



## **Quarterly Report to Unitholders**

For the period ended June 30, 2003

H&R Real Estate Investment Trust (TSX: HR.UN) announced consistent financial performance in its second quarter of 2003. The REIT continued to execute its well-proven strategy of building a quality portfolio and tenant base to generate steady increases in cash distributions to unitholders.

### **Financial Results**

Approximately \$380 million of accretive acquisitions over the past year of commercial real estate properties contributed to the REIT's increase in operating revenue (7% in the second quarter; 12% in the first half) compared to the same periods in 2002. Total net earnings dropped marginally (1%) from the second quarter last year, while cash distributions to unitholders increased 8%. On a per-unit basis, basic net earnings dropped slightly (3%) to \$0.29 in the second quarter and distributable income was unchanged at \$0.35 compared to the three months ended June 30, 2002.

### **Operating Strategy**

Since inception in 1996, H&R's operating strategy has been to focus its investments on quality commercial properties, using a disciplined approach to asset management and acquisitions to produce sustainable distributable income and maximize return on equity for unitholders. H&R leases its properties to highly creditworthy tenants through long-term leases matched with primarily long-term, fixed-rate financing. As a result, the REIT maintained at the end of the second quarter an overall portfolio occupancy rate of 99% and an average term to maturity of 12.3 years for leases and 12.6 years for mortgages. H&R's office portfolio was 96% occupied at the end of June, when a general softening in the Canadian multi-tenant office market had lowered the country's average occupancy rate to 88%.

### **Acquisitions**

During the second quarter, H&R completed the previously reported acquisition of 21 retail and four industrial properties in Canada and the United States at a cost of approximately \$209 million. The trust assumed mortgages of \$103 million on these properties. With all the acquisitions to date this year, H&R has produced levered returns on equity in excess of 13%.

### **Financing**

On April 30, 2003, the trust issued 1.9 million units in the first of four \$25-million tranches, which in total will represent a \$100-million private placement. The proceeds were used to finance recent acquisitions and pay down short-term debt. H&R has a current acquisition capacity in excess of \$200 million.

Tom Hofstedter  
August 14, 2003

Unaudited Consolidated Financial Statements of

**H&R REAL ESTATE INVESTMENT TRUST**

For the six months ended June 30, 2003

# H&R REAL ESTATE INVESTMENT TRUST

## Consolidated Balance Sheets and Statements of Unitholders' Equity

(In thousands of dollars)

<b>Consolidated Balance Sheets</b>	<b>June 30 2003</b>	<b>December 31 2002</b>	<b>June 30 2002</b>
	<b>(unaudited)</b>	<b>(audited)</b>	<b>(unaudited)</b>
<b>Assets</b>			
Income properties (note 2)	\$ 2,166,713	\$ 1,922,200	\$ 1,837,462
Mortgages receivable (note 3)	78,976	60,079	65,879
Deferred expenses (note 4)	29,392	28,859	28,530
Prepaid expenses and sundry assets	17,900	11,504	12,657
Accrued rent receivable	11,705	10,913	10,120
Accounts receivable	7,267	7,131	5,632
Cash and cash equivalents	6,717	10,208	8,278
	<b>\$ 2,318,670</b>	<b>\$ 2,050,894</b>	<b>\$ 1,968,558</b>

### Liabilities and Unitholders' Equity

Liabilities:			
Mortgages payable (note 5)	\$ 1,384,110	\$ 1,239,224	\$ 1,020,348
Bank indebtedness (note 6)	95,243	1,280	144,166
Accounts payable	40,592	42,742	38,932
	<b>1,519,945</b>	<b>1,283,246</b>	<b>1,203,446</b>
Unitholders' equity (note 7)	807,107	767,484	765,112
Cumulative foreign translation adjustment	(8,382)	164	-
	<b>\$ 2,318,670</b>	<b>\$ 2,050,894</b>	<b>\$ 1,968,558</b>

### Consolidated Statements of Unitholders' Equity

Unitholders' equity, beginning of period	\$ 767,484	\$ 754,737	\$ 754,737
Proceeds from issuance of units	39,528	13,164	8,596
Issue costs	(78)	(121)	(106)
Net earnings	44,435	84,022	42,912
Distributions to unitholders	(44,262)	(84,318)	(41,027)
Unitholders' equity, end of period	<b>\$ 807,107</b>	<b>\$ 767,484</b>	<b>\$ 765,112</b>

See accompanying notes to consolidated financial statements

# H&R REAL ESTATE INVESTMENT TRUST

## Unaudited Consolidated Statements of Earnings

(In thousands of dollars, except per unit amounts)

	Three Months Ended June 30		Six Months Ended June 30	
	2003	2002	2003	2002
Operating revenue:				
Rentals from income properties	\$ 78,483	\$ 73,178	\$ 153,705	\$ 137,568
Mortgage interest income and other	1,711	1,757	6,906	5,735
	<u>80,194</u>	<u>74,935</u>	<u>160,611</u>	<u>143,303</u>
Operating expenses:				
Property operating costs	27,283	27,747	54,814	52,571
Mortgage and other interest	25,111	20,246	47,861	36,654
Depreciation of income properties	4,816	3,883	9,162	7,223
Amortization of deferred expenses	1,009	899	2,030	1,680
	<u>58,219</u>	<u>52,775</u>	<u>113,867</u>	<u>98,128</u>
Operating income from properties	\$ 21,975	\$ 22,160	\$ 46,744	\$ 45,175
Trust expenses	1,159	1,109	2,309	2,263
Net earnings	\$ 20,816	\$ 21,051	\$ 44,435	\$ 42,912
Basic net earnings per unit (note 8)	\$ 0.29	\$ 0.30	\$ 0.62	\$ 0.61
Diluted net earnings per unit (note 8)	\$ 0.28	\$ 0.30	\$ 0.61	\$ 0.61

See accompanying notes to consolidated financial statements

# H&R REAL ESTATE INVESTMENT TRUST

## Unaudited Consolidated Statements of Cash Flows

(In thousands of dollars)

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2003	2002	2003	2002
Cash provided by (used in):				
Operations:				
Net earnings	\$ 20,816	\$ 21,051	\$ 44,435	\$ 42,912
Items not affecting cash:				
Depreciation	4,816	3,883	9,162	7,223
Amortization of deferred leasing costs	820	754	1,674	1,440
Gain on sale of income properties	-	(187)	(3,633)	(1,684)
Funds from operations	26,452	25,501	51,638	49,891
Net changes in:				
Amortization of deferred financing costs	189	145	356	240
Other non-cash operating items (note 10)	(3,556)	(15,322)	(13,718)	(13,774)
	23,085	10,324	38,276	36,357
Financing:				
Bank indebtedness	54,289	(13,676)	93,963	141,913
Mortgages payable:				
Acquisitions	37,800	26,901	37,800	199,668
Repayments	(9,091)	(8,218)	(16,799)	(16,448)
Proceeds from issuance of units, net	32,655	8,017	39,450	8,490
Distributions to unitholders	(22,328)	(20,719)	(44,262)	(41,027)
	93,325	(7,695)	110,152	292,596
Investments:				
Income properties				
Proceeds on disposition of income properties	-	95	11,446	2,646
Acquisitions	(108,412)	(16,365)	(144,468)	(334,569)
Mortgages receivable	(8,495)	(1,364)	(18,897)	(13,083)
	(116,907)	(17,634)	(151,919)	(345,006)
Decrease in cash and cash equivalents	(497)	(15,005)	(3,491)	(16,053)
Cash and cash equivalents, beginning of period	7,214	23,283	10,208	24,331
Cash and cash equivalents, end of period	\$ 6,717	\$ 8,278	\$ 6,717	\$ 8,278
Supplemental cash flow information:				
Interest paid	26,551	20,067	48,962	36,427
Supplemental disclosure of non-cash investing activities:				
Acquisitions of income properties through assumption of mortgages payable	103,215	-	152,260	125,500
Acquisitions of income properties through repayment of mortgages receivable	-	-	-	42,760
Mortgages payable assumed by purchasers on disposition of income properties	-	-	11,054	30,983
Mortgages receivable granted to purchasers on disposition of income properties	-	415	-	14,981

See accompanying notes to consolidated financial statements

# H&R REAL ESTATE INVESTMENT TRUST

## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

June 30, 2003

H&R Real Estate Investment Trust (the "Trust") is an unincorporated trust with each unitholder participating pro rata in distributions of income and, in the event of termination of the Trust, participating pro rata in the net assets remaining after satisfaction of all liabilities.

### 1. Basis of Presentation:

Interim Financial Statements:

The unaudited interim period consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and follow the same accounting policies and methods of application with those used in the preparation of the audited annual consolidated financial statements for the year ended December 31, 2002. Under Canadian GAAP, additional disclosure is required in annual financial statements and accordingly the interim financial statements should be read together with the audited annual consolidated financial statements and the accompanying notes included in the H&R Real Estate Investment Trust's 2002 annual report.

The results of operations for the three and six months ended June 30, 2003 are not necessarily indicative of the results for the full year.

### 2. Income properties:

			June 30 2003	December 31 2002	June 30 2002
	Cost	Accumulated depreciation	Net book value	Net book value	Net book value
Land	\$ 436,281	-	\$ 436,281	\$ 388,070	\$ 370,435
Buildings	1,781,450	51,018	1,730,432	1,534,130	1,467,027
	\$ 2,217,731	\$ 51,018	\$ 2,166,713	\$ 1,922,200	\$ 1,837,462

### 3. Mortgages receivable:

The mortgages receivable are secured by real property, bear interest at a weighted average of 9.5% (December 31, 2002 - 8.8%, June 30, 2002 - 9.2%) per annum and are repayable between 2003 and 2008. The Trust has options to acquire interests in these properties.

### 4. Deferred expenses:

			June 30 2003	December 31 2002	June 30 2002
	Cost	Accumulated amortization	Net book value	Net book value	Net book value
Leasing	\$ 29,673	\$ 9,103	\$ 20,570	\$ 21,059	\$ 21,201
Financing	10,131	1,309	8,822	7,800	7,329
	\$ 39,804	\$ 10,412	\$ 29,392	\$ 28,859	\$ 28,530

# H&R REAL ESTATE INVESTMENT TRUST

## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

June 30, 2003

### 5. Mortgages payable:

The mortgages payable are secured by the income properties, bearing fixed interest, with a weighted average rate of 7.3% (December 31, 2002 - 7.4%, June 30, 2002 - 7.6%) per annum and maturing between 2003 and 2023. Included in the mortgages payable are US \$159,435 (Cdn \$215,237) at June 30, 2003 (December 31, 2002 - US \$51,649 (Cdn \$81,606), June 30, 2002 - US \$7,388 (Cdn \$11,156)). Future principal payments are as follows:

Year ending December 31:

2003	\$	19,435
2004		65,702
2005		60,841
2006		65,718
2007		81,634
Thereafter		1,090,780
	\$	1,384,110

### 6. Bank indebtedness:

The bank indebtedness bears interest at rates approximating the prime rate of a Canadian chartered bank, is secured by fixed charges over certain income properties and is due on demand. At June 30, 2003, the prime interest rate was 5.00% (December 31, 2002 - 4.5%, June 30, 2002 - 4.25%) per annum.

### 7. Unitholders' equity:

(a) The following units are issued and outstanding:

As at December 31, 2001	69,771,049
Issued under the distribution reinvestment plan and direct unit purchase plan	109,673
Options exercised	675,332
As at June 30, 2002	70,556,054
Issued under the distribution reinvestment plan and direct unit purchase plan	298,098
Options exercised	56,666
As at December 31, 2002	70,910,818
Issued on April 30, 2003 (at a price of \$13.23 per unit)	1,889,302
Issued under the distribution reinvestment plan and direct unit purchase plan	231,001
Options exercised	1,025,234
As at June 30, 2003	74,056,355

# H&R REAL ESTATE INVESTMENT TRUST

## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

**June 30, 2003**

(b) Incentive unit option plan:

The Trust may grant options to its officers, employees and certain trustees for up to 5,800,000 units. The exercise price of each option approximates the market price of the Trust's units on the date of grant. The options vest at 33.3% per year from the grant date, being fully vested after three years, and expire ten years after the date of the grant.

A summary of the status of the plan as at June 30, 2003 and 2002 and the changes during the period ended on those dates are as follows:

	2003	2003	2002	2002
		Weighted average exercise price (\$)		Weighted average exercise price (\$)
Options	Units		Units	
Outstanding, beginning of period	3,848,834	11.93	3,805,832	11.42
Granted	468,168	13.36	775,000	13.12
Exercised	(1,025,234)	11.06	(675,332)	10.55
Outstanding, end of period	3,291,768	12.40	3,905,500	11.91
Options exercisable at June 30	1,524,542	11.91	1,620,308	11.20

The options outstanding at June 30, 2003 are exercisable at varying prices ranging from \$9.17 to \$13.36 with a weighted average remaining life of 7.9 years. The vested options are exercisable at varying prices ranging from \$9.17 to \$13.12 with a weighted average remaining life of 6.9 years.

### 8. Per unit amounts:

The following table sets forth the computation of basic net earnings per unit and diluted net earnings per unit using weighted average units outstanding and adjusted weighted average units, respectively:

	Three Months Ended		Six Months Ended	
	June 30 2003	June 30 2002	June 30 2003	June 30 2002
Weighted average units outstanding	72,970,451	70,067,440	71,995,631	69,927,642
Effect of dilutive securities:				
Employee unit options	487,923	532,443	420,883	540,211
Adjusted weighted average units and assumed conversions	73,458,374	70,599,883	72,416,514	70,467,853

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## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

June 30, 2003

### 9. Stock based compensation:

The Trust accounts for stock-based compensation and other stock-based payments to employees using the settlement method of accounting. Accordingly, no compensation cost has been recognized for its unit option plan. The only stock-based compensation or payment granted by the Trust is pursuant to its unit option plan.

As a result, the Trust discloses proforma amounts to reflect the impact if the Trust had elected to adopt the fair value method of accounting for stock-based compensation. Accordingly, the Trust's net earnings and basic net earnings per unit would have decreased to the proforma amounts as indicated below for the three months and six months ended June 30.

	Three Months Ended		Six Months Ended	
	June 30	June 30	June 30	June 30
	2003	2002	2003	2002
Net earnings				
Reported	\$ 20,816	\$ 21,051	\$ 44,435	\$ 42,912
Proforma	20,717	20,976	44,236	42,837
Basic net earnings per unit				
Reported	\$ 0.29	\$ 0.30	\$ 0.62	\$ 0.61
Proforma	0.28	0.30	0.61	0.61

The fair value of the stock options used to compute proforma net earnings and proforma basic net earnings per unit is the estimated fair value of each option grant on the grant date using the Black-Scholes option pricing model with the following weighted average assumptions:

Weighted Average Assumptions	June 30	June 30
	2003	2002
Expected distribution yield	9.0%	8.6%
Expected volatility	12.5%	10.2%
Risk free interest rate	5.0%	5.4%
Expected option life in years	10	10

468,168 options were issued during the six months ended June 30, 2003. 775,000 options were issued during the six months ended June 30, 2002.

# H&R REAL ESTATE INVESTMENT TRUST

## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

June 30, 2003

### 10. Changes in other non-cash operating items:

	Three months ended		Six months ended	
	June 30 2003	June 30 2002	June 30 2003	June 30 2002
Deferred expenses	\$ (1,385)	\$ (4,220)	\$ (4,244)	\$ (9,157)
Prepaid expenses and sundry assets	(2,858)	(1,852)	(6,396)	(6,062)
Accrued rent receivable	(396)	(395)	(792)	(792)
Accounts receivable	503	979	(136)	(1,440)
Accounts payable	580	(9,834)	(2,150)	3,677
	\$ (3,556)	\$ (15,322)	\$ (13,718)	\$ (13,774)

### 11. Distributable Income:

Distributable income, which is not defined within Canadian generally accepted accounting principles, has been calculated with reference to the terms of the Declaration of Trust as follows:

	Three months ended		Six months ended	
	June 30 2003	June 30 2002	June 30 2003	June 30 2002
Net earnings	\$ 20,816	\$ 21,051	\$ 44,435	\$ 42,912
Depreciation	4,816	3,883	9,162	7,223
Accrued rent	(396)	(395)	(792)	(792)
Distributable Income	\$ 25,236	\$ 24,539	\$ 52,805	\$ 49,343
Distributable income per unit (note 8)	\$ 0.35	\$ 0.35	\$ 0.73	\$ 0.71
Cash distribution per unit	\$ 0.31	\$ 0.30	\$ 0.61	\$ 0.59

### 12. Segment disclosures:

Geographic information:

Segmented information on rentals from income properties and identifiable assets by geographic region is as follows:

Rentals from Income Properties	Three months ended		Six months ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
Canada	72,429	72,479	144,700	136,251
United States	6,054	699	9,005	1,317
	\$ 78,483	\$ 73,178	\$ 153,705	\$ 137,568

# H&R REAL ESTATE INVESTMENT TRUST

## Notes to Unaudited Consolidated Financial Statements

(In thousands of dollars, except per unit amounts)

June 30, 2003

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Income Properties	June 30, 2003	December 31, 2003	June 30, 2002
Canada	\$ 1,848,031	\$ 1,807,984	\$ 1,816,935
United States	318,682	114,216	20,527
	<hr/>	<hr/>	<hr/>
	\$ 2,166,713	\$ 1,922,200	\$ 1,837,462

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Revenues are attributed to countries based on location of the properties.

### 13. Significant transactions:

On January 31, 2003, the Trust completed the sale of a 148,000 square foot office property for \$22.5 million. This was paid for in part by the purchaser assuming the existing mortgage payable of approximately \$11.1 million. A gain of approximately \$3.6 million was realized on this transaction.

During the first quarter, the Trust acquired one industrial and four retail properties totalling 661,000 square feet for approximately \$82.6 million. Mortgages payable of \$49.0 million were assumed on these properties.

The Trust entered into an agreement to sell, on a private placement basis, \$100 million of units to accounts managed by a single Canadian institutional money manager. The financing will be effected in four equal tranches. The first \$25 million of trust units was issued on April 30, 2003. The three additional tranches will be issued on or about July 31, 2003, October 31, 2003 and January 15, 2004.

During the second quarter, the Trust acquired four industrial and 21 retail properties in Canada and the United States totalling 1,825,000 square feet at a cost of approximately \$209.2 million. The Trust assumed mortgages of \$103.2 million on these properties.

### 14. Subsequent events:

On July 21, 2003, the Trust sold a 41,000 square foot retail property for approximately \$4.5 million.

On July 31, 2003, the second \$25 million of trust units was issued pursuant to the terms of the above-noted private placement agreement.

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

The following discussion should be read in conjunction with the consolidated financial statements of the REIT and the notes thereto for the six months ended June 30, 2003 and 2002, with the Management's Discussion and Analysis for December 31, 2002 including the section on "Risks and Uncertainties", and with the audited consolidated financial statements and notes thereto for year-end of December 31, 2002.

### RESULTS OF OPERATIONS

Net earnings for the three months ended June 30, 2003 of \$20.8 million or \$0.29 per unit, decreased slightly by 1.1% on a dollar basis and by 3.3% on a per unit basis as compared to the net earnings of \$21.1 million or \$0.30 per unit for June 30, 2002.

For the six month period ended June 30, 2003 compared to June 30, 2002, net earnings increased 3.5% from \$42.9 million to \$44.4 million on a dollar basis and 1.6% from \$0.61 to \$0.62 on a per unit basis.

Depreciation of \$4.8 million (Q2 2002 - \$3.9 million) and amortization of \$1.0 million (Q2 2002 - \$0.9 million) are included in the determination of net earnings for the three months ended June 30, 2003. For the six months ended June 30, 2003, net income determination included depreciation of \$9.2 million (2002 - \$7.2 million) and amortization of \$2.0 million (2002 - \$1.7 million). The REIT does not consider depreciation expense when calculating distributions paid to unitholders.

### **Income from rental operations before depreciation, amortization and trust expenses (in thousands of dollars)**

	For the three months ended		For the six months ended	
	June 30 2003	June 30 2002	June 30 2003	June 30 2002
Rentals from income properties	\$78,483	\$73,178	\$153,705	\$137,568
Mortgage interest income and other	<u>1,711</u>	<u>1,757</u>	<u>6,906</u>	<u>5,735</u>
	80,194	74,935	160,611	143,303
Property operating costs	<u>27,283</u>	<u>27,747</u>	<u>54,814</u>	<u>52,571</u>
Operating income before interest	52,911	47,188	105,797	90,732
Mortgage and other interest	<u>25,111</u>	<u>20,246</u>	<u>47,861</u>	<u>36,654</u>
Income from operations before depreciation, amortization and trust expenses	\$27,800	\$26,942	\$57,936	\$54,078

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

### RENTALS FROM INCOME PROPERTIES

Rentals from income properties for the three month period ended June 30 increased 7.2% from \$73.2 million in Q2 2002 to \$78.5 million in 2003. For the six month period ended June 30, rentals increased from \$137.6 million in 2002 to \$153.7 million in 2003 or 11.7%. The increase is primarily the result of the REIT's ongoing strategy of adding to its properties either through acquisitions or its mezzanine financing program. A total of 33 properties were added and two properties were sold between June 30, 2002 and June 30, 2003 representing a net increase in the book value of income properties (after depreciation) of \$329.3 million.

Property operating costs and mortgage and other interest have also changed from \$27.7 million and \$20.2 million to \$27.3 million and \$25.1 million respectively for the second quarter of 2003. These costs also increased from \$52.6 million and \$36.7 million to \$54.8 million and \$47.9 million respectively for the six months ended June 30, 2003. These changes reflect the increase in activity resulting from the additional properties added to the portfolio (see "changes in financial position – income properties" below).

The occupancy rate in the REIT's portfolio as at June 30, 2003 remains unchanged at 99% from March 31, 2003 and June 30, 2002. The exposure to lease rollovers as a result of lease expiries over the next 5 years (as a percentage of the REIT owned portion of the properties) is as follows:

2003	0.50%	for the balance of the year
2004	2.67%	
2005	1.86%	
2006	2.00%	
2007	<u>3.01%</u>	
	10.04%	

### MORTGAGE INTEREST INCOME AND OTHER INCOME

The REIT earned \$1.7 million in mortgage interest income and other income in the second quarter of 2003 compared to \$1.8 million in 2002 remaining virtually unchanged. For the six month period ended June 30, 2003 compared to June 30, 2002 this income increased to \$6.9 million from \$5.7 million, a 20.4% increase. Included in this \$6.9 million amount are gains on sale of income properties (see "sale of income properties" below) of \$3.6 million (2002 - \$1.7 million). The balance of this type of income (when excluding gains on sale) has therefore declined by 19.2% or \$0.8 million to \$3.3 million when comparing the six month periods ended June 30, 2003 to 2002.

This reduction is mainly due to the decline in the average mortgage receivable asset balance between the six month periods ended June 30, 2002 and 2003 (see "changes in

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

financial position – mortgages receivable" below). As more development opportunities arise in the future this trend could then reverse itself. The weighted average interest earned on these investments for the six months ended June 30, 2003 was 9.5% compared to the 9.2% earned in the same period ended June 30, 2002. This slight increase in the weighted average interest rate was an offsetting factor in the reduction of the second quarter interest income over the same period in 2002.

### SALE OF INCOME PROPERTIES

The REIT's philosophy is to dispose of assets that no longer fit its investment strategy and re-deploy the proceeds in more attractive investment opportunities. During this quarter, the REIT did not dispose of any assets compared to the Q2 2002 disposition of certain excess industrial lands yielding a profit of approximately \$0.2 million.

Therefore the disposition of one non-core 148,000 square foot office property in the 2003 first quarter as compared to a 294,000 square foot retail property for the quarter ended March 31, 2002 yielding a \$1.5 million gain (plus \$0.2 million gain mentioned above) has generated a profit of approximately \$3.6 million for the six months ended June 30, 2003 compared to \$1.7 million earned during the six months ended June 30, 2002.

### TRUST EXPENSES

Trust expenses increased slightly in the second quarter 2003 over second quarter 2002 by \$0.1 million and were relatively unchanged for the equivalent six month periods despite the increase in size and activity of the REIT. These expenses amount to 1.5% of rentals from income properties for the 2002 and 2003 second quarters. The year-to-date percentage has declined from 1.6% in 2002 to 1.5% in 2003.

### DISTRIBUTION TO UNITHOLDERS

Currently, the REIT is required to distribute not less than 80% of its normalized distributable income to Unitholders on a monthly basis.

Depreciation, accrued rent and other non-cash items (including gains on sale) are added to, or deducted from, net earnings to determine the amount of income available for distribution. Accrued rent represents the adjustment made to normalize rents for certain tenants whose rental rate increases substantially over the term of their respective leases. This adjustment is required by Canadian generally accepted accounting principles and represents a non-cash item to be deducted in determining distributable income.

Distributable income increased slightly by \$0.7 million from \$24.5 million for the quarter ended June 30, 2002 to \$25.2 million for the quarter ended June 30, 2003. This represents virtually no change on a per unit basis amounting to \$0.35 for the quarters ended June 30, 2002 and June 30, 2003.

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

Distributable income increased to \$52.8 million or \$0.73 per unit from \$49.3 million or \$0.71 per unit for the six months ended June 30, 2003 compared to the same period in fiscal 2002.

The primary reason for this increase is the higher capital gain realized in Q1 2003 of \$3.6 million compared to \$1.5 million in Q1 2002 (see "Sale of Income Properties" above). The balance of the increase is attributable to the acquisition of properties between July 2002 and June 2003 plus rental escalations in existing leases, offset by the lower rate of interest earned on mortgage receivables (see "Mortgage Interest Income and Other Income" above) and the general softening in the multi-tenant office market in the GTA which has given rise to lower rents on renewal and new leasing, as well as slightly higher vacancies in the office portfolio.

Since December 31, 2002 office occupancy has decreased by approximately 1%. This can be attributed primarily to three different leases in our suburban GTA office portfolio totaling a net 65,000 square feet for which the timing of releasing is unknown at this point. At an average gross rental of \$32.00 per square foot, financial impact on Q1 2003 was \$400,000 increasing to \$480,000 in Q2 2003.

Adjusting for these gains previously mentioned will result in normalized distributable income of \$25.2 million or \$0.35 per unit for the quarter ended June 30, 2003 versus \$24.4 million or \$0.35 per unit for the same period in 2002, and \$49.2 million or \$0.68 per unit for the six months ended June 30, 2003 as compared to \$47.7 million or \$0.68 per unit for the same period in 2002. For both the quarters and six months period under review, distributable income per unit has remained virtually unchanged.

Total distributions in the current quarter, at 10.2c per unit per month, amounted to \$22.3 million or 88.5% of distributable income. This compares to \$20.7 million at 9.7c per unit per month for April and May 2002 and 10.2 cents per unit in June representing an 84.4% payout in the same quarter of the prior year. The percentage increase is due to the higher payout per unit adopted in June 2002.

Total distributions for the six month period ended June 30, 2003 amounted to \$44.3 million or 83.8% of distributable income, compared to \$41.0 million or 83.1% of distributable income for the same period in the 2002 year. This percentage is virtually unchanged as the higher payout per unit in 2003 for the full six months at 10.2 cents per unit per month is offset in percentage terms by the larger capital gains realized in 2003 included in distributable income as previously described.

The percentage of distributions to normalized distributable income described previously is 88.5% for the quarter ended June 30, 2003 (Q2 2002 – 85.1%) and 90.0% for the six months ended June 30, 2003 (2002 – 86.1%). Management expects this ratio to decline to approximately 87% for the 2003 fiscal year assuming distributions remain constant throughout the remainder of the year.

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## Management's Discussion & Analysis

For the six months ended June 30, 2003

Readers are cautioned that distributable income is a non-GAAP measure and should not be construed as an alternative to net earnings determined in accordance with GAAP as an indicator of the REIT's performance. The REIT's method of calculating distributable income may differ from other issuers' methods and accordingly distributable income may not be comparable to measures used by other issuers.

Calculation of Distributable Income (in thousands of dollars)	For the three months ended		For the six months ended	
	June 30 2003	June 30 2002	June 30 2003	June 30 2002
Net earnings	\$20,816	\$21,051	\$44,435	\$42,912
Add (deduct)				
Depreciation	4,816	3,883	9,162	7,223
Accrued rent	(396)	(395)	(792)	(792)
Distributable Income	\$25,236	\$24,539	\$52,805	\$49,343

### CHANGES IN FINANCIAL POSITION

#### **ASSETS**

##### Income Properties

During the first quarter ended March 31, 2003, the REIT acquired five properties and disposed of one property.

In January 2003, a non-core multi-tenant office building located in Toronto, Ontario totaling 148,000 square feet was sold for gross proceeds of \$22.5 million, realizing a gain of \$3.6 million.

In February 2003, the REIT acquired a new 255,000 square foot logistics warehouse in Oakville, Ontario for approximately \$17.4 million. The property is leased to UPS Logistics Group.

During March 2003, three free standing retail home improvement stores leased to Lowes Companies Inc. were purchased for approximately \$60.6 million. The stores, comprising a total of 395,000 square feet, are all located in the Atlanta, Georgia area. An additional 11,000 square foot retail store leased to Eckerd Corporation in the same region was purchased for \$4.6 million.

During the second quarter, the REIT acquired 25 properties, mainly in the United States.

In April 2003, three single tenant industrial properties totaling 460,000 square feet leased to Borders Inc. and Georgia Pacific Corporation on long term leases were purchased for \$27.7 million.

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## Management's Discussion & Analysis

For the six months ended June 30, 2003

During May 2003, the REIT purchased 21 retail properties and one industrial property.

A portfolio of 17 retail properties leased to investment grade tenants with approximately 15 years remaining on their leases was purchased from New York Life. These single tenant free standing retail stores comprising 834,000 square feet were purchased for \$112.3 million. An additional two retail stores totaling 147,000 square feet located in Georgia and Florida were purchased for \$25.2 million.

Finally, in Canada, three properties were acquired. A 150,000 square foot Rona Inc. retail store located in Edmonton was purchased for \$14.6 million. A 122,000 power center in Ottawa, tenanted by Best Buy, Linens 'N Things and Loeb's, was purchased for \$22.7 million and lastly a 112,000 square foot industrial distribution center leased long term to UAP Inc. in Cambridge, Ontario was purchased for \$6.7 million.

Consequently, as a result of these transactions, income properties increased by 12.7% to \$2,166.7 million at June 30, 2003 from \$1,922.2 million at December 31, 2002.

### Mortgages Receivable

The REIT provides mezzanine financing for development projects that are consistent with the REIT's objectives and philosophy.

At June 30, 2003 there were five projects for which the REIT had provided mezzanine development financing as compared to four at December 31, 2002.

Mortgages receivable increased 31.5% from \$60.1 million at December 31, 2002 to \$79.0 million at June 30, 2003. This increase is primarily due to new financing of \$6.5 million provided in the first quarter for an industrial project in Kitchener, Ontario as well as an additional \$13.9 million advanced on Phase II of the Bell Canada Complex in Mississauga, Ontario, offset by the reduction in another mortgage of \$2.6 million in May 2003.

### Deferred Expenses

Deferred expenses increased slightly by \$0.5 million from \$28.9 million at December 31, 2002 to \$29.4 million at June 30, 2003, an increase of 1.8%. This increase reflects the normal increase in activity resulting from additional properties added to the portfolio offset by the ongoing amortization of this asset.

### Other Assets

Accounts receivable and accrued rents receivable were not significantly different between December 31, 2002 and June 30, 2003.

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

Prepaid expenses and sundry assets increased from \$11.5 million at December 31, 2002 to \$17.9 million at June 30, 2003, an increase of 55.6%. The increase is primarily as a result of realty taxes being prepaid on most of the REIT's assets.

Cash and cash equivalents decreased by \$3.5 million between December 31, 2002 and June 30, 2003. Of the balance of \$6.7 million, \$4.0 million related to funds being held in escrow until the expiry of certain non-recourse public mortgage bonds and other non-recourse US mortgages.

## LIABILITIES

The REIT's Declaration of Trust limits the indebtedness to a maximum of 65% of the gross book value of the REIT. At June 30, 2003 the REIT's indebtedness was 62.4% compared to 59.3% at December 31, 2002. This increase is due to the increase in mortgages payable and bank indebtedness as outlined below.

### Mortgages Payable

Mortgages payable increased by 11.7% from the December 2002 year-end figure of \$1.239 billion to \$1.384 billion at June 30, 2003. This \$144.9 million net increase is primarily a result of four mortgages totaling \$65.5 million assumed on the closing of the four Lowes stores purchased in Georgia, mortgages of \$78.9 million secured on the closing of the New York Life Portfolio and three mortgages secured on the newly acquired Canadian properties (see "Assets – Income Properties" above).

The mortgages payable balance was however reduced by \$11.1 million with the sale of the office property at 250 University Avenue, Toronto when the mortgage was assumed by the purchaser, as well as by the regular monthly self amortizing principal payments made in the normal course of business operations.

### Bank Indebtedness

Liabilities at June 30, 2003 included bank indebtedness of \$95.2 million compared to \$1.3 million at December 31, 2002, an increase of \$93.9 million. The debt bears interest at rates approximating the prime rate of a Canadian Chartered bank and is secured by fixed charges over certain income properties and is due on demand. These funds were primarily used to provide the equity required for the asset purchases previously described and the provision of additional mezzanine financing for development projects.

### Accounts Payable

Accounts payable decreased by \$2.1 million from \$42.7 million at December 31, 2002 to \$40.6 million at June 30, 2003. This decrease reflects regular fluctuations occurring in the normal course of business operations.

# H&R REAL ESTATE INVESTMENT TRUST

## Management's Discussion & Analysis

For the six months ended June 30, 2003

### UNITHOLDERS' EQUITY

Subsequent to the first quarter of 2003, the REIT entered into an agreement to sell, on a private placement basis, \$100 million of units to accounts managed by a single Canadian institutional money manager with proceeds to be received in four equal tranches. The first \$25 million of trust units was issued on April 30, 2003 with the three additional tranches to be issued on or about July 31, 2003, October 31, 2003 and January 15, 2004.

Unitholders' equity increased by \$39.6 million between December 31, 2002 and June 30, 2003 as a result of an excess of net earnings over distributions to unitholders, the proceeds from the REIT's distribution reinvestment program, the exercise of options by officers and trustees of the REIT during the period as well as by \$25 million of trust units issued as described above.

### CUMULATIVE FOREIGN EXCHANGE ADJUSTMENTS

As a result of the strengthening of the Canadian dollar against the US dollar during the six months ended June 30, 2003, an unrealized loss of \$8.4 million was recorded on the financial statements at June 30, 2003 as compared to a gain of \$0.2 million at December 31, 2002. This amount reflects the net adjustment to the equity invested in US properties, with the REIT's debt being held in US dollars currently acting as a natural hedge against its total investment in US dollars. This amount fluctuates continuously depending on the US exchange rate and had reduced to \$5.9 million by July 31, 2003 as the Canadian dollar declined from a rate of \$0.7407 per US \$ at June 30, 2003 to \$0.7143 per US \$ at July 31, 2003.

In addition, as part of the REIT's strategy of providing stable distributable income to its unitholders, the REIT has implemented a hedging strategy on its US income to minimize exposure to currency fluctuations.

### LIQUIDITY AND CAPITAL RESOURCES

Funds from operations during the second quarter amounted to \$26.5 million, an increase from \$25.5 million in the same quarter of 2002. Funds from operations during the first six months of the year amounted to \$51.6 million, an increase from \$49.9 million in the same period of 2002. This cash provided from operating activities, together with proceeds from issue of units, conventional mortgage financing and short term bank financing, have been used mainly to fund net property acquisitions of \$144.5 million and distributions to unitholders of \$44.3 million for the six months ended June 30, 2003.

Management expects to be able to meet all of the REIT's ongoing obligations and to finance future growth through the issue of new equity as well as by using conventional real estate debt, short term financing from the bank and through a related party and the REIT's stable cash flow. A significant source of future liquidity will be the balance of the proceeds from the \$100 million private placement that was agreed to subsequent to the

# **H&R REAL ESTATE INVESTMENT TRUST**

## **Management's Discussion & Analysis**

For the six months ended June 30, 2003

end of the first quarter whereby the funds are to be received in an additional three \$25 million tranches every three months beginning July 31, 2003.

### SUBSEQUENT EVENTS

Subsequent to the quarter end, the REIT, pursuant to a private placement agreement previously described sold the second tranche of \$25 million of trust units on July 31, 2003 with the remaining two additional tranches to be issued on or about October 31, 2003 and January 15, 2004.

In July, the REIT sold a 41,000 square foot retail property for approximately \$4.5 million.

### RISKS AND UNCERTAINTIES

The REIT is exposed to interest rate risk on its borrowings. It minimizes this risk by restricting total debt to 65% of aggregate assets and by obtaining long-term fixed rate debt to replace short-term floating rate borrowings. In addition, the weighted average term to maturity of long-term debt is closely matched to the remaining average lease terms.

The REIT is exposed to credit risk as an owner of real estate in that tenants may become unable to pay the contracted rents. Management mitigates this risk by carrying out appropriate credit checks and related due diligence on the significant tenants. Management has diversified the REIT's holdings so that it owns several categories of properties (office, industrial and retail) and acquires properties throughout Canada and the United States. In addition, management ensures that no tenant or related group of tenants, other than investment grade tenants, account for a significant portion of the cash flow. The only tenants which account for more than 5% of the rentals from income properties of the REIT are TCPL, Bell Canada and Bell Mobility, but each individually represent less than 15% of the rentals from income properties of the REIT and currently are at least A rated by a recognized rating agency.

The REIT is also exposed to credit risk as a lender on the security of real estate in the event that a borrower is unable to make the contracted payments. Such risk is mitigated through credit checks and related due diligence of the borrowers and through careful evaluation of the worth of the underlying assets.

The REIT is exposed to foreign exchange fluctuations as a result of ownership of assets in the United States. In order to mitigate the risk of significant fluctuations, a hedging program has been implemented to protect income earned in US dollars.

The REIT has been structured to ensure that mandated investment guidelines and operating criteria are strictly adhered to. These policies govern such matters as the type and location of properties that the REIT can acquire, the maximum leverage allowed, the requirement for appropriate insurance coverage as well as environmental policies.

# **H&R REAL ESTATE INVESTMENT TRUST**

## **Management's Discussion & Analysis**

For the six months ended June 30, 2003

The REIT has maintained its ability to properly manage both operational and financial risks. The REIT's properties are leased under long-term arrangements to a diversified base of creditworthy tenants with strong covenants and are financed with long-term fixed rate mortgages.

Other than as described above, no single tenant is critical to the REIT's ability to meet its financial obligations. The REIT's broad tenant base assists in attempting to fulfill its primary goal of maintaining a predictable cash flow. Risk is further minimized through a low vacancy rate and relatively few short to medium-term lease renewals.

# H&R REAL ESTATE INVESTMENT TRUST

## Supplemental financial information, page 1.

For the six months ended June 30, 2003

The following are details of selected supplemental financial information for the six months ended June 30, 2003.

### OVERVIEW OF PORTFOLIO

(Net ownership position)

	June 30, 2003			
	Office	Industrial	Retail	Total
Number of Properties	26	77	39	142
Total Leasable Area (square feet)	5,747,273	11,066,719	3,278,670	20,092,662
Occupancy *	96%	100%	100%	99%
Average Rent per sq.ft.	\$17.61	\$5.24	\$14.68	\$10.32
Average Age of Buildings (years)	12.58	12.89	5.57	11.61
Average Interest Rate on Outstanding Mortgages *	7.6%	7.1%	6.6%	7.3%

\* Weighted average

	December 31, 2002			
	Office	Industrial	Retail	Total
Number of Properties	27	72	14	113
Total Leasable Area (square feet)	5,895,448	10,240,292	1,617,066	17,752,806
Occupancy *	97%	100%	99%	99%
Average Rent per sq.ft.	\$17.68	\$5.23	\$16.31	\$10.38
Average Age of Buildings (years)	12.06	12.81	4.53	11.80
Average Interest Rate on Outstanding Mortgages *	7.6%	7.2%	6.9%	7.4%

\* Weighted Average

# H&R REAL ESTATE INVESTMENT TRUST

## Supplemental financial information, page 2.

For the six months ended June 30, 2003

### NET OPERATING INCOME

#### Diversification by Asset Class

	6 Months ended June 30, 2003	Year ended December 31, 2002
Office	58%	60%
Industrial	28%	27%
Retail	14%	13%

#### Diversification by Region

	6 Months ended June 30, 2003	Year ended December 31, 2002
Ontario	60%	62%
Alberta	23%	24%
Quebec	9%	10%
United States	5%	1%
Other	3%	3%

### ASSETS

#### Book Value by Asset Class (\$millions)

	As at June 30, 2003	As at December 31, 2002
Office	\$1,089	\$1,113
Industrial	\$580	\$539
Retail	\$498	\$270

#### Book Value by Region (\$millions)

	As at June 30, 2003	As at December 31, 2002
Ontario	\$1,112	\$1,084
Alberta	\$484	\$471
United States	\$319	\$115
Quebec	\$187	\$187
Other	\$65	\$65

# H&R REAL ESTATE INVESTMENT TRUST

## Supplemental financial information, page 3.

For the six months ended June 30, 2003

### TENANTS

(Analysis of largest 10 tenants  
as a percentage of rental from income properties)

	Tenant	% of rentals from income properties	Lease term to maturity (years)
1.	Bell Canada	14.52%	18.25
2.	TransCanada PipeLines Limited	10.86%	17.75
3.	Bell Mobility	6.43%	18.75
4.	Lowe's Companies Inc.	3.93%	14.50
5.	Purolator Courier Limited	2.96%	18.00
6.	Finning International	2.89%	18.75
7.	Public Works of Canada	2.42%	13.00
8.	Rona Inc.	2.34%	16.50
9.	Royal Bank of Canada	2.26%	7.75
10.	Nestle Canada Inc.	1.51%	16.25
	<b>Total</b>	<b><u>50.12%</u></b>	

### LEASE EXPIRIES

Percent of total expiring and average net rent on expiry

	Office		Industrial		Retail		Total	
	%	Rent \$	%	Rent \$	%	Rent \$	%	Rent \$
*2003	0.48	12.75	-	-	0.02	16.14	0.50	12.89
2004	1.14	19.32	1.45	5.54	0.08	21.26	2.67	11.89
2005	1.49	17.63	0.20	6.21	0.17	17.94	1.86	16.43
2006	1.40	14.37	0.39	5.23	0.21	19.89	2.00	13.17
2007	0.72	16.67	2.21	4.99	0.08	29.90	3.01	8.45
Total	<u>5.23</u>	<u>16.55</u>	<u>4.25</u>	<u>5.26</u>	<u>0.56</u>	<u>20.79</u>	<u>10.04</u>	<u>12.00</u>

\* For the balance of the year

# H&R REAL ESTATE INVESTMENT TRUST

Supplemental financial information, page 4.

For the six months ended June 30, 2003

## DEBT RATIOS

Debt to Gross Book Value (Guideline maximum 65%)						
	1998	1999	2000	2001	2002	2003
Quarter 1	44%	48%	48%	42%	58%	60%
Quarter 2	38%	49%	48%	55%	58%	62%
Quarter 3	47%	38%	50%	55%	59%	
Quarter 4	45%	48%	50%	48%	59%	
Percentage of Fixed Rate Debt to Total Debt						
	83%	79%	83%	99%	99%	94%

## DEBT MATURITY

Balances due on Maturity					
	June 30, 2003		December 31, 2002		June 30, 2003
	(\$000's) *	Average Interest Rate (%)	(\$000's) *	Average Interest Rate (%)	Future Principal Repayments (\$000's)
**2003	638	9.25	1,811	9.57	19,435
2004	26,049	5.24	27,748	5.81	65,702
2005	19,256	7.05	19,256	7.05	60,841
2006	21,575	6.98	21,575	6.98	65,718
2007	<u>35,636</u>	8.18	<u>35,636</u>	8.18	<u>81,634</u>
Total	<u>103,154</u>		<u>106,026</u>		<u>293,330</u>

\* Balances due on maturity exclusive of normal periodic self-amortizing principal repayments

\*\* For the balance of the year

# H&R REAL ESTATE INVESTMENT TRUST

Supplemental financial information, page 5.

For the six months ended June 30, 2003

## Allocation of Debt (including bank indebtedness)

	June 30, 2003	December 31, 2002
Recourse – Debt to Gross Book Value of Subject Assets	55.0%	51.0%
Non Recourse – Debt to Gross Book Value of Subject Assets	75.9%	76.3%
Total Debt to Gross Book Value	62.4%	59.3%
Non Recourse Debt as a Percentage of Total Debt	43.3%	42.1%

## Other Statistics

	June 30, 2003	December 31, 2002
Mortgage term to maturity	12.6 years	12.8 years
Lease term to maturity	12.3 years	12.2 years
Tax deferred percentage of distributions	*50%	53%
Payout ratio (including gain on sale of income properties)	83.8%	86.2%

\* Estimate

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Additional information is available on H&R REIT's web site at: [www.hr-reit.com](http://www.hr-reit.com).