

## **PIZZA PIZZA ROYALTY INCOME FUND MANAGEMENT'S DISCUSSION AND ANALYSIS**

---

The following Management's Discussion and Analysis is a discussion of the results of operations and financial condition of the Pizza Pizza Royalty Income Fund (the "Fund") for the quarter ended June 30, 2007 and the year-to-date results from January 1, 2007 to June 30, 2007. The consolidated financial statements of the Fund are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The MD&A has been prepared as of August 1, 2007.

A copy of this report and additional information about the Fund is available at [www.sedar.com](http://www.sedar.com) or [www.pizzapizzaroyaltyincomefund.com](http://www.pizzapizzaroyaltyincomefund.com).

### **OVERVIEW AND BUSINESS OF THE FUND**

The Fund is a limited purpose, open-ended trust established under the laws of Ontario to indirectly, through the Pizza Pizza Royalty Limited Partnership (the "Partnership"), acquire the trademarks and trade names used by Pizza Pizza in its restaurants. The trademarks were licensed to Pizza Pizza Limited ("Pizza Pizza") in 2005 for 99 years, for which Pizza Pizza pays the Fund a royalty equal to 6% of the system sales of its Pizza Pizza restaurants in the Royalty Pool. There are 531 restaurants in the Royalty Pool for the year 2007.

A key attribute of the Fund is that it is based on top-line, system sales of the Royalty Pool restaurants and not on the profitability of either Pizza Pizza or the restaurants in the Royalty Pool. The success of the Fund depends primarily on the ability of Pizza Pizza to maintain and increase system sales of the Royalty Pool and to meet its royalty obligations.

Increases in system sales are derived from both the development of new Pizza Pizza restaurants and same store sales growth ("SSSG"). The key metric for yield growth of the Fund is SSSG which is dependent on maintaining operational excellence within each Pizza Pizza restaurant, general market conditions, pricing, and marketing programs undertaken by Pizza Pizza. One of Pizza Pizza's competitive strengths in increasing SSSG is that over 95% of its restaurants are new or renovated and have been expanded to accommodate customer seating. The seating in the larger restaurants, as compared to the prior smaller store model, offers Franchisees the ability to concentrate on increasing "walk-in" sales, thereby potentially increasing same store sales.

From inception, the Fund adopted the guideline of Canadian Institute of Chartered Accountants referred to as "AcG-15", Consolidation of Variable Interest Entities. As a result, the Fund's subsidiary, the Partnership which owns the PPL Rights, is accounted for on the equity basis. Pizza Pizza, the operating company that pays the 6% royalty to the Partnership, consolidates the Partnership based on this same guideline.

Annually, on January 1 (the "Adjustment Date"), an adjustment is made to the Royalty Pool to include the forecasted system sales from new Pizza Pizza restaurants opened on or before December 31 of the prior year, less system sales from any Pizza Pizza restaurants that have been permanently closed during the year. The change in the amount of the Royalty due to the Partnership as a result of changes in the system sales of the Royalty Pool will affect Pizza Pizza's retained interest through an adjustment to the rate at which the Class B Partnership units may ultimately be exchanged for units of the Fund. On the Adjustment Date, the adjustment to the Class B Exchange Multiplier (as defined in the License and Royalty Agreement) involves first calculating the "Determined Amount", which is defined as 92.5% of the royalty revenue added to the Royalty Pool, divided by the prevailing yield of the Fund units. The Determined Amount is multiplied by 80%, then divided by the current market price of the units, and then further divided by the number of Class B Partnership units outstanding. This fraction is added to the Class B Exchange Multiplier from the preceding year, which was "one" on the closing of the initial public offering. On the following Adjustment Date, a second adjustment to the Class B Exchange Multiplier will be made in the same manner once the system sales for new restaurants are known with certainty. The adjustment for new restaurants rolled into the Royalty Pool is designed to be accretive for current unitholders.

If, during a year, a restaurant is closed, the sales of the restaurant from the closing date would no longer be included in the calculation of the royalty payable to the Partnership by Pizza Pizza. To compensate for this, in certain circumstances, the License and Royalty Agreement and the Limited Partnership Agreement provide that an amount (the Make-Whole Payment) reflecting the reduction in the royalty resulting from the restaurant

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

closure will be paid by Pizza Pizza to the Partnership for the balance of the year in which the restaurant was closed, commencing from the closing date. The Make-Whole Payment will be the sales of the closed restaurant for the first 52-week period in which it was included in the Royalty Pool multiplied by the royalty rate, payable as to one-twelfth per month.

Pizza Pizza's agreement to maintain at least a 20% interest in the Fund expired on June 30, 2007. As at June 30, 2007, Pizza Pizza owned an effective 23% interest in the Fund. Pizza Pizza's interest was decreased to approximately 20% on July 24, 2007 as a result of the transaction described in "Subsequent Events". Effective July 1, 2007, the distributions on Pizza Pizza's minimum 20% are no longer subordinated under the subordination agreement.

As of June 30, 2007 Pizza Pizza's 23% interest in the earnings of the Partnership arises from its ownership of Class B and Class C Partnership units. Subject to the Subordination Agreement, each Class B Unit can be exchanged indirectly for that number of units equal to the Class B Exchange Multiplier (as defined in the License and Royalty Agreement) applicable at the date of the exchange. Class C Units can be exchanged by requiring the Fund to purchase those Class C Units in consideration of the assumption by the Fund of an amount of the indebtedness under the PPL Loan equal to \$10.00 per Class C Unit transferred.

### **FINANCIAL HIGHLIGHTS**

The following tables set out selected financial information and other data of the Fund and should be read in conjunction with the attached unaudited consolidated financial statements of the Fund. Readers should note that the 2007 results are not directly comparable to the 2006 results due to the fact that there are 531 restaurants in the Royalty Pool for 2007 compared to 501 restaurants in the Royalty Pool for the 2006.

Equity earned by the Fund through its interest in the Partnership and interest income from the Pizza Pizza Limited Loan have been derived as shown in the table below:

**PIZZA PIZZA ROYALTY INCOME FUND**  
**Management's Discussion & Analysis**

**Pizza Pizza Royalty Limited Partnership**  
**Analysis of Distributable Cash**

	3 months ended		6 months ended	
	June 30, 2007 (unaudited)	June 30, 2006 (unaudited)	June 30, 2007 (unaudited)	June 30, 2006 (unaudited)
(in thousands of dollars, except number of restaurants, days in the period, and per unit amounts)				
Restaurants in Royalty Pool	531	501	531	501
Days in the Period	90	91	181	181
Same store sales growth	4.3%	4%	4.9%	5%
System sales reported by restaurants in the Royalty Pool	\$ 92,162	\$ 86,015	\$ 181,680	\$ 168,498
Royalty - 6% of system sales	\$ 5,530	\$ 5,161	\$ 10,901	\$ 10,110
Partnership expenses <sup>(1)</sup>	(498)	(455)	(836)	(894)
Earnings available for distribution to the Fund and Pizza Pizza	5,032	4,706	10,065	9,216
Pizza Pizza's interest <sup>(2)</sup>	(1,508)	(1,314)	(3,017)	(2,589)
Interest income <sup>(3)</sup>	3,524	3,392	7,048	6,627
Net earnings excluding the impact of the non-cash future income tax expense	\$ 450	\$ 450	\$ 900	\$ 900
Net earnings (loss) <sup>(4)</sup>	\$ 3,974	\$ 3,842	\$ 7,948	\$ 7,527
Basic earnings per Fund unit excluding the impact of non-cash future income tax expense	\$ 0.221	\$ 0.214	\$ 0.443	\$ 0.419
Basic earnings (loss) per Fund unit <sup>(4)</sup>	\$ (0.263)	\$ 0.214	\$ (0.043)	\$ 0.419
Diluted earnings (loss) per Fund unit <sup>(4)</sup>	\$ (0.157)	\$ 0.209	\$ 0.058	\$ 0.409
Distributions declared	\$ 3,931	\$ 3,744	\$ 7,862	\$ 7,461
Distributions per Fund unit	\$ 0.219	\$ 0.209	\$ 0.438	\$ 0.416
Payout ratio	99%	97%	99%	99%
	June 30, 2007		December 31, 2006	
Total assets	\$ 177,785		\$ 171,796	
Total liabilities	\$ 10,010		\$ 1,275	

(1) The Fund, indirectly through the Partnership, incurs administrative expenses and interest expense on the \$20 million outstanding bank loan. Interest expense on the bank loan for the current quarter was \$265 and \$527 for the six months ended (2006 - \$277 and \$551).

(2) Represents the interest of Pizza Pizza in the earnings of the Partnership from Class B and Class C Partnership units. The Class B units are exchangeable into Fund units based on value of the Class B Exchange Multiplier at the time of exchange as defined in the Licence and Royalty Agreement and represents 23% of the fully diluted units of the Fund at June 30, 2007.

(3) The Fund indirectly earns interest income on the \$30 million loan to Pizza Pizza, with interest income accruing at 6% per annum, payable monthly.

(4) Net loss for the quarter and six months ended June 30, 2007 reflect the non-cash future tax expense of \$8.7 million relating to the new tax legislation.

**PIZZA PIZZA ROYALTY INCOME FUND**  
**Management's Discussion & Analysis**

	Q2 2007 (unaudited)	Q1 2007 (unaudited)	Q4 2006 (unaudited)	Q3 2006 (unaudited)
(in thousands of dollars, except number of restaurants, days in the Period and per unit amounts)				
Restaurants in Royalty Pool	531	531	501	501
Days in the Period	91	90	92	92
Same store sales growth	4%	5.5%	5%	4%
System sales reported by restaurants in Royalty Pool	\$ 92,162	\$ 89,518	\$ 93,866	\$ 90,773
Royalty - 6% of system sales	\$ 5,530	\$ 5,371	\$ 5,632	\$ 5,446
Partnership expenses <sup>(1)</sup>	(498)	(338)	(426)	(390)
Earnings available for distribution to the Fund and Pizza Pizza	5,032	5,033	5,206	5,056
Pizza Pizza's interest <sup>(2)</sup>	(1,508)	(1,509)	(1,414)	(1,385)
	3,524	3,524	3,792	3,671
Interest income <sup>(4)</sup>	450	450	450	450
Net earnings excluding the impact of the non-cash future income tax expense	\$ 3,974	\$ 3,974	\$ 4,242	\$ 4,121
Net earnings (loss) <sup>(5)</sup>	\$ (4,726)	\$ 3,974	\$ 4,242	\$ 4,121
Basic earnings per Fund unit excluding the impact of non-cash future income tax expense	\$ 0.221	\$ 0.221	\$ 0.237	\$ 0.230
Basic earnings (loss) per Fund unit	\$ (0.263)	\$ 0.221	\$ 0.237	\$ 0.230
Diluted earnings (loss) per Fund unit	\$ (0.157)	\$ 0.215	\$ 0.231	\$ 0.225
Distributions declared	\$ 3,931	\$ 3,931	\$ 3,822	\$ 3,824
Distributions per Fund unit	\$ 0.219	\$ 0.219	\$ 0.213	\$ 0.213
Payout ratio	99%	99%	90%	93%

	Q2 2006 (unaudited)	Q1 2006 (unaudited)	Q4 2005 (unaudited)	For the Period from July 6, to September 30, 2005 (unaudited)
(in thousands of dollars, except number of restaurants, days in the Period and per unit amounts)				
Restaurants in Royalty Pool	501	501	500	500
Days in the Period	91	90	92	87
Same store sales growth	4%	5%	6%	6%
System sales reported by restaurants in Royalty Pool	\$ 86,015	\$ 82,484	\$ 89,651	\$ 83,582
Royalty - 6% of system sales	\$ 5,161	\$ 4,949	\$ 5,379	\$ 5,015
Partnership expenses <sup>(1)</sup>	(455)	(439)	(418)	(391)
Earnings available for distribution to the Fund and Pizza Pizza	4,706	4,510	4,961	4,624
Pizza Pizza's interest <sup>(2)</sup>	(1,314)	(1,275)	(1,352)	(1,269)
	3,392	3,235	3,608	3,355
Interest income <sup>(4)</sup>	450	450	450	430
Net earnings excluding the impact of the non-cash future income tax expense <sup>(3)</sup>	\$ 3,842	\$ 3,685	\$ 4,058	\$ 3,785
Net earnings (loss)	\$ 3,842	\$ 3,685	\$ 4,058	\$ 3,785
Basic earnings per Fund unit excluding the impact of non-cash future income tax expense <sup>(3)</sup>	\$ 0.214	\$ 0.205	\$ 0.226	\$ 0.211
Basic earnings (loss) per Fund unit	\$ 0.214	\$ 0.205	\$ 0.226	\$ 0.211
Diluted earnings (loss) per Fund unit	\$ 0.209	\$ 0.203	\$ 0.209	\$ 0.206

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

Distributions declared	\$	3,744	\$	3,717	\$	3,643	\$	3,398
Distributions per Fund unit	\$	0.209	\$	0.207	\$	0.203	\$	0.189
Payout ratio		97%		101%		90%		89%

- (1) The Fund, indirectly through the Partnership, incurs administrative expenses and interest expense on the \$20 million outstanding bank loan. Interest expense on the bank loan for the current quarter was \$265 and \$527 for the six months ended (2006 - \$277 and \$551).
- (2) Represents the interest of Pizza Pizza in the earnings of the Partnership from Class B and Class C Partnership units. The Class B units are exchangeable into Fund units based on value of the Class B Exchange Multiplier at the time of exchange as defined in the Licence and Royalty Agreement.
- (3) For December 31, 2005, earnings shown exclude structuring costs of \$9.5 million related to indirectly receiving proceeds from the Fund's initial public offering. The structuring costs were paid from the initial public offering proceeds and were expensed during 2005 since they were determined to be a cost without a future benefit.
- (4) The Fund indirectly earns interest income on the \$30 million loan to Pizza Pizza, with interest income accruing at 6% per annum, payable monthly.
- (5) Net loss for the quarter and six months ended June 30, 2007 reflect the non-cash future tax expense of \$8.7 million relating to the new tax legislation.

## SUBSEQUENT EVENTS

### *Acquisitions*

Effective July 20, 2007, the Partnership acquired the trademarks and other intellectual property of Pizza 73, Inc. and its affiliated companies (together "Pizza 73") for \$54.04 million.

Effective July 24, 2007, Pizza Pizza acquired the shares of Pizza 73 for \$16.21 million. Immediately after the acquisition, Pizza Pizza and Pizza 73, Inc amalgamated.

Pizza Pizza has licensed the trademarks and other intellectual property associated with Pizza 73 from the Partnership for a 9% royalty payment on system sales of the 41 Pizza 73 restaurants included in the Royalty Pool.

### *Issuance of Units*

Effective July 24, 2007, the Fund issued 2,600,000 units to the public at \$9.15 per unit for gross proceeds of \$23.79 million and 766,392 units at \$9.15 through a private placement with the ultimate shareholder of Pizza Pizza and the vendors of Pizza 73 for gross proceeds of approximately \$7 million.

The net proceeds from the Offering, after deducting fees, together with the private placement and the net borrowings under the Partnership's new credit facility, were used to fund the acquisition of the Pizza 73 Rights and Marks.

### *New Credit Facility*

On July 24, 2007, the Partnership amended the existing credit agreement to increase the committed, non-revolving facility from \$20 million to \$47 million and to extend the term by five years to 2012. The \$1 million revolving, operating facility continues. The facilities bear interest at Prime plus 0% to 0.25% or the Bankers Acceptance rate plus 1.0% to 1.75%, depending on the level of debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"). The Partnership continued its current interest rate swap and entered into two additional interest rate swaps to mitigate the risk associated with the credit facilities bearing interest at a floating rate. The interest rate on the existing \$20 million interest swap decreased to 4.8% from 5.3% until July 2012 and the incremental facility of \$27 million will be initially fixed at 5.05% plus a 1.25% spread or 6.3% and may change based on the level of debt to EBITDA. As part of the amended credit agreement, the Partnership has agreed to a financial covenant in which, on a four quarter rolling basis, Distributions may not exceed Distributable Cash Flow for such period *plus* the aggregate amount of Distributable Cash Flow for prior Distribution Periods not distributed.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

#### **RESTAURANTS ADDED TO THE ROYALTY POOL**

In January 2007, adjustments to royalty payments and Pizza Pizza's Class B Exchange Multiplier were made based on the actual performance of the net, one restaurant added to the Royalty Pool on January 1, 2006. As a result of the adjustments, the new Class B Exchange Multiplier is 1.02345 and Pizza Pizza's exchangeable units increase by 30,113 to 4,593,233 Fund units, effective January 1, 2006, which equates to 20.37% of the fully diluted units of the Fund.

On January 1, 2007, 30 net, new restaurants were added to the Royalty Pool as a result of 35 new restaurants opening from September 2, 2005 to December 31, 2006 and five closings during 2006. The additional system sales from the 30 net, new restaurants are estimated at \$15.4 million annually. The total number of restaurants in the Royalty Pool has increased to 531. The yield of the Fund units was determined to be 10.56% calculated using \$7.94 as a weighted average unit price. Weighted average unit price is calculated based on the market price of the units traded on the TSX during the period of 20 consecutive days ending on the fifth trading day before January 1, 2007. As a result of the contribution of the additional net sales to the Royalty Pool, Pizza Pizza's Class B Exchange Multiplier increased fractionally by 80% of the total adjustment or 0.18174; the new Class B Multiplier is 1.20519. This adjustment will also increase the entitlement of the holders of the Class B Units to distributions of cash and allocations of income from the Partnership. The second adjustment to the Class B Exchange Multiplier will be adjusted to be effective January 1, 2007, once the actual performance of the new restaurants is determined in early 2008.

In lieu of converting the new entitlements into Fund units, Pizza Pizza has increased the Class B Exchange Multiplier. As a result, Pizza Pizza holds Class B Partnership units exchangeable into 5,408,915 Fund units which equates to 23% of the fully diluted units of the Fund as of January 1, 2007. The Fund reported an increase in its investment in the Partnership and a contributed surplus of \$5.4 million to reflect the increase in value as a result of the vend-in of the new royalty stream.

#### **ROYALTY POOL SALES**

System sales from the 531 restaurants in the Royalty Pool for the three months ended June 30, 2007 were \$92.2 million and for the six months ended June 30, 2007 Royal Pool system sales were \$181.7. For the prior year comparative quarter and six month periods, system sales for the 501 restaurants in the Royalty Pool were \$86 million and \$168.5 million, respectively.

Pizza Pizza's system sales for the quarter ended March 31 have generally been the softest quarter and the December 31 quarter system sales have been the strongest due to seasonality of the business.

**Same Store Sales Growth**, the key driver of yield growth for unitholders of the Fund, increased by 4.3% for the second quarter and 4.9% for the six months ended June 30, 2007 as compared with 4% and 5% for the comparable periods in 2006. Sales benefited from increased traffic at the restaurants coupled with an increase in the average check. System sales were also impacted by the addition of new restaurants added since January 1, 2006.

#### **OPERATING RESULTS**

The operations of the Fund and Partnership are separately analyzed in the following information to provide a better appreciation of the financial condition and results of the Fund and should be read in conjunction with the Fund's consolidated financial statements and accompanying notes.

##### **Partnership Operations**

The Partnership, which is 77% owned by the Fund at June 30, 2007, earns a 6% royalty income on the Royalty Pool system sales of the Pizza Pizza restaurants. The Fund earns equity income from its investment in the

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

Partnership. The Fund's equity income from the Partnership is calculated as the royalty income less the Partnership's operating expenses less earnings attributable to Pizza Pizza.

The following provides information on the Partnership performance for the quarter and six months ended June 30, 2007.

#### **Revenues**

Royalty Income earned by the Partnership was \$5.5 million for the quarter ended June 30, 2007 and \$10.9 million for the six months ended June 30, 2007. The 6% royalty is earned on the Royalty Pool of 531 Pizza Pizza restaurants reporting \$92.2 million in system sales for the quarter ended June 30, 2007 and \$181.7 for the six months ended June 30, 2007.

Royalty Income earned by the Partnership for the prior year comparative quarter and six month period in 2006 was \$5.2 million and \$10.1 million respectively. The 501 Pizza Pizza restaurants in the Royalty Pool reported system sales of \$86 million for the quarter and \$168.5 for the six months ended June 30, 2006.

The quarter over quarter increase is due to the additional 30 restaurants in the Royalty Pool and period-over-period same store sales growth.

#### **Expenses**

The Partnership's operating expenses include administrative expenses, amortization of deferred financing fees and interest paid on a \$20 million bank term loan. [See "Liquidity and Capital Resources-Term Loan".]

Operating expenses for the quarter were \$498,000, including \$265,000 of interest expense on its \$20 million credit facility, \$220,000 of administrative expenses, and \$13,000 in amortization of deferred financing fees. For the six month period, the operating expenses were \$836,000, including \$527,000 of interest, \$283,000 of administrative expenses, and \$26,000 in amortization.

Operating expenses for the prior year comparative quarter were \$455,000 including \$277,000 of interest expense on its \$20 million credit facility, \$165,000 of administrative expenses, and \$13,000 in amortization of deferred financing fees. For the comparative six month period, operating expenses were \$894,000 including \$551,000 of interest expense on its \$20 million credit facility, \$317,000 of administration expenses, and \$26,000 in amortization of deferred financing fees.

The decrease in year-to-date interest expense is the result of a decrease in the interest rate on the \$20 million bank term loan which took effect on April 1, 2006. The fixed interest rate on the loan was reduced to 5.3% from 5.55%; thus resulting in a \$24,000 decrease in the interest expense. Administration expenses increased by \$55,000 from the comparative quarter in 2006. As compared with the second quarter of 2006, trustee fees and travel expenses accounted for \$29,000 of the increase and annual general meeting expenditures were \$26,000. The administration expenses decreased on a year-to-date basis from the comparative period in 2006 due to less professional fees.

#### **Net earnings**

The Partnership had net earnings for the quarter of \$5 million and \$10.1 million for the six months ended June 30, 2007, which were allocated to the Fund and Pizza Pizza based on their respective interest in the Partnership, as compared to \$4.7 million and \$9.2 million earned in the comparable quarter and six month period, respectively.

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

#### Selected Partnership balance sheet items

	(in thousands of dollars)	
	<u>June 30, 2007</u>	<u>December 31, 2006</u>
Current Assets	\$ 2,561	\$ 2,909
Total Assets	240,700	234,333
Current Liabilities	\$ 1,352	\$ 1,443
Loan Payable	20,000	20,000
Total Liabilities & Equity	240,700	234,333

#### Fund Operations

Equity income is earned by the Fund through limited partnership holdings of LP units representing its effective 77% interest in the Partnership. Interest income is earned on a \$30 million loan to Pizza Pizza Limited (the "PPL Loan") and is calculated at 6% per annum, payable monthly.

#### Equity income in the Partnership

Equity income earned for the quarter and six month period ended June 30, 2007 by the Fund from its 77% share of the Partnership was \$3.5 million and \$7 million respectively. The equity income earned for the comparative quarter and six month period by the Fund from its investment in the Partnership were \$3.4 million and \$6.6 million respectively based on its 79.7% share of the Partnership at that time. The increase in equity income is the result of greater royalty revenue earned by the Partnership from the Royalty Pool.

The decrease in ownership in the Partnership to 77% on January 1, 2007 from 79.7% in the prior year is a result of Pizza Pizza vending in restaurants on January 1, 2007 and thereby increasing its Partnership interest to 23% from 20.3% in the prior year. (See "Restaurants Added to the Royalty Pool").

#### Interest Income

The interest income for the quarter ended June 30, 2007 and June 30, 2006 was \$450,000 and for the six months ended June 30, 2007 and June 30, 2006 was \$900,000, earned on the \$30 million loan from the Fund to Pizza Pizza, with interest paid monthly at 6% per annum.

#### Net earnings before income taxes

Net earnings before income taxes for the quarter ended June 30, 2007 were \$4.0 million or \$0.221 per unit, as compared to \$3.8 million or \$0.214 per unit for the comparable quarter in 2006 which equates to a 2.8% increase. Net earnings for the six month period ended June 30, 2007 were \$7.9 or \$0.44 per unit, as compared to \$7.5 million of \$0.419 per unit, a 5% increase.

#### Future tax expense

On October 31, 2006, the Department of Finance (Canada) announced proposed tax legislation which included a provision to eliminate the deduction of distributions from taxable income for certain forms of publicly traded income trusts and partnerships. The proposed legislation became substantively enacted law on June 12, 2007 and changes the rules applicable to publicly traded income trusts in 2011. As the new trust tax legislation has been substantively enacted, the Fund is required to give accounting recognition to these new rules. As a result, on June 12, 2007, the Fund recognized a non-cash future

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

income tax expense and corresponding liability amounting to \$8.7 million. This liability represents the Fund's proportionate share of the temporary difference between the accounting and tax basis, at the 31.5% tax rate applicable to the Fund, on the Rights and Marks in the Partnership. The Fund will not be liable for current taxes until January 1, 2011.

#### Net earnings (loss)

Net loss for the quarter ended June 30, 2007 was \$4.7 million or \$0.26 per unit, as compared to net earnings of \$3.8 million or \$0.214 per unit for the comparable quarter in 2006. Net loss for the six month period ended June 30, 2007 was \$0.8 million or \$0.04 per unit, as compared to net earnings of \$7.5 million of \$0.419 per unit for the comparable period in 2006. The net loss for the current quarter and six month period ended June 30, 2007 is solely the result of the non-cash, future tax expense recognized in the second quarter of 2007.

#### Distributions

The Fund declared distributions of \$3.9 million or \$0.219 per unit for the quarter ended June 30, 2007, equating to a 99% payout ratio; for the 2006 comparable quarter the fund declared distributions of \$3.7 million or \$0.209 per unit for a payout ratio of 97%. For the six-months ended June 30, 2007, distributions of \$7.9 million, or \$0.438 per unit were declared, compared with \$7.5 million, or \$0.416 per unit.

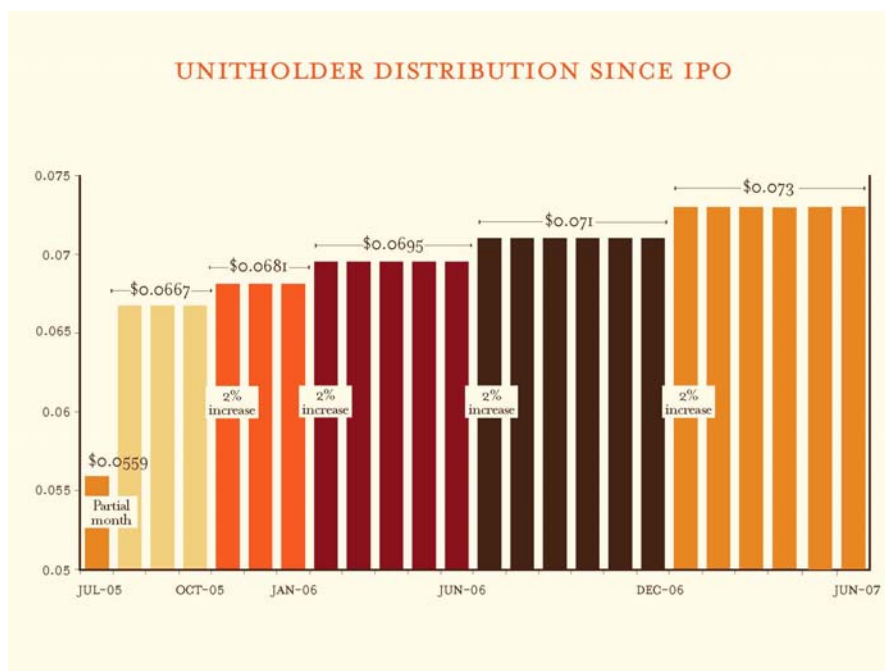
As of June 30, 2007, working capital of the Partnership was \$1.2 million, accumulated as a reserve to cover seasonality and any unusual administrative expenditures.

Distributions declared for 2007 are as follows:

<u>Period</u>	<u>Payment Date</u>	<u>Amount/unit</u>
January 1-31, 2007	February 15, 2007	7.3¢
February 1-28, 2007	March 15, 2007	7.3¢
March 1-31, 2007	April 13, 2007	7.3¢
April 1-30, 2007	May 15, 2007	7.3¢
May 1-31, 2007	June 15, 2007	7.3¢
June 1-30, 2007	July 13, 2007	7.3¢
Total		43.8¢

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

**PIZZA PIZZA ROYALTY INCOME FUND**  
**Management's Discussion & Analysis**



**LIQUIDITY & CAPITAL RESOURCES**

The Fund's distribution policy is to distribute all available cash in order to maximize returns to Unitholders, after allowing for reasonable reserves held at the Partnership level. In light of seasonal variations that are inherent to the restaurant industry, the Fund's policy is to make equal distribution payments to Unitholders on a monthly basis in order to smooth out these fluctuations. Any further increase in distributions will be implemented in such a manner so that the continuity of uniform monthly distributions is maintained. It is expected that future distributions will continue to be funded entirely by cash flow from operations.

As of June 30, 2007, working capital of the Partnership was \$1.2 million (December 31, 2006 - \$1.5 million), accumulated as a reserve to cover seasonality and any unusual administrative expenditures.

**Term Loan and Operating Loan**

The Partnership has a \$20 million non-revolving, three-year term loan facility, which was arranged during the initial public offering to partially finance the purchase of the PPL Rights from Pizza Pizza. As security for repayment of the facility, Pizza Pizza Limited granted to the Partnership a continuing, general security interest, subject to certain exceptions, in all present and acquired property of Pizza Pizza which may not be assigned without the prior consent of Pizza Pizza. The facility bears interest at Prime plus 0.50% to 0.75% or the Bankers Acceptance rate plus 1.75% to 2.00%, depending on the level of funded debt to EBITDA, defined as annualized earnings before interest, taxes, depreciation and amortization. During 2005, the interest rate on the facility was fixed with an interest rate swap through January 6, 2010 at 3.55% plus 1.75% to 2% credit spread dependent upon the Fund's annualized EBITDA (calculated as set forth in the credit facility documentation). In the initial four quarters of operations, the interest rate swap was fixed at 3.55% plus 2%. During that year, the Fund achieved an annualized EBITDA in excess of \$20 million resulting in the credit spread being reduced to 1.75% and became effective April 1, 2006, reducing the effective fixed interest rate on the loan to 5.3%. Subsequent to the quarter ending June 30, 2007, the credit spread on the credit facility was reduced to 1.25% from 1.75% and the fixed interest rate on the \$20 million facility, accordingly, was reduced to 4.8%.

The Bank has also granted an extendable 364 day, committed, revolving operating facility for up to \$1 million; no funds have been drawn on this facility.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

#### **CONTROLS AND PROCEDURES**

Internal controls and procedures are designed to provide reasonable assurance that relevant information is gathered and reported to senior management, including the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") of Pizza Pizza GP Inc., managing general partner of the Partnership and administrator of the Fund, on a timely basis so that the appropriate decisions can be made regarding public disclosure.

There have been no changes in internal control over financial reporting during the quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Fund's internal control over financial reporting.

As of December 31, 2006, an evaluation of the design of the Fund's internal controls and procedures, as defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* issued by the Canadian Securities Administrators, was carried out under the supervision of and with the participation of management, including the CEO and the CFO. Based on the evaluation, the CEO and the CFO concluded that the design of these controls and procedures are effective.

#### **CRITICAL ACCOUNTING ISSUES**

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 PPL Rights, the valuation of the Fund's investment is based primarily upon the valuation of intangible assets in the Partnership. The PPL Rights are not amortized as they have an indefinite life. The Pizza Pizza GP, Inc., 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. Pizza Pizza GP, Inc. 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 June 30, 2007.

#### **CHANGES IN ACCOUNTING POLICIES, INCLUDING INITIAL ADOPTION**

##### *Financial Instruments, Hedges and Comprehensive Income*

Commencing January 1, 2007, the Fund has adopted three new Canadian Institute of Chartered Accountants ("CICA") accounting standards: (i) *Financial Instruments – Recognition and Measurements*, (ii) *Hedges* and (iii) *Comprehensive Income*, as they affect the accounting of the Partnership.

As allowed under the transitional provisions for the implementation of new accounting standards, prior periods have not been restated. As a result, the Fund has recorded its share of the Partnership's increase of \$298 to opening fiscal 2007 Accumulated Other Comprehensive Income and Investment in Pizza Pizza Royalty Limited Partnership, for the cumulative prior period effect arising on adoption of the new accounting standards. This transition impact arose from recognizing in other comprehensive income, the value of the deferred gains and losses on transition date relating to the interest rate swap, designated as a cash flow hedge by the Partnership.

##### i) Financial Instruments

The new standards require all financial assets and financial liabilities to be carried at fair value in the Consolidated Balance Sheet, except the following which are carried at amortized cost unless designated as held for trading upon initial recognition: loans and receivables, securities designated as held-to-maturity and non-trading financial liabilities. The method used by the Fund is unchanged as a result of implementing these new accounting standards.

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

The Fund has decided to elect its accounts receivable from Pizza Pizza Limited, receivable from Pizza Pizza Royalty Limited Partnership and loan receivable from Pizza Pizza Limited as a loan and receivable.

The Fund has decided to elect its distributions payable to Fund unitholders as a financial liability not held for trading.

#### ii) Hedges

The criteria specifying when a derivative instrument may be accounted for as a hedge has not changed substantially. There are three main types of hedges: (i) fair value hedges, (ii) cash flow hedges and (iii) net investment hedges.

The Partnership's interest rate swap qualifies as a cash flow hedge and thus is being accounted for under this Handbook Section; thus the Fund has reflected the change in the investment in Partnership for the equity share of comprehensive earnings.

#### iii) Comprehensive Income

A new Statement of Comprehensive Income now forms part of the Fund's consolidated financial statements and displays current period net income and other comprehensive income.

Accumulated other comprehensive income (loss) is a separate component of shareholders' equity. The Consolidated Statement of Accumulated Other Comprehensive Income reflects changes in accumulated other comprehensive income, comprised of changes in unrealized gains and losses on available-for-sale assets as well as changes in the fair value of derivatives designated as cash flow hedges, to the extent they are effective.

The above result in various adjustments to the opening financial statements as follows:

	Increase
Investment in Pizza Pizza Royalty Limited Partnership	\$ 298,000
Accumulated other comprehensive income – beginning	298,000

#### *Accounting Changes*

Effective January 1, 2007, the Fund has adopted the new recommendations of the CICA Handbook Section 1506, Accounting Changes. Under these new recommendations, voluntary changes in accounting policy are permitted only when they result in the financial statements providing reliable and more relevant information, requires changes in accounting policy to be applied retrospectively unless doing so is impracticable, requires prior period errors to be corrected retrospectively and requires enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements. These recommendations also require the disclosure of new primary sources of generally accepted accounting principles that have been issued but not yet effective.

The impact that the adoption of this section will have on the Fund's financial statements will depend on the nature of future accounting changes and the required additional disclosure on Recent Accounting Pronouncements is disclosed in note 11.

#### *Cash Flow Statements*

Effective January 1, 2007, the Fund has adopted the new recommendations of the CICA Handbook Section 1540, Cash Flow Statements, which has been amended to include disclosure of the extent to which cash

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

distributions are non-discretionary. These requirements apply to all cash distributions on financial instruments classified as equity that are determined in accordance with a contractual agreement or relevant constating document. The Fund does not expect the adoption of this standard to have a material impact on disclosure in its financial statements.

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

Recent accounting pronouncements issued and not yet effective:

##### *Capital Disclosures*

CICA Handbook Section 1535, Capital Disclosures, requires disclosure of an entity's objectives, policies and processes for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund has not yet determined the impact that the adoption of this change on the disclosure in its financial statements.

##### *Financial Instruments Disclosures*

CICA Handbook Section 3862, Financial Instruments – Disclosures, increases the disclosures currently required that will enable users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about liquidity risk and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund has not yet determined the impact that the adoption of this change on the disclosure in its financial statements.

##### *Financial Instruments Presentation*

CICA Handbook Section 3863, Financial Instruments – Presentation, replaces the existing requirements on presentation of financial instruments which have been carried forward unchanged to this new section. This standard is effective for the Fund for interim and annual financial statements beginning on January 1, 2008. The Fund does not expect the adoption of this standard to have a material impact on presentation in its financial statements.

##### *General Standards on Financial Statement Presentation*

CICA Handbook Section 1400, General Standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The changes are effective for the Fund for interim and annual financial statements beginning January 1, 2008. The Fund does not expect the adoption of these changes to have an impact on its financial statements.

##### *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 Fund's financial statements is not yet determinable.

#### **OUTLOOK**

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

Pizza Pizza management has advised the Trustees that in 2007 it expects to organically grow the number of Pizza Pizza restaurants by 3% this year, and to continue researching strategic expansion opportunities. Additionally, Pizza Pizza expects to continue franchising its remaining Company-owned restaurants.

Same Store Sales Growth, the key driver of yield growth for Unitholders, was 4.3% for the quarter ended June 30, 2007 and for the six months ended June 30, 2007 was 4.9% compared with the same period in 2006. With the continued increase in same store sales, the Fund increased its January 2007 distribution by 2.8%, from \$0.071 to \$0.073 per unit.

With over 95% of traditional restaurants now expanded or relocated, Pizza Pizza offers expanded seating capacity, thereby targeting additional day-parts and allowing for additional product offerings to enable restaurants to continue increasing same store sales.

Subsequent to June 30, 2007, Pizza Pizza announced the strategic acquisition of Pizza 73, Inc. which is based in Alberta. (See "Subsequent Events") Pizza 73, comprising of 48 stores, has experienced strong same store sales growth in the past four years and will offer Pizza Pizza exposure to the strong, Alberta economy.

### **RISKS & 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 Pizza Pizza, 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 Pizza Pizza. The amount of royalty received from Pizza Pizza is dependent on various external factors that may affect the limited service sector of the restaurant industry. The restaurant industry, generally, is intensely competitive with respect to price, service, location and food quality. Competitors include national and regional chains, as well as independently owned restaurants. If Pizza Pizza and Pizza Pizza franchisees are unable to successfully compete in the limited service sector, System Sales may be adversely affected, the amount of royalty reduced and the ability of Pizza Pizza to pay the royalty or interest on the PPL Loan may be impaired. Changes in demographic trends, traffic patterns, and the type, number, and location of competing restaurants also affect the restaurant industry. In addition, factors such as government regulations, smoking bylaws, inflation, publicity from any food borne illnesses, increased food, labour and benefits costs, and the availability of experienced management and hourly employees may adversely affect the restaurant industry in general and therefore, potentially, Pizza Pizza System Sales. Pizza Pizza's success also depends on numerous factors affecting discretionary 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 sales and operating income, which could adversely affect revenue, the royalty and the ability of Pizza Pizza to pay the royalty to the Fund or interest on the PPL Loan.

#### **Substantively Enacted Tax Changes**

On October 31, 2006, the Minister of Finance (Canada) announced proposals to significantly change the income tax treatment of most publicly traded trusts and partnerships (other than certain real estate investment trusts) and the distributions and allocations, as the case may be, from these entities to their investors. The proposals were released in draft legislative form on December 21, 2006 and were substantively enacted in June 2007.

Under the legislation, certain income earned by these entities will be taxed in a manner similar to income earned by a corporation and distributions or allocations of such income made by these entities to investors will be taxed in a manner similar to dividends from taxable Canadian corporations. The deemed dividend will be

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

eligible for the new enhanced dividend tax credit if paid or allocated to a resident of Canada. The legislation will be effective commencing in the 2011 taxation year for trusts and partnerships that were publicly traded prior to November 1, 2006, such as the Fund. However, the deferral until 2011 may be rescinded where the affected entity does not comply with the Department of Finance's "normal growth" guidelines.

For illustrative purposes, the consequence for an individual Unitholder, holding units outside a tax-deferred plan who received a \$1 distribution would be as follows, assuming that 25% of the distribution was a non-taxable return of capital:

	2006	2011
	Tax Measures	Tax Measures
Distributable amount before tax	\$1.00	\$1.00
Tax paid by the Fund <sup>(1)</sup>	\$0.00	\$0.24
Distribution after the Fund's tax	\$1.00	\$0.76
Tax paid by the unitholder	\$0.35 <sup>(2)</sup>	\$0.11 <sup>(3)</sup>
Net amount	\$0.65	\$0.65

Notes:

- (1) 31.5% on the taxable portion (75% of the \$1.00 distribution)
- (2) Assuming a 46.41% combined tax rate currently in effect in Ontario on 75% of the distribution treated as income
- (3) Assuming a 22.38% tax rate on the deemed dividend income, and assuming that Ontario adopts the reduction in the tax rate on dividends proposed by the Federal government

The foregoing presentation is based on the Fund's understanding of the legislation substantively enacted. The tax consequences of the legislation to a Unitholder that is tax-exempt, holds units in a tax-deferred plan or is a non-resident of Canada would differ from the presentation set forth above. Unitholders are encouraged to consult their own tax advisors concerning the application of the legislation to their investment in units, with reference to their particular circumstances.

The Fund is currently considering the legislation and guidelines and the possible impact they will have on the Fund and its investors. This legislation is not expected to have an immediate impact on the Fund's distribution policy or the tax treatment of distributions to investors.

### Litigation

In the second quarter of 2007, Pizza Pizza Royalty Income Fund received an update from Pizza Pizza regarding a potential claim disclosed in the Fund's 2005 initial public offering prospectus and Pizza Pizza's subsequent financial statement filings.

The claim, which does not name the Fund or its subsidiaries, was formally served on Pizza Pizza and certain of its associates by Lawrence Austin, a former consultant to Pizza Pizza. In the claim, Mr. Austin asserts a right to \$45 million in damages and other amounts, including entitlements to a portion of the proceeds of the Fund's IPO that were directly or indirectly received by Pizza Pizza and its associates.

Pizza Pizza has advised the Fund that it believes the demand to be without merit and it will vigorously defend the claim. The parties are currently exchanging documents, with examinations to be scheduled. The Fund notes that Michael Overs, the Chairman and CEO of Pizza Pizza, has agreed in an indemnity agreement to indemnify Pizza Pizza and the Fund against any liabilities they may incur in this matter.

### Other

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

For a more detailed list of risks and uncertainties please refer to the Fund's Annual Information Form which is available at [www.sedar.com](http://www.sedar.com) and [www.pizzapizzaroyaltyincomefund.com](http://www.pizzapizzaroyaltyincomefund.com).

#### **FORWARD LOOKING STATEMENTS**

Certain statements in this report may constitute "forward-looking" statements which involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward looking statements. When used in this report, such statements include such words as "may", "will", "expect", "believe", "plan", and other similar terminology. These statements reflect management's current expectations regarding future events and operating performance and speak only as of the date of this report. These forward-looking statements involve a number of risks and uncertainties. The following are some factors that could cause actual results to differ materially from those expressed in or underlying such forward-looking statements: competition; changes in demographic trends; changing consumer preferences and discretionary spending patterns; changes in national and local business and economic conditions; legislation and governmental regulation; accounting policies and practices; and the results of operations and financial condition of Pizza Pizza. The foregoing list of factors is not exhaustive.

#### **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) or at the Fund's website [www.pizzapizzaroyaltyincomefund.com](http://www.pizzapizzaroyaltyincomefund.com).

**PIZZA PIZZA ROYALTY INCOME FUND**  
**Management's Discussion & Analysis**

**UNITHOLDER INFORMATION**

Corporate Head Office:  
Pizza Pizza Royalty Income Fund  
580 Jarvis Street  
Toronto, Ontario M4Y 2H9

Registrar and Transfer Agent:  
CIBC Mellon  
P.O. Box 7010  
Adelaide Street Postal Station  
Toronto, Ontario M5A 4K9

**Stock Exchange Listing:**  
**Toronto Stock Exchange: PZA.UN**

**Trustees of the Fund:**

Arnie Cader<sup>(1)</sup>  
Richard McCoy  
Terence Reid<sup>(1)</sup>  
Ron Rogers<sup>(1)</sup>  
Elizabeth Wright  
(1) Denotes Audit Committee member

Investor Enquiries:  
Curt Feltner  
Chief Financial Officer  
Telephone: (416) 967-1010  
Facsimile: (416) 967-5941  
Email: [cfeltner@pizzapizza.ca](mailto:cfeltner@pizzapizza.ca)  
Website: [www.pizzapizzaroyaltyincomefund.com](http://www.pizzapizzaroyaltyincomefund.com)

**Directors and Officers of the Pizza Pizza GP, Inc.**, the General Partner of  
the Pizza Pizza Royalty Limited Partnership:

Arnold Cader  
Curt Feltner<sup>(1)</sup>  
Richard McCoy  
Michael Overs<sup>(1)</sup>  
Terence Reid  
Ronald Rogers  
Daniel Vukovich<sup>(1)</sup>  
Elizabeth Wright  
(1) Denotes members of Pizza Pizza Limited management team.