did not have a material impact on KRL’s consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 3. 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. (“KUS”), and The Keg Rights Limited Partnership (the “Partnership”) (note 6) 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.

(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 12). 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 6).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

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

(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 giftcards issued by KRL during the last two years, which remain unredeemed. The amount of any gift certificates and giftcards previously included in income is expensed in the year of redemption. Gift certificates and giftcards issued by franchises are recorded only when redeemed at a corporately owned restaurant and the corresponding amount is subsequently recovered from the franchisee. The amount of unredeemed gift certificates and giftcards held by franchises are not expected to result in any loss to KRL.

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) Foreign currency:

These consolidated financial statements are presented in Canadian dollars. The majority of KRL's operations are located in Canada and are conducted in Canadian dollars. KRL's U.S. operations are conducted in U.S. dollars and use the U.S. dollar as their functional currency. The U.S. entities' financial statements have been translated into Canadian dollars using the exchange rate in effect at the balance sheet date for asset and liability amounts and at the average rate for the period for amounts included in the determination of income.

Cumulative unrealized gains or losses arising from the translation of the assets and liabilities of these operations into Canadian dollars are recorded as a foreign currency translation adjustment, a separate component of shareholder's deficiency.

Exchange gains or losses arising on the translation of long-term monetary items that are denominated in foreign currencies to the applicable currency of measurement are included in the determination of net income.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

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

(i) 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.

### 4. NOTE RECEIVABLE FROM THE CHARLES F. WHITE CORPORATION:

On November 22, 2007, KRL loaned \$6,000,000 to a company wholly owned by the sole shareholder of KRL. The loan is unsecured, non-interest bearing and payable on demand on or before the maturity date of May 31, 2009.

### 5. PROPERTY, PLANT AND EQUIPMENT:

	<u>Cost</u>	<u>Accumulated amortization</u>	September 28, 2008 Net book value
Buildings .....	\$ 37,815	\$ 15,194	\$ 22,621
Equipment and furnishings .....	47,442	32,014	15,428
Leasehold improvements .....	59,154	29,527	29,627
Construction in progress .....	<u>7,542</u>	<u>-</u>	<u>7,542</u>
	<u>\$ 151,953</u>	<u>\$ 76,735</u>	<u>\$ 75,218</u>

  

	<u>Cost</u>	<u>Accumulated amortization</u>	September 30, 2007 Net book value
Buildings .....	\$ 27,638	\$ 11,712	\$ 15,926
Equipment and furnishings .....	40,950	28,850	12,100
Leasehold improvements .....	51,198	26,673	24,525
Construction in progress .....	<u>3,097</u>	<u>-</u>	<u>3,097</u>
	<u>\$ 122,883</u>	<u>\$ 67,235</u>	<u>\$ 55,648</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 6. 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.

### 7. 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.

### 8. INCOME TAXES:

Income tax expense 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 September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
Earnings (loss) before income taxes .....	\$ (651)	\$ 4,873
Combined Canadian federal and provincial rates .....	<u>32.00%</u>	<u>33.00%</u>
Computed "expected" tax expense (recovery) .....	(208)	1,608
Increased (reduced) by:		
Permanent differences .....	302	894
Realization of previously unrecognized tax assets .....	-	(163)
Change in valuation allowance .....	316	(3,115)
Adjustment to future tax assets and liabilities for enacted changes in tax laws and rates .....	118	1,252
Other items .....	<u>(51)</u>	<u>944</u>
Total income tax expense per the statement of operations .....	<u>\$ 477</u>	<u>\$ 1,420</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 8. INCOME TAXES (CONTINUED):

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

	September 28, <u>2008</u>	September 30, <u>2007</u>
Future tax assets:		
Property, plant and equipment .....	\$ 1,179	\$ 1,078
Non-capital losses .....	6,496	7,152
Deferred gain and non-controlling interest .....	11,390	10,659
Unearned revenue and other items deductible in future periods for income tax purposes .....	<u>6,032</u>	<u>4,723</u>
Total gross future tax assets .....	25,097	23,612
Valuation allowance .....	<u>(8,083)</u>	<u>(7,861)</u>
Total future tax assets .....	17,014	15,751
Future tax liabilities:		
Intangible and other assets, including Partnership earnings .....	<u>(11,738)</u>	<u>(10,035)</u>
Net future tax assets .....	<u>\$ 5,276</u>	<u>\$ 5,716</u>

KRL has loss carryforwards remaining of approximately \$19.4 million (\$16.1 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 2009.

### 9. 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 second business day immediately prior to the end of the month following the month for which such interest has accrued. Included in interest expense is \$4,254,551 (52 weeks ended September 30, 2007 - \$4,263,288) relating to this note of which \$3,565,412 (52 weeks ended September 30, 2007 - \$3,911,918) had been paid as at September 28, 2008 and \$689,139 (September 30, 2007 - \$351,370) is included in accounts payable and accrued liabilities.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 9. 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.

### 10. LONG-TERM DEBT:

	September 28, <u>2008</u>	September 30, <u>2007</u>
Canadian bank debt .....	\$ 26,500	\$ 16,000
GE Capital (U.S. \$12.684 million) .....	<u>13,127</u>	<u>9,598</u>
	39,627	25,598
Current portion .....	(6,065)	(3,143)
Deferred financing charges .....	<u>(384)</u>	<u>(370)</u>
	<u>\$ 33,178</u>	<u>\$ 22,085</u>

#### (a) Canadian bank debt:

On June 1, 2007, 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 of which a principal balance of \$14,500,000 is outstanding at September 28, 2008. Principal payments on this facility are required according to the following schedule:

October 2008 – September 2009 .....	\$ 4,500
October 2009 – September 2010 .....	6,000
October 2010 – September 2011 .....	4,000

- ii. A \$12,000,000 revolving facility for 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 September 28, 2008

52 weeks ended September 30, 2007

### 10. 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 September 28, 2008, 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 9.63%, 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 September 28, 2008, under the long-term debt agreements, are as follows:

2009 .....	\$	6,065
2010 .....		7,645
2011 .....		17,708
2012 .....		1,776
2013 .....		1,297
Thereafter .....		<u>5,136</u>
	\$	<u>39,627</u>

Deferred financing charges related to the long-term debt prior to October 2, 2006 were presented as a separate asset on the consolidated balance sheet and amortized on a straight-line basis. Under new standards adopted during fiscal 2007, deferred financing charges are recognized as an offset to the carrying value of long-term debt and amortized using the effective interest method. This change in accounting policy was applied retrospectively without adjustment of prior years.

### 11. EXCHANGEABLE UNITS:

In return for adding net sales to the Royalty Pool, KRL has received the following Partnership units that are exchangeable into Fund units:

	September 28, <u>2008</u>	September 30, <u>2007</u>
Class A Partnership units (a) .....	905,944	905,944
Class B Partnership units (b) .....	1,826,700	1,530,840
Class D Partnership units (c) .....	<u>265,520</u>	<u>-</u>
	<u>2,998,164</u>	<u>2,436,784</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 11. EXCHANGEABLE UNITS (CONTINUED):

Pursuant to the declaration of trust, the holders (other than the Fund or its subsidiaries) of the Class A units, Class B units and Class D Partnership units (“Class D units”) 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, entitled Class B and Class D 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.

- (a) The Class A units are entitled to a preferential proportionate distribution equal to the distribution on the Class C units, multiplied by the number of Class A units divided by the number of LP Partnership units (“LP units”) issued and outstanding. KHT holds all of the 8,153,500 LP units issued and outstanding at September 28, 2008. 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 and Class D units, the number issued and outstanding multiplied by the Class B and Class D current distribution entitlement, respectively). Class A units are exchangeable for Fund units on the basis of one Fund unit for one Class A unit.
- (b) 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 until such date that all Class B units have received entitlement (the “Class B Termination Date”). Concurrent with the January 1, 2008 roll-in, the Class B Termination Date was reached and the last of the Class B units became entitled. 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 28, 2008, 1,826,700 (September 30, 2007 – 1,530,840) Class B units held by KRL receive a distribution entitlement.
- (c) The Class D 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 D units are adjusted annually on January 1. Class D 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 28, 2008, 265,520 (September 30, 2007 – nil) Class D units held by KRL receive a distribution entitlement. Class D units are issued subsequent to the Class B Termination Date and are identical to Class B units except that the Trustees of KHT can require KRL to surrender any or all of the issued Class D units for a price that is equal to the one originally used in the formula to calculate the number of units issued.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

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

	September 28, <u>2008</u>	September 30, <u>2007</u>
Cash proceeds received on sale of Keg Rights .....	\$ 30,487	\$ 30,487
Fund units received on exchange of Class B Partnership units .....	17,697	17,697
Disposition costs .....	<u>(322)</u>	<u>(322)</u>
	47,862	47,862
The Fund's 76.40% ownership interest (September 30, 2007 – 79.93%) .....	<u>(15,599)</u>	<u>(16,322)</u>
	32,263	31,540
Accumulated amortization .....	<u>(1,312)</u>	<u>(980)</u>
	<u>\$ 30,951</u>	<u>\$ 30,560</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.

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 95 as of December 31, 2007. Twenty-seven new Keg restaurants that opened during the period from April 1, 2002 through October 2, 2006, with annual gross sales of \$128.0 million, have been added to the Royalty Pool. Twelve permanently closed Keg restaurants with annual sales of \$30.5 million have been removed from the Royalty Pool. This has resulted in a net increase in Royalty Pool sales of \$97.5 million annually and KRL receiving a cumulative Additional Entitlement equivalent to 3,311,525 Fund units as of December 31, 2007.

On January 1, 2008, four new Keg restaurants that opened during the period from October 3, 2006 to October 2, 2007 were added to the Royalty Pool. The gross sales of these four new restaurants have been estimated at \$20.5 million annually. Three permanently closed Keg restaurants with annual sales of \$7.4 million have been removed from the Royalty Pool, resulting in an estimated net increase in Royalty Pool sales of \$13.1 million annually. The total number of restaurants in the Royalty Pool has increased to 96. The yield of the Fund units was determined to be 8.54% calculated using a weighted average unit price of \$13.78.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

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

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 413,367 Fund units, being 3.23% of the Fund units on a fully diluted basis. On January 1, 2008, KRL received 80% of this entitlement representing the equivalent of 330,694 Fund units, being 2.60% 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 2,998,164 Fund units, representing 23.60% of the Fund units on a fully diluted basis. The balance of the Additional Entitlement will be adjusted to be effective January 1, 2008 once the actual performance of the new restaurants have been confirmed. If KRL were to receive 100% of the estimated Additional Entitlement for 2008, it would have the right to exchange its Partnership units for 3,080,837 Fund units, representing 24.10% of the Fund units on a fully diluted basis.

### 13. NON-CONTROLLING INTEREST:

	September 28, <u>2008</u>	September 30, <u>2007</u>
The Fund's ownership interest in the Keg Rights (note 12) .....	\$ 15,599	\$ 16,322
Non-controlling interest in earnings of the Partnership, net of distributions declared, beginning of the period .....	725	494
Non-controlling interest in earnings of the Partnership .....	8,974	8,569
Distributions declared on Partnership units held by non-controlling interest .....	<u>(8,914)</u>	<u>(8,338)</u>
	<u>\$ 16,384</u>	<u>\$ 17,047</u>
	52 weeks ended September 28, <u>2008</u>	52 weeks ended September 30, <u>2007</u>
Partnership royalty income .....	\$ 17,451	\$ 16,619
Partnership expenses .....	<u>(350)</u>	<u>(397)</u>
Net earnings of the Partnership for the period .....	17,101	16,222
KRL's interest .....	<u>(8,127)</u>	<u>(7,653)</u>
Non-controlling interest in Partnership earnings .....	<u>\$ 8,974</u>	<u>\$ 8,569</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 9).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 14. RELATED PARTY TRANSACTIONS:

- (a) The \$850,324 total amount owing from Hy's as at September 28, 2008 (September 30, 2007 - \$655,170) is included in accounts receivable. Also included in accounts receivable as at September 28, 2008 is a \$52,000 non-interest bearing demand note from an employee (September 30, 2007 – \$332,000).
- (b) 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.
- (c) At September 28, 2008, \$1,877,000 due from the sole shareholder of KRL is included in accounts receivable (September 30, 2007 – \$167,000 due to the shareholder of KRL was included in accounts payable and accrued liabilities). This amount is non-interest bearing, due on demand and was repaid subsequent to year end in accordance with KRL's banking requirements.
- (d) KRL also provided services to another company wholly owned by its sole shareholder under the terms of a management agreement. The charge for these services for the 52 weeks ended September 28, 2008, which amounted to \$Nil (52 weeks ended September 30, 2007 - \$100,000), is recorded as a reduction in general and administrative expenses.

### 15. SHARE CAPITAL:

Authorized:

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

	September 28, <u>2008</u>	September 30, <u>2007</u>
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Issued:

100 common shares .....	<u>\$ 1</u>	<u>\$ 1</u>
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### 16. CAPITAL DISCLOSURES:

KRL's objectives in managing its liquidity and capital are:

- To safeguard KRL's ability to continue as a going concern;
- To provide financial capacity and flexibility to meet its strategic objectives;
- To provide adequate return to its shareholder commensurate with the level of risk; and
- Return excess cash through dividends.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 16. CAPITAL DISCLOSURES (CONTINUED):

	September 28, <u>2008</u>	September 30, <u>2007</u>
Liquidity:		
Cash .....	\$ 5,370	\$ 18,860
Undrawn credit facilities .....	<u>4,866</u>	<u>14,000</u>
Total liquidity .....	10,236	32,860
Capitalization:		
Long-term debt, including current portion .....	<u>39,243</u>	<u>25,228</u>
Total debt .....	39,243	25,228
Deferred gain .....	30,951	30,560
Shareholder's deficiency .....	<u>(55,054)</u>	<u>(51,972)</u>
	<u>(24,103)</u>	<u>(21,412)</u>
Total capitalization .....	<u>\$ 25,376</u>	<u>\$ 36,676</u>

KRL maintains financial policies and manages its liquidity and capital structure and makes adjustments to it in light of changes to economic conditions, the underlying risks inherent in its operations and capital requirement to maintain and grow its operations.

KRL is not subject to any statutory capital requirements and has no commitments to sell or otherwise issue shares.

The undrawn credit facilities in the amount of \$4,866,000 are subject to certain financial covenants.

### 17. FINANCIAL INSTRUMENTS:

This section gives an overview of the significance of the financial instruments for KRL and provides additional information on balance sheet items that contain financial instruments.

KRL classified its financial instruments as follows:

- Cash as *held-for-trading*, which is measured at fair value.
- Accounts receivable and note receivable from The Charles F. White Corporation ("CFW") as *loans and receivables*, which are measured at amortized cost.
- Accounts payable, amount due to related parties, distributions due to non-controlling interest, long-term debt and note payable to the Fund as *other financial liabilities*, which are measured at amortized cost.

The right to transfer Class C units in consideration of its note payable to the Fund is classified as a *derivative instrument*. KRL has reviewed the net impact of this potential exchange requirement on its cash flows and has determined there is no significant value applicable to this feature.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 17. FINANCIAL INSTRUMENTS (CONTINUED):

The following table presents the carrying amounts of each category of financial assets and liabilities:

	September 28, <u>2008</u>	September 30, <u>2007</u>
Financial assets:		
Held-for-trading financial assets .....	\$ 5,370	\$ 18,860
Loans or receivables .....	<u>13,864</u>	<u>4,592</u>
	<u>\$ 19,234</u>	<u>\$ 23,452</u>
Financial liabilities:		
Financial liabilities measured at cost .....	<u>\$ 118,540</u>	<u>\$ 101,598</u>

The fair values of accounts receivable (excluding related party receivables), accounts payable and accrued liabilities and distributions due to non-controlling interest approximate their carrying amounts largely due to the short-term maturities of these instruments.

The fair value of the note receivable from CFW, note payable to the Fund and other related party receivables and payables is not readily determinable due to the related party nature of these amounts. The fair value of long-term debt approximates fair market value based on prevailing interest rates.

### 18. FINANCIAL RISK MANAGEMENT:

KRL is primarily exposed to credit risk, liquidity risk, interest rate risk and foreign currency exchange rate risk as they relate to KRL's identified financial instruments.

(a) Credit risk:

Credit risk is defined as the risk of financial loss to KRL if a counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from KRL's accounts receivable and note receivable from CFW. The effective monitoring and controlling of credit risk is a core competency of KRL. Each potential franchisee must complete a thorough interview process and pass mandatory credit evaluations. Franchise receivables represent the most significant balances in accounts receivable at any given time. The note receivable from CFW is from a company owned by the sole shareholder of KRL and is not considered a significant credit risk. KRL's maximum exposure to credit risk is the value of its accounts receivable of \$7,864,000.

The amount of past-due accounts is \$1,294,665 of which \$950,324 is due from related parties (note 14). There has been a \$344,341 provision for impaired accounts receivable determined necessary at September 28, 2008. KRL continues to make every effort to collect all past due amounts.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 18. FINANCIAL RISK MANAGEMENT (CONTINUED):

#### (b) Liquidity risk:

Liquidity risk results from KRL's potential inability to meet its financial liabilities. KRL constantly monitors its operations and cash flows to ensure that current and future obligations will be met. KRL believes that its current sources of liquidity are sufficient to cover its currently known short and long term cash obligations.

KRL's capital resources are comprised of cash and cash flow from operating activities. The maturities of KRL's financial liabilities are as follows:

	<u>Value</u>	<u>Maturity</u>
Accounts payable and accrued liabilities .....	\$ 21,579	< 1 year
Due to related parties .....	133	< 1 year
Distributions due to non-controlling interest .....	685	< 1 year
Current portion of long-term debt .....	6,065	< 1 year
Long-term debt .....	33,178	2010 to 2019
Note payable to The Keg Royalties Income Fund .....	57,000	2042

#### (c) Interest rate risk:

KRL's interest rate risk exposure is mainly related to its \$26,500,000 floating rate debt in its Canadian operations. This facility requires interest payments at bank prime and net earnings would change by approximately \$132,500 during a 52 week period if the prime rate changed by 0.5%. All other debt obligations have minimal interest rate risk as they bear interest at fixed rates.

#### (d) Foreign currency exchange rate risk:

KRL is exposed to foreign currency exchange rate risk as a result of its operations in the United States. To manage its foreign currency exchange rate risk, KRL's subsidiary in the United States, KUS, has entered into financing arrangements in United States dollars. KRL has not entered into any derivative arrangements to further mitigate this risk. Based on the US dollar sales and net earnings of KUS for the 52 weeks ended September 28, 2008, a 100 basis point change in the US dollar exchange rate would result in an approximate \$545,000 and \$15,000 change in sales and net earnings, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 19. COMMITMENTS AND CONTINGENT LIABILITIES:

(a) Operating leases:

Minimum rentals under head leases extending to the year 2029 (excluding CPI adjustment factors and rentals based on sales) are approximately as follows:

	<u>Total</u>	<u>Sub-lease reimbursement</u>	<u>Net</u>
2009 .....	\$ 14,055	\$ (2,169)	\$ 11,886
2010 .....	13,487	(2,186)	11,301
2011 .....	12,808	(2,002)	10,806
2012 .....	12,257	(1,866)	10,391
2013 .....	10,669	(1,556)	9,113
Thereafter .....	63,167	(6,403)	56,764

Under the terms of certain lease agreements, KRL is contingently liable to the landlord for any default in payment by sub-lessees. At September 28, 2008, 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\$444,000 and US\$15,000. At September 28, 2008 these amounts are covered by the \$2,000,000 operating credit facility described in note 10(a)(iii).
- iii. As of September 28, 2008, KRL has guaranteed lease obligations of certain franchises in the amount of \$6,873,413 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 September 28, 2008

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### 20. 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 September 28, 2008	52 weeks ended September 30, 2007
Restaurant sales:		
Canada .....	\$ 167,284	\$ 149,529
United States .....	<u>54,931</u>	<u>62,826</u>
	<u>\$ 222,215</u>	<u>\$ 212,355</u>
Franchise fee revenue:		
Canada .....	\$ 10,975	\$ 10,313
United States .....	<u>94</u>	<u>86</u>
	<u>\$ 11,069</u>	<u>\$ 10,399</u>
	September 28, 2008	September 30, 2007
Property, plant and equipment:		
Canada .....	\$ 50,437	\$ 39,700
United States .....	<u>24,781</u>	<u>15,948</u>
	<u>\$ 75,218</u>	<u>\$ 55,648</u>

### 21. SUPPLEMENTARY CASH FLOW INFORMATION:

	52 weeks ended September 28, 2008	52 weeks ended September 30, 2007
(a) Change in non-cash operating working capital:		
Accounts receivable .....	\$ (1,395)	\$ (1,149)
Inventories .....	(796)	(186)
Prepaid expense and other assets .....	(3,706)	(297)
Accounts payable and accrued liabilities .....	2,333	788
Due to related parties .....	76	(212)
Distributions due to non-controlling interest .....	685	-
Unearned revenue .....	5,258	5,854
Cumulative translation adjustment .....	<u>(256)</u>	<u>86</u>
	<u>\$ 2,199</u>	<u>\$ 4,884</u>
(b) Supplementary information:		
Interest received .....	\$ 397	\$ 670
Interest paid .....	5,743	6,172
Income taxes paid (recovered) .....	35	(1)
Non-cash transactions:		
Exchange of Class B units for Fund units .....	-	7,785

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Tabular amounts expressed in thousands of dollars)

52 weeks ended September 28, 2008

52 weeks ended September 30, 2007

### 22. COMPARATIVE FIGURES:

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