

# A&W Revenue Royalties Income Fund

## Management's Discussion and Analysis

for the period from

February 15th, 2002 (commencement of operations)

to December 31, 2002



## Management's Discussion and Analysis

The following is a discussion of the consolidated financial condition and results of operations of A&W Revenue Royalties Income Fund (the "Fund"). It should be read in conjunction with the audited Consolidated Financial Statements of the Fund which are on pages 15 to 22. Since this is the first year of operations of the Fund, comparisons of operations to prior periods are not available.

The annual report of the Fund, including the enclosed annual review of A&W Food Services of Canada Inc. ("Food Services") and this Management Discussion and Analysis contain forward-looking statements based on assumptions that management considered reasonable at the time they were prepared. These forward-looking statements, by their nature, necessarily involve risks and uncertainties that could cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause results or events to differ from current expectations include, but are not limited to, the risk factors described on pages 12 and 13.

### INCEPTION OF THE FUND

Inception of the Fund began with the issue and commencement of trading of Fund units on the Toronto Stock Exchange (TSX) on February 15, 2002 (TSX symbol AW.UN).

The Fund was created as a limited purpose trust to invest in securities of A&W Trade Marks Inc. (the "Company"). The Company acquired the A&W trade-marks from Food Services which were then licenced to Food Services for use in its hamburger quick service restaurant business in return for payment of a royalty of 3% of sales of A&W restaurants in Canada. At the inception of the Fund, there were 585 A&W restaurants across Canada for which gross sales were calculated for the purpose of determining the royalty. (See "Subsequent Events" on page 13 for a discussion of the increase in number of restaurants in the Royalty Pool which occurred in January 2003.)

Since the Fund is based on the gross sales of A&W restaurants, its expenses are limited to general and administrative expenses, interest on long-term debt, amortization of deferred financing fees, taxes and Class A share dividends.

At the Fund's inception, Food Services owned 25% of the units of the Fund on a fully diluted basis. In January 2003, Food Services' ownership interest in the Fund increased to 28%. (See "Subsequent Events" on page 13).

So long as Food Services holds an indirect interest in the Fund, distributions by the Fund to unitholders in the amount of approximately 9 cents per month are made before an equivalent amount is paid to Food Services.

From inception in February 2002 to year end, the Fund made its projected distributions to unitholders of 9 cents per unit per month.

### Summary of Operating Results

(in thousands of dollars except per unit amounts)

For the period from February 15, 2002  
(commencement of operations) to  
December 31, 2002

Gross sales reported by the 585 A&W outlets in the Royalty Pool	\$ 384,286
Royalty income	\$ 11,529
Class A share dividends	2,620
Net earnings for the period	7,063
Basic and diluted earnings per Unit	\$ 0.847

### GROSS SALES REPORTED BY A&W OUTLETS

Gross Sales from the 585 restaurants in the Royalty Pool during the period February 15 to December 31, 2002 were \$384,286,000.

Same store sales for the restaurants in the Royalty Pool declined by 1.4% from 2001. While this decline was disappointing, it was a better result than that realized by others in the industry (QSR).

The following chart shows the changes in same store sales by A&W Restaurants in 2002 versus 2001 compared to those of the industry (QSR) and its competitors in the same periods.

#### Changes in Same Store Sales 2002 compared to 2001

A&W	-1.4%
Major Competitor	-2.5% <sup>1</sup>
Canadian QSR Industry	-5.1% <sup>2</sup>

<sup>1</sup> As reported by the competitor in print media.

<sup>2</sup> Based on overall sales decline of 0.8% as reported by Stats Can, and an estimated growth in new restaurants of 4.3%

Sales results across the total Canadian foodservice market were the poorest year-over-year since 1991 when the

GST was first applied to restaurant meals. Management of Food Services believes that this decline was primarily attributable to lower expenditures by Canadians on consumables such as foodservice, versus expenditures on capital items such as housing, automobiles, etc. which were driven by record low interest rates.

Despite one of the worst years in Canadian restaurant history, A&W outperformed the overall QSR industry in 2002 – evidence that its strategy of focusing on the “baby boomers” is working. Key strategic initiatives aimed at building same store sales during the year included a focus on establishing Chubby Chicken as a take home meal alternative for the family. Chubby Chicken was reintroduced to the A&W menu nationally in 2001 and was the focus of a national advertising campaign in 2002.

In addition, a major program to re-image A&W’s freestanding (on street) restaurants was undertaken in 2002. Restaurants are being re-imaged in colours and with design features specifically focused on evoking the rich memories that the boomers have of A&W. Seventy-five restaurants were re-imaged in 2002.

### Expenses and Taxes

(in thousands of dollars)

For the period from February 15, 2002  
(commencement of operations) to  
December 31, 2002

General and Administrative	\$ 365
Interest on Term Loan	\$ 500
Amortization of deferred financing fees	120
Taxes	861
Class A share dividends	\$ 2,620
	\$ 4,466

Expenses of the Fund are limited to general and administrative expenses for the administration of the Fund itself, such as printing, postage, legal and

accounting, interest expenses on the Fund's term loan, amortization of deferred financing fees associated with the creation of the Fund and Class A share dividends.

Taxes include future income taxes described in note 7(b) on page 21, and the large corporations capital tax of \$250,000. The Government of Canada recently announced that the large corporations capital tax is to be phased out between 2004 and 2008, and limited to capital in excess of \$50 million in 2004. This change will reduce capital taxes payable by the Fund in the future.

The dividends on the Class A shares are treated for accounting purposes as interest expense and, as such, are deducted in arriving at Net Earnings.

#### Distributions to Unitholders

(in thousands of dollars except per unit amounts)

	For the period from February 15, 2002 (commencement of operations) to December 31, 2002	
Net earnings for the period	\$	7,063
Add		
Amortization of deferred financing fees		120
Future income taxes		611
Class A share dividends		2,620
Distributable cash	\$	10,414
Distributable cash available for Trust Units	\$	7,860
Distributable cash available for dividends		2,554
	\$	10,414
Dividends accrued and unpaid on Class A shares	\$	338
	<b>Per Trust Unit</b>	
Distributable cash (8,340,000 Units)	\$ 0.942	\$ 7,860
Distributions declared and paid (8,340,000 Units)	0.848	7,075
Distributions accrued (8,340,000 Units)	0.090	751

During 2002, Class A share dividends accrued and payable to Food Services amounted to \$2,620,000 and dividends of \$2,282,000 were paid. Distributable cash available to pay Class A share dividends totalled \$2,554,000. At the end of 2002, Class A share dividends accrued but not paid to Food Services amounted to \$338,000. On January 15, 2003 the Company declared a dividend payable to Food Services of \$253,000 payable on January 31, 2003. Distributable cash was available to declare a further Class A share dividend of \$19,000.

#### TAX TREATMENT OF DISTRIBUTIONS

The distributions paid and payable in the year are taxable to unitholders as other investment income.

#### SEASONALITY OF CASH AVAILABLE FOR DISTRIBUTION

Sales in the QSR industry fluctuate seasonally in freestanding restaurants due to the impact of weather. In shopping centers, where A&W has approximately 250 of its restaurants, seasonality (e.g. Christmas, back to school) impacts sales as well. Distributions to unitholders are made on a monthly basis and are levelled out in order to provide unitholders with uniform monthly distributions.

#### RISKS AND UNCERTAINTIES

The performance of the Fund is dependent upon the royalty the Company receives from Food Services. The amount of the royalty is dependent upon the gross sales of the A&W restaurants in the Royalty Pool. Sales are subject to a number of factors that affect the restaurant industry generally and the quick service segment of this

industry in particular. These include: the highly competitive nature of the industry, traffic patterns, demographic considerations and the type, number and proximity of competing quick service restaurants. In addition, factors such as the availability of experienced management and hourly employees may also adversely affect the gross sales of the quick service restaurant industry in general, and the gross sales by A&W restaurants in particular.

Food Services competes with other companies, including other well-capitalized franchisors with extensive financial, technological, marketing and personnel resources and high brand name recognition and awareness. There can be no assurance that Food Services will be able to respond successfully to various competitive factors affecting the franchise operations of Food Services in the quick service restaurant industry.

Any significant event that adversely affects consumption of hamburgers, fries and soft drinks (such as cost, changing tastes or health concerns) could adversely impact the gross sales of A&W restaurants and, consequently, the amount of the royalty payable to the Company.

The growth of the royalty is dependent upon the ability of Food Services to (i) maintain and grow the current system of franchises, (ii) execute its current strategy for growth, (iii) locate new retail sites in prime locations and (iv) obtain qualified operators to become A&W franchisees. Food Services faces competition for retail locations and franchisees from its competitors and from franchisors of other businesses. Food Services' inability to successfully obtain qualified franchisees could adversely affect its business development.

Food Services and A&W franchisees may be the subject of complaints or litigation from guests alleging food-related illnesses, injuries suffered on the premises or other food quality, health or operational concerns. Adverse publicity resulting from such allegations may materially affect the sales of A&W restaurants, regardless of whether such allegations are true or whether Food Services or an A&W franchisee is ultimately held liable.

## EVENTS SUBSEQUENT TO YEAR-END

### a) Change in Royalty Pool

Effective January 5, 2003, the number of A&W restaurants for which royalties are paid to the Fund was increased to include the revenues from 27 new restaurants less eight permanently closed restaurants. The Company paid Food Services \$5,505,000, by issuance of 487,624 Class B shares, as initial consideration for the estimated royalty stream from the 19 net additional restaurants added to the Royalty Pool. A final adjustment to the Class B share consideration will be made in December 2003 based upon the 2003 annual gross sales reported by the new restaurants. Until the 2003 gross sales of the new restaurants are reported, 20% of the Class B shares will be held in escrow. The Class B shares have substantially the same terms as the Class A shares.

The issuance of the Class B shares comprise the first payment of the \$40,000,000 unpaid consideration on the acquisition of the A&W trade-marks and will be recorded as an additional cost of the A&W trade-marks.

**b) Declaration of distributions and dividends in respect of 2002**

On January 6, 2003, the Trustees declared a distribution payable to unitholders of record on January 15, 2003 of 9 cents per unit (\$750,600) and declared a dividend payable to Food Services of \$253,000, both payable on January 31, 2003.

**OUTLOOK**

The Canadian economy is generally forecast to perform at levels below that of 2002. There is considerable uncertainty associated with the war in Iraq as this is being written, and the impact of this conflict on the global and North American economies.

However, Food Services' strategic focus on baby boomers should continue to result in superior performance versus its industry and therefore, despite the economic uncertainties reflected in general equity market malaise, distributions to unitholders from the Fund are expected to be maintained in 2003 at 9 cents per unit, per month.

In terms of strategic initiatives, in mid-March Food Services introduced a new advertising campaign designed to strengthen its bond with boomer consumers. Food Services has also begun the roll out of new menu boards throughout its restaurants. These menu boards are designed to increase the average amount spent per customer transaction by 2%.

Continued focused marketing of Chubby Chicken will also occur in 2003, and Food Services will continue its re-imaging program with an aim of re-imaging 75 restaurants in 2003.