

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

**FINANCIAL HIGHLIGHTS**

The following tables set out selected financial information and other data of the Pizza Pizza Royalty Income Fund (the "Fund") and should be read in conjunction with the audited 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 572 restaurants in the Royalty Pool for 2007 compared to 501 restaurants in the Royalty Pool for 2006, and the inclusion of the Pizza 73 in 2007.

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

	January 1, 2007 to December 31, 2007	January 1, 2006 to December 31, 2006	Period from July 6, 2005 to December 31, 2005 <sup>(9)</sup>
(in thousands of dollars, except number of restaurants and per unit amounts)			
Restaurants in Royalty Pool <sup>(1)</sup>	572	501	500
Same store sales growth	4.6%	4.5%	6%
System sales reported by Pizza Pizza restaurants in the Royalty Pool	\$ 376,375	\$ 353,138	\$ 173,233
System sales reported by Pizza 73 restaurants in the Royalty Pool	33,124	-	-
	\$ 409,499	\$ 353,138	\$ 173,233
Royalty – 6% on Pizza Pizza system sales	\$ 22,583	\$ 21,188	\$ 10,394
Royalty – 9% on Pizza 73 system sales	2,981	-	-
Total Royalty on System Sales	25,564	21,188	10,394
Partnership expenses <sup>(2)</sup>	(2,545)	(1,710)	(781)
Earnings available for distribution to the Fund and Pizza Pizza <sup>(3)</sup>	23,019	19,478	9,613
Pizza Pizza's interest <sup>(4)</sup>	(6,200)	(5,388)	(2,627)
Equity income before issuance costs <sup>(3)(8)</sup>	16,819	14,090	6,985
Interest income <sup>(5)</sup>	1,849	1,800	880
Net earnings excluding the impact of non-cash future income tax expense & issuance costs <sup>(6)(7)</sup>	\$ 18,668	\$ 15,890	\$ 7,865
Provision for future income taxes	8,208	-	-
Net earnings (loss) <sup>(6)</sup>	\$ 10,291	\$ 15,890	\$ (1,614)
Basic earnings per Fund unit excluding the impact of non-cash future income tax expense and issuance costs <sup>(7)</sup>	\$ 0.954	\$ 0.885	\$ 0.438
Basic earnings (loss) per Fund unit <sup>(6)</sup>	\$ 0.526	\$ 0.885	\$ (0.091)
Diluted earnings (loss) per Fund unit <sup>(6)</sup>	\$ 0.526	\$ 0.865	\$ (0.100)
Distributions declared	\$ 17,608	\$ 15,108	\$ 7,041
Distributions per Fund unit	\$ 0.888	\$ 0.842	\$ 0.392
Payout ratio	94%	95%	89%
	December 31, 2007	December 31, 2006	December 31, 2005
Total assets	\$ 212,643	\$ 171,796	\$ 170,363
Total liabilities	\$ 9,866	\$ 1,275	\$ 1,223

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

- (1) The Pizza 73 Rights were acquired on July 24, 2007 and resulted in the addition of 41 restaurants to the Royalty Pool.
- (2) The Fund, indirectly through the Partnership, incurs administrative expenses and interest expense on the \$47,000 outstanding bank loan (2006 - \$20,000, 2005 - \$20,000). Interest expense on the bank loan for the current year was \$1,800 (2006 - \$1,100, 2005 - \$544).
- (3) For December 31, 2007, earnings shown exclude issuance costs of \$207 paid from the proceeds raised to acquire the Pizza 73 trademarks and rights.
- (4) Represents the interest of Pizza Pizza in the earnings of the Partnership from Class B, Class C and Class D 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 Pizza Pizza Licence and Royalty Agreement and represents 18.4% of the fully diluted units of the Fund at December 31, 2007 (2006 - 20.3%). The Class D Units are exchangeable into Fund units based on the value of the Class D Exchange Multiplier at the time of exchange as defined in the Pizza 73 Licence and Royalty Agreement (which was nil at December 31, 2007).
- (5) The Fund indirectly earns interest income on the \$30,000 loan to Pizza Pizza, with interest income accruing at 6% per annum, payable monthly.
- (6) Net earnings (loss) for the year ended December 31, 2007 reflect the non-cash future tax expense of \$8,208, relating to the new tax legislation and the Fund's share of the Partnership's issuance costs, \$169. See "Operating Results - Future Tax Expense".
- (7) Net earnings excluding the impact of non-cash future income tax expense and issuance costs is not a recognized measure under Canadian GAAP. References to net earnings excluding the impact of non-cash future income tax expense and issuance costs are to earnings determined in accordance with GAAP applicable to the financial statements before amounts for taxes and the Fund's share of issuance costs of the Partnership as included in the earnings. Pizza Pizza believes that, in addition to net earnings, net earnings excluding the impact of non-cash future income tax expense and issuance costs is a useful supplemental measure in evaluating its performance as it provides investors with an indication of operating earnings. Investors are cautioned, however, that this should not be construed as an alternative net earnings as a measure of profitability. The method of calculating net earnings excluding the impact of non-cash future income tax expense and issuance costs for the purposes of this report may differ from that used by other issuers and, accordingly, it may not be comparable to that used by other issuers.
- (8) For December 31, 2005, earnings shown exclude issuance costs of \$9,500 related to indirectly receiving proceeds from the Fund's initial public offering. The issuance 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.
- (9) For December 31, 2005, the period is not directly comparable to 2006 and 2007, as it is for the 26 weeks of the Fund's initial, formation year.

	Q4 2007 (unaudited) <sup>(1)</sup>	Q3 2007 (unaudited) <sup>(1)</sup>	Q2 2007 (unaudited)	Q1 2007 (unaudited)
(in thousands of dollars, except number of restaurants, days in the Period and per unit amounts)				
Restaurants in Royalty Pool	572	572	531	531
Days in the Period	92	92	91	90
Same store sales growth	4.9%	5.1%	4.3%	5.5%
System sales reported by Pizza Pizza restaurants in Royalty Pool	\$ 99,654	\$ 95,041	\$ 92,162	\$ 89,518
System sales reported by Pizza 73 restaurants in Royalty Pool	19,230	13,894	-	-
	\$ 118,884	\$ 108,935	\$ 92,162	\$ 89,518
Royalty - 6% on Pizza Pizza system sales	\$ 5,979	\$ 5,703	\$ 5,530	\$ 5,371
Royalty - 9% on Pizza 73 system sales	1,731	1,250	-	-
Royalty on System Sales of Royalty Pool Partnership expenses <sup>(2)</sup>	\$ 7,710 (896)	\$ 6,953 (813)	\$ 5,530 (498)	\$ 5,371 (338)
Earnings available for distribution to the Fund and Pizza Pizza	6,814	6,140	5,032	5,033
Pizza Pizza's interest <sup>(3)</sup>	(1,619)	(1,564)	(1,508)	(1,509)
	5,195	4,576	3,524	3,524
Interest income <sup>(4)</sup>	450	499	450	450
Net earnings excluding the impact of non- cash future income tax expense and issuance costs <sup>(6)</sup>	\$ 5,645	\$ 5,075	\$ 3,974	\$ 3,974
Provision for (recovery of) future taxes	(4,690)	4,198	8,700	-
Net earnings (loss)	\$ 10,335	\$ 708 <sup>(5)</sup>	\$ (4,726)	\$ 3,974
Basic earnings per Fund unit excluding the impact of non-cash future income tax expense and issuance costs <sup>(6)</sup>	\$ 0.259	\$ 0.248	\$ 0.221	\$ 0.221
Basic earnings (loss) per Fund unit <sup>(5)</sup>	\$ 0.474	\$ 0.035	\$ (0.263)	\$ 0.221
Diluted earnings (loss) per Fund unit <sup>(5)</sup>	\$ 0.430	\$ 0.035	\$ (0.157)	\$ 0.215
Distributions declared	\$ 4,974	\$ 4,772	\$ 3,931	\$ 3,931
Distributions per Fund unit	\$ 0.228	\$ 0.222	\$ 0.219	\$ 0.219
Payout ratio	88%	94%	99%	99%

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

	Q4 2006 (unaudited)	Q3 2006 (unaudited)	Q2 2006 (unaudited)	Q1 2006 (unaudited)
(in thousands of dollars, except number of restaurants, days in the Period and per unit amounts)				
Restaurants in Royalty Pool	501	501	501	501
Days in the Period	92	92	91	90
Same store sales growth	5%	4%	4%	5%
System sales reported by restaurants in Royalty Pool	\$ 93,866	\$ 90,773	\$ 86,015	\$ 82,484
Royalty	\$ 5,632	\$ 5,446	\$ 5,161	\$ 4,949
Partnership expenses <sup>(2)</sup>	(426)	(390)	(455)	(439)
Earnings available for distribution to the Fund and Pizza Pizza	5,206	5,056	4,706	4,510
Pizza Pizza's interest <sup>(3)</sup>	(1,414)	(1,385)	(1,314)	(1,275)
	3,792	3,671	3,392	3,235
Interest income <sup>(4)</sup>	450	450	450	450
Net earnings	\$ 4,242	\$ 4,121	\$ 3,842	\$ 3,685
Basic earnings per Fund unit	\$ 0.237	\$ 0.229	\$ 0.214	\$ 0.205
Diluted earnings per Fund unit	\$ 0.231	\$ 0.225	\$ 0.209	\$ 0.203
Distributions declared	\$ 3,822	\$ 3,824	\$ 3,744	\$ 3,717
Distributions per Fund unit	\$ 0.213	\$ 0.213	\$ 0.209	\$ 0.207
Payout ratio	90%	93%	97%	101%

- (1) The Pizza 73 Rights were acquired on July 24, 2007 and resulted in the addition of 41 restaurants to the Royalty Pool.
- (2) The Fund, indirectly through the Partnership, incurs administrative expenses and interest expense on the \$47,000 outstanding bank loan (2006 - \$20,000). Interest expense on the bank loan for the current quarter was \$697 and \$1,800 for the year ended (2006 - \$267 and \$1,100). Expenses exclude the write-off of \$207 in issuance costs paid from the proceeds raised to acquire the Pizza 73 trademarks and rights on July 24, 2007.
- (3) 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 Pizza Pizza Licence and Royalty Agreement and represents 18.4% of the fully diluted units of the Fund at December 31, 2007.
- (4) The Fund indirectly earns interest income on the \$30,000 loan to Pizza Pizza, with interest income accruing at 6% per annum, payable monthly.
- (5) Net earnings (loss) for the quarter and year ended December 31, 2007 reflect the non-cash future tax expense (recovery) of \$(4,690) and \$8,208 respectively, relating to the new tax legislation, and for the quarter ended September 30, 2007 also reflect the Fund's share of the Partnership's issuance costs of \$169. See "Operating Results - Future Tax Expense".
- (6) Net earnings excluding the impact of non-cash future income tax expense and issuance costs is not a recognized measure under Canadian GAAP. References to net earnings excluding the impact of non-cash future income tax expense and issuance costs are to earnings determined in accordance with GAAP applicable to the financial statements before amounts for taxes and the Fund's share of issuance costs of the Partnership as included in the earnings. Pizza Pizza believes that, in addition to net earnings, net earnings excluding the impact of non-cash future income tax expense and issuance costs is a useful supplemental measure in evaluating its performance as it provides investors with an indication of operating earnings. Investors are cautioned, however, that this should not be construed as an alternative net earnings as a measure of profitability. The method of calculating net earnings excluding the impact of non-cash future income tax expense and issuance costs for the purposes of this report may differ from that used by other issuers and, accordingly, it may not be comparable to that used by other issuers.

**OVERVIEW AND BUSINESS OF THE FUND**

The following Management's Discussion and Analysis (the "MD&A") is a discussion of the results of operations and financial condition of the Fund for the year ended December 31, 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 March 4, 2008.

The Fund is a limited purpose, open-ended trust established under the laws of Ontario to indirectly, through the Partnership, acquire the trademarks and trade names used by Pizza Pizza Limited ("Pizza Pizza") in its Pizza Pizza and Pizza 73 restaurants. The Pizza Pizza trademarks and other intellectual property (the "Pizza Pizza Rights") were Licenced to 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 Pizza Pizza restaurants in the Royalty Pool for the year 2007. On July 24,

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

2007, the Partnership acquired the trademarks and other intellectual property of Pizza 73 (the "Pizza 73 Rights") from Pizza 73, Inc. and Licenced them to Pizza Pizza for 99 years, for which Pizza Pizza pays the Fund a royalty equal to 9% of the system sales of 41 Pizza 73 restaurants added to the Royalty Pool, increasing the Pool to 572 restaurants.

A key attribute of the Fund is that revenues are 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. Moreover, the Fund is not subject to the variability of earnings or expenses of the operating companies. The Fund's only expenses are administration expenses and the interest on debt. Thus, 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 and Pizza 73 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 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 98% of its Pizza Pizza restaurants are new or renovated and have been expanded to accommodate customer seating. The seating offers franchisees the ability to increase "walk-in" sales, thereby, potentially increasing same store sales. Restaurant closures also affect system sales. Pizza Pizza maintains a low closure rate throughout its chain; as of December 31, 2007, 15 traditional and 33 non-traditional restaurants have been permanently closed since 2000, whereas total restaurants increased from 413 to 559 during that same period.

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 Pizza Pizza and Pizza 73 Rights, is accounted for on the equity basis. Pizza Pizza, the operating company that pays royalties to the Partnership, consolidates the Partnership based on this same guideline.

### **ROYALTY POOL ADJUSTMENTS**

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 Pizza Pizza Licence 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 Pizza Pizza 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 Licence 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 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-

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

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.

Similarly, on the Adjustment Date, a separate adjustment is made to the Royalty Pool for the Pizza 73 restaurants. The Royalty Pool is increased to include the forecasted system sales from new Pizza 73 restaurants opened on or before September 1 of the prior year, less system sales from any Pizza 73 restaurants that have been permanently closed during the year. On the Adjustment Date, the adjustment to the Class D Exchange Multiplier is calculated in a similar manner as the Class B Exchange Multiplier described above. At the time of acquisition of the Pizza 73 Rights, the Class D Exchange Multiplier was zero.

Readers should note that the number of restaurants added to the Royalty Pool each year may differ from the number of restaurant openings and closings reported by Pizza Pizza on an annual basis, as the periods for which they are reported differ slightly.

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 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 was 1.20519. This adjustment also increased 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 has been made effective January 1, 2007, based on the actual performance of the new restaurants as determined in early 2008. See "Subsequent Event" for additional information surrounding the transaction.

As a result of the January 1, 2007 vend-in, Pizza Pizza's Class B Partnership units increased to 5,408,915 exchangeable Fund units which, at the time, equated to 23% of the fully diluted units of the Fund. 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.

On July 24, 2007, the number of Royalty Pool restaurants was further increased to 572, to include 41 Pizza 73 restaurants as a result of the Partnership acquiring the Pizza 73 trademarks and rights. (See "Significant Business Activity")

On January 1, 2008, the Royalty Pool was increased to include the royalties from 36 new Pizza Pizza restaurants and nine new Pizza 73 restaurants. The Royalty Pool will decrease by eight non-traditional Pizza Pizza restaurants which were closed during the year. Of the 36 new Pizza Pizza restaurants opened between January 1, 2007 and December 31, 2007, 12 are traditional restaurants and 24 are non-traditional locations. The nine Pizza 73 restaurants are comprised of eight traditional restaurants and one non-traditional location and opened on or before September 1, 2007. With the addition of the 37 net, new restaurants, royalties are now paid to the Fund on 609 restaurants in the Royalty Pool. See "Subsequent Event" for additional information surrounding the transaction.

### **OWNERSHIP OF THE FUND**

Pizza Pizza's interest in the Fund was diluted from, what was 23% as of January 1, 2007, to approximately 20% on July 24, 2007 as a result of the issuance of Fund units to partially underwrite the Pizza 73 acquisition. Additionally on September 27, 2007, Pizza Pizza sold 500,000 of its equivalent Fund units, through a private placement with an entity controlled by its ultimate shareholder, which further reduced its ownership in the Fund. As at December 31, 2007, Pizza Pizza owns an effective 18.4% interest in the Fund.

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

Pizza Pizza's 18.4% interest in the earnings of the Partnership arises from its ownership of Class B, Class C and Class D Partnership units. Each Class B and Class D unit can be exchanged indirectly for that number of units equal to the Class B Exchange Multiplier and Class D Exchange Multiplier, respectively, (as defined in the Licence and Royalty Agreements) 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.

**Ownership of the Fund on a fully diluted basis is as follows:**

	Issued & Outstanding units, and Exchangeable Equivalent units
Fund units outstanding on January 1, 2007	17,952,000
Issued on July 24, 2007	
Public offering	2,600,000
Private placement	766,392
Converted on September 27, 2007	
Pizza Pizza's conversion of 414,872 of its Class B Partnership units, equivalent to 500,000 Class B Partnership units when applied against the Class B Exchange Multiplier	500,000
Fund units outstanding on December 31, 2007	<u>21,818,392</u>
Class B exchangeable units held by Pizza Pizza is 18.4% of total Fully diluted units on December 31, 2007	<u>4,908,915</u>
	<u><u>26,727,307</u></u>

**SAME STORE SALES GROWTH**

Royalty income is equal to 6% of Pizza Pizza Royalty Pool sales and 9% of Pizza 73 Royalty Pool sales.

**Same Store Sales Growth**, the key driver of yield growth for unitholders of the Fund, increased by 4.9% (2006 - 5%) for the quarter and increased 4.6% (2006 - 4.5%) for the year-ended December 31, 2007 compared with the same period in 2006. For the quarter, SSSG for Pizza Pizza restaurants was 2.6% and 18.1% for Pizza 73 restaurants. For the year, SSSG for Pizza Pizza was 3.4% and 19.2% for Pizza 73. Sales benefited from an increase in average cheque while traffic counts increased in Western Canada and decreased slightly in Ontario.

Industry statistics released by the Ontario Ministry of Tourism reported U.S. border crossings to Ontario decreased by 13.5% in the first 11 months of 2007 over the same period in 2006, while visits to the U.S. by Ontario residents increased 7.2%. A decrease in Ontario tourism negatively impacted sales at a select number of our restaurants, particularly during the summer months at outdoor-themed, non-traditional locations.

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



**ROYALTY POOL SALES**

The restaurants in the Royalty Pool increased on July 24, 2007 to 572 from 501 in 2006, to include 30, net new restaurants vended in on January 1, 2007 and 41 Pizza 73 restaurants vended in on the purchase of the Pizza 73 Rights by the Partnership.

System sales from the 572 restaurants in the Royalty Pool for the three months and year-ended December 31, 2007 were \$118.9 million and \$409.5 million respectively. For the prior year comparative quarter and year, system sales for the 501 restaurants in the Royalty Pool were \$93.9 million and \$353.1 million, respectively. Sales from the 41 Pizza 73 restaurants added to the Pool on July 24, 2007 were \$19.2 million for the quarter and \$33.1 million since acquisition. The increase in Royalty Pool sales, as compared to the prior year is the result of adding 30, net new restaurants on January 1, 2007, 41 new Pizza 73 restaurants in July 2007 and the positive same store sales growth.

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

An independent audited statement of Royalty Pool system sales is performed and reported each year, the results of which follow:

**System sales reported by Pizza Pizza Royalty Pool Restaurants**  
**From January 1, 2007 to December 31 ,2007**

(in thousands of dollars)

Total Pizza Pizza retail sales	\$	380,325
New locations <sup>(1)</sup>		(4,463)
Closed locations		513
2007 Pizza Pizza Royalty Pool System Sales	<u>\$</u>	<u>376,375</u>

**System sales reported by Pizza 73 Royalty Pool Restaurants**  
**From July 24, 2007 to December 31 ,2007**

(in thousands of dollars)

Total Pizza 73 retail sales	\$	37,724
New locations <sup>(1)</sup>		(4,600)
Closed locations		-
2007 Pizza 73 Royalty Pool System Sales	<u>\$</u>	<u>33,124</u>

<sup>1</sup> Reflects sales at newly opened restaurants not yet included in the applicable Royalty Pool.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

System sales (as defined in the Licence and Royalty Agreements between Pizza Pizza and the Partnership) reported by Pizza Pizza and Pizza 73 restaurants include the gross sales of Pizza Pizza Company-owned, jointly-controlled and franchised restaurants, excluding (i) sales and goods and service tax or similar amounts levied by any governmental or administrative authority, and (ii) initial or renewal franchise fees charged by Pizza Pizza upon the establishment or renewal of franchises and franchise agreements.

Total Pizza Pizza retail sales for the 52-week period ended December 31, 2007, include sales reported by franchisees and sales from Company-owned locations during the reporting period. Sales from new locations include sales from franchise or Company-owned locations that were opened after January 1, 2007 and on or prior to December 31, 2007. Sales from closed locations include sales from restaurants that were closed on or after January 1, 2007 and on or prior to December 31, 2007, and for which Pizza Pizza is required to pay the Make Whole Payment.

Total Pizza 73 retail sales for the period ended December 31, 2007 include sales reported by the jointly-controlled locations during the reporting period. Sales from new locations include sales from jointly-controlled locations that were opened after July 24, 2007, as well as sales from the seven locations that were not vended-in to the Royalty Pool on July 24, 2007, and any amounts calculated as Step-Out Payments under the Pizza 73 Licence and Royalty Agreement. Sales from closed locations include sales from restaurants that were closed on or after July 24, 2007 and on or prior to December 31, 2007, and for which Pizza Pizza is required to pay a Make Whole Payment.

As new restaurants are opened within the Pizza 73 group of restaurants, it is expected that the territory assigned to certain of the existing Pizza 73 restaurants, already included in the Royalty Pool, may be reallocated between existing restaurants and new Pizza 73 restaurants that will be opened, among other reasons, to address capacity or market growth issues or increase market penetration. Pursuant to the Pizza 73 Licence and Royalty Agreement, Pizza Pizza will pay to the Partnership a monthly Step-Out Payment in respect of a Pizza 73 restaurant, the territory of which has been reduced, from the month in which the reduction occurs to the end of the next following calendar year. As a result, during this period, the opening of the new restaurant will not cause a reduction of the Pizza 73 royalty in respect of the affected restaurant from the average level paid in the previous year.

Systems sales reported by Pizza Pizza and Pizza 73 restaurants to the Company are self-assessed by each restaurant on a weekly reporting basis and are submitted without audit or other form of independent assurance.

## **OPERATING RESULTS**

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 Pizza Pizza Rights, is accounted for on the equity basis. To provide further disclosure, the Fund has prepared the following table, Table One, that shows the non-GAAP combination of the Fund, as if the VIE rules were not applied to the Fund and the Partnership. Pizza Pizza believes that, in addition to the audited financial statements, the following combination is a useful supplemental measure of performance. The method of performing the combination may differ from that used by other issuers and, accordingly, it may not be comparable to that used by other issuers.

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

Table One: Combined statement of Pizza Pizza Royalty Income Fund

	Pizza Pizza Royalty Income Fund (per GAAP) <sup>(1)</sup>	Pizza Pizza Royalty Limited Partnership	Eliminating Entries		Pizza Pizza Royalty Income Fund (non-GAAP) <sup>(2)</sup>
<b>Balance Sheet</b>					
<b>As at December 31, 2007</b>					
Current Assets	\$ 1,659	\$ 4,317	\$ (1,512)	(3)	\$ 4,464
Loan receivable from Pizza Pizza	30,000	-	-		30,000
Investment in Pizza Pizza Royalty Limited Partnership	180,984	-	(180,984)	(4)	-
Rights and Marks	-	295,215	-		295,215
<b>Total Assets</b>	<b>\$ 212,643</b>	<b>\$ 299,532</b>	<b>\$ (182,496)</b>		<b>\$ 329,679</b>
Current Liabilities	\$ 1,658	\$ 2,372	\$ (1,512)	(3)	\$ 2,518
Long-term debt, net of deferred financing	-	46,865	-		46,865
Future Income Taxes	8,208	-	-		8,208
Non-controlling interest	-	-	74,711	(5)	74,711
Equity	202,777	250,294	(255,695)	(4)(5)	197,376
<b>Total Liability and Equity</b>	<b>\$ 212,643</b>	<b>\$ 299,532</b>	<b>\$ (182,496)</b>		<b>\$ 329,679</b>
<b>Statement of Earnings</b>					
<b>For the Year ended December 31, 2007</b>					
Royalty Income	\$ -	\$ 25,564	\$ -		\$ 25,564
Equity income excluding issuance costs	16,819	-	-		-
Issuance costs	(169)	-	-		-
Equity Income	16,650	-	(16,650)	(4)	-
Interest Income	1,849	-	-		1,849
<b>Total Revenue</b>	<b>18,499</b>	<b>25,564</b>	<b>(16,650)</b>		<b>27,413</b>
General and Administrative expenses <sup>(6)</sup>	-	843	-		843
Interest on long-term debt	-	1,909	-		1,909
Earnings before non-controlling interest and taxes	18,499	22,812	(16,650)		24,661
Non-controlling interest	-	-	6,162	(5)	6,162
Taxes	8,208	-	-		8,208
<b>Net earnings for the period</b>	<b>\$10,291</b>	<b>\$ 22,812<sup>(7)</sup></b>	<b>\$ (22,812)</b>		<b>\$ 10,291</b>

(1) As publicly filed and audited.

(2) Represents the Fund combined with the Partnership, as it would appear if the VIE rules were not applied.

(3) Eliminate receivable/payable balance.

(4) Eliminate investment in the Partnership, distributions from Partnership.

(5) Set up Pizza Pizza's interest in Partnership.

(6) General and administrative expenses include \$207 of issuance costs, excluding issuance costs general and administrative expense are \$636.

(7) Net earnings include \$207 of issuance costs; excluding issuance costs, net earnings are \$23,019.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

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 earns royalty income from restaurants in the Royalty Pool. The Fund earns equity income from its investment in the 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 year ended December 31, 2007.

#### **Revenues**

Royalty Income earned by the Partnership was \$7.7 million for the quarter and \$25.6 million for the year ended December 31, 2007. A 6% royalty was earned on the Royalty Pool of 531 Pizza Pizza restaurants reporting \$99.7 million sales for the quarter and \$376.4 million for the year ended December 31, 2007. A 9% royalty was earned on the Royalty Pool of 41 Pizza 73 restaurants reporting \$19.2 million in system sales for the quarter and \$33.1 million for the period July 24, 2007 to December 31, 2007.

Royalty Income earned by the Partnership for the comparative quarter and prior year was \$5.6 million for the quarter and \$21.2 million for the year ended December 31, 2006. The 501 restaurants in the Royalty Pool reported sales of \$93.9 million and \$353.1 million, for the quarter and year then ended.

The period over period increase is due to the addition of 30 Pizza Pizza restaurants, 41 Pizza 73 restaurants, and the period-over-period SSSG.

#### **Expenses**

The Partnership's operating expenses include administrative expenses, amortization of deferred financing fees and interest paid on a \$47 million bank term loan (2006 - \$20 million). See "Liquidity and Capital Resources-Term Loan".

Operating expenses for the quarter were \$896,000, including \$697,000 of interest expense on the \$47 million term loan, \$189,000 of administrative expenses, and \$10,000 in amortization of deferred financing fees. Operating expenses for the year, excluding the issuance costs, were \$2.5 million including \$1.9 million of interest expense and amortization of financing fees on the \$47 million term loan and \$636,000 of administration expenses.

Operating expenses for the comparative quarter of 2006 were \$426,000, including \$267,000 of interest expense on a \$20 million term loan, \$146,000 of administrative expenses, and \$13,000 in amortization of deferred financing fees. Operating expenses for the comparative year were \$1.7 million including \$1.1 million of interest expense on a \$20 million term loan, \$587,000 of administration expenses, and \$50,000 in amortization of deferred financing fees.

The increase in the year-to-date interest expense is the result of the increase in the term loan from \$20 million to \$47 million, offset by a decrease in the interest rate charged on the \$20 million facility. On July 24, 2006, the fixed rate on \$20 million of the credit facility was reduced to 4.8% and the interest on the remaining \$27 million was 6.3%. See "Liquidity and Capital Resources-Term Loan".

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

Administration expenses increased by \$49,000 from the comparative year. As compared with the prior year, trustee fees and auditor fees accounted for the increase in general and administrative expenses. Amortization of deferred financing fees increased this year with the write-off of the previous loan financing fees totaling \$47,000.

A one time expense for issuance costs incurred in 2007 of \$207,000, which related to the Pizza 73 transaction, is not reflected in the financial highlights table of this Management's Discussion and Analysis. The issuance costs were deducted from the proceeds of the issuance. Therefore, there was no effect on the Partnership's cash from operations for the current period. The issuance costs were determined to be without future benefit and were expensed.

#### **Net earnings**

The Partnership had net earnings before issuance costs for the quarter of \$6.8 million and \$23.0 million for the year ended December 31, 2007, which were allocated to the Fund and Pizza Pizza based on their respective interest in the Partnership, as compared to \$5.2 million and \$19.5 million earned in the comparable quarter and annual period, respectively.

#### **Fund Operations**

Equity income is earned by the Fund through limited partnership holdings of LP units representing its effective 81.6% 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 by the Fund before the write-off of issuance costs for the quarter and year ended December 31, 2007 was \$5.2 million and \$16.8 million, respectively. Equity income, including issuance costs was \$5.2 million and \$16.7 million for the quarter and year ended December 31, 2007, respectively. The equity income earned for the comparative quarter and year-end period were \$3.8 million and \$14.1 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.

During 2007, the Fund's percentage ownership interest in the Partnership increased to 81.6% from 79.7% in 2006, as a result of the issuance of new Class A Partnership units to acquire the Pizza 73 Rights and on the conversion of the Class B Partnership units by Pizza Pizza. Thus, the Fund has recorded a larger percentage of the income of the Partnership.

#### **Interest Income**

The interest income for the quarter and year ended December 31, 2007 was \$450,000 and \$1.8 million, respectively, earned on the \$30 million loan from the Fund to Pizza Pizza, with interest paid monthly at 6% per annum. An additional \$49,000 of interest was earned during the third quarter of 2007 on the subscription receipt proceeds held during July.

#### **Net earnings before income taxes and write-off of issuance costs**

Net earnings excluding the impact of non-cash future income tax and the write-off of issuance costs for the quarter ended December 31, 2007 were \$5.6 million or \$0.259 per unit, as compared to \$4.2 million or \$0.237 per unit for the comparable quarter in 2006 which equates to an 9.7% increase per unit. Net earnings excluding the impact of non-cash future income taxes and write-off of issuance costs for the year ended December 31, 2007 were \$18.7 million or \$0.954 basic earnings per unit, as compared to \$15.9 million or \$0.885 basic earnings per unit, a 7.8% increase.

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

#### 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 enacted into law in the second quarter of 2007 and changed the rules applicable to publicly traded income trusts in 2011. As the new trust tax legislation has been enacted, the Fund gave accounting recognition to these new rules in the second quarter. During the current quarter, the Fund recognized a non-cash future income tax recovery and a decrease to the corresponding liability of \$4.7 million. On a year-to-date basis, the Fund recognized \$8.2 million of future tax expense representing the Fund's proportional share of the temporary difference between the accounting and tax basis at a 29% tax rate applicable to the Fund on the Pizza 73 Rights in the Partnership. The Fund will not be liable for current taxes until January 1, 2011. The future income tax would only be paid if the Pizza Pizza and Pizza 73 Rights were to be sold by the Partnership.

#### Net earnings

Net earnings in 2007 were reduced by the non-cash, future tax expense. For the quarter ended December 31, 2007 net earnings were \$10.3 million or \$0.474 per unit, as compared to net earnings of \$4.2 million or \$0.237 per unit for the comparable quarter in 2006. Net earnings for the year ended December 31, 2007 was \$10.3 million or \$0.526 per unit, as compared to net earnings of \$15.9 million of \$0.885 per unit for 2006.

#### Distributions

The Fund declared distributions of \$5.0 million or \$0.228 per unit for the quarter, equating to a 88% payout ratio; for the 2006 comparable quarter, the Fund declared distributions of \$3.8 million or \$0.213 per unit for a payout ratio of 90%. For the year ended December 31, 2007, distributions of \$17.6 million or \$0.888 per unit were declared, equating to a 94% payout ratio. For the 2006 year-end, distributions of \$15.1 million or \$0.842 per unit were declared equating to a payout ratio of 95%. The \$0.888 per unit represents a 5.5% increase over 2006.

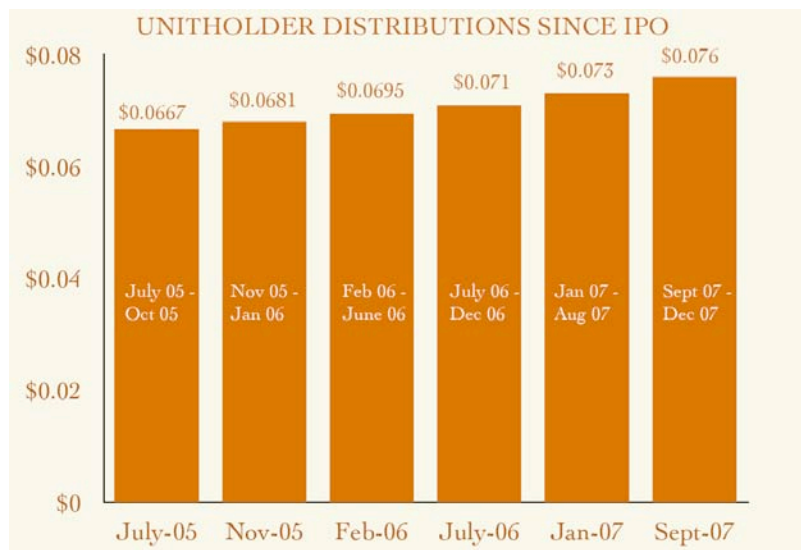
For those unitholders holding units outside a tax deferred plan, the 2007 distributions will be treated as 65% taxable income and 35% as a tax-deferred return of capital.

During the year, the Fund increased its monthly distribution in January (by 2%) and again in September (by 4%). 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¢
July 1-31, 2007	August 15, 2007	7.3¢
August 1-31, 2007	September 14, 2007	7.3¢
September 1-30, 2007	October 15, 2007	7.6¢
October 1-31, 2007	November 15, 2007	7.6¢
November 1-30, 2007	December 14, 2007	7.6¢
<u>December 1-31, 2007</u>	<u>January 15, 2008</u>	<u>7.6¢</u>
<u>Total</u>		<u>88.8¢</u>

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

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.



### 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 December 31, 2007, working capital of the Partnership was \$1.9 million (2006 - \$1.5 million), accumulated as a reserve to cover seasonality and any unusual administrative expenditures.

### Term Loan and Operating Loan

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 initial \$20 million facility was arranged during the initial public offering to partially finance the purchase of the Pizza Pizza Rights from Pizza Pizza. To partially finance the Pizza 73 transaction, the facility was increased by \$27 million to \$47 million. As security for repayment of the facility, the Partnership has provided the bank with a first ranking general security agreement charging all tangible and intangible assets of the Partnership, as well as an assignment of all security supporting the Royalty Agreements. In addition, 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. The facility bears 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 EBITDA, with EBITDA defined as annualized earnings before interest, taxes, depreciation and amortization. During 2007, the interest rate on the facility was fixed with three interest rate swaps through July 23, 2012 but may decrease should the debt-to-EBITDA ratio decrease.

The interest rate on the initial \$20 million facility has decreased during the third quarter from 3.55% plus 1.50% credit spread to 3.55% plus 1.25% credit spread. The remaining \$27 million is initially fixed with two swaps at 5.05% plus 1.25% credit spread.

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

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.

These facilities include affirmative and negative covenants customary for agreements of this nature. In particular, the Partnership is required to maintain a funded debt to EBITDA ratio not to exceed 2.5:1. At any time, distributions for the previous four quarters shall not exceed Distributable Cash Flow for the previous four quarters. Distributable Cash Flow in the case of the Borrower shall be defined as EBITDA less the aggregate amount of unfunded capital expenditures, net interest expense, cash taxes and other permitted debt payments plus the aggregate amount of Distributable Cash Flow not distributed in prior periods and cash on hand at the Closing, which at December 31, 2007 was \$2.2 million.

### SUBSEQUENT EVENTS

Subsequent to the year ended December 31, 2007, the Fund declared distributions are as follows:

<u>Period</u>	<u>Payment Date</u>	<u>Amount/unit</u>
January 1-31, 2008	February 15, 2008	7.6¢
February 1-28, 2008	March 14, 2008	7.6¢

#### *2007 Vend-in Adjustment*

In early January 2008, adjustments to royalty payments and Pizza Pizza's Class B Exchange Multiplier were made based on the actual performance of the 30 net, restaurants added to the Royalty Pool on January 1, 2007. As a result of the adjustments, the Class B Exchange Multiplier effective for 2007 was 1.23525 and Pizza Pizza's exchangeable units increased by 122,427 to 5,031,342 Fund units, effective January 1, 2007, which equates to 18.7% of the fully diluted units of the Fund.

#### *2008 Vend-in Adjustment – Class B Exchange Multiplier*

On January 1, 2008, 28 net, new Pizza Pizza restaurants were added to the Royalty Pool as a result of 36 new restaurants opening and eight closings during 2007. The additional system sales from the 28 net, new restaurants are estimated at \$8.0 million annually. The total number of Pizza Pizza restaurants in the Royalty Pool has increased to 559. The yield of the Fund units was determined to be 9.0% calculated using \$9.87 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, 2008. 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 0.09805; the new Class B Multiplier is 1.33330. 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, 2008, once the actual performance of the new restaurants is determined in early 2009. As a result of the Adjusted Class B Exchange Multiplier, Pizza Pizza will hold Class B Partnership units exchangeable into 5,430,700 Fund units.

#### *2008 Vend-in Adjustment – Class D Exchange Multiplier*

On January 1, 2008, nine new Pizza 73 restaurants opened prior to September 1, 2007 were added to the Royalty Pool. The additional system sales from the nine new restaurants are estimated at \$7.5 million annually. The total number of Pizza 73 restaurants in the Royalty Pool has increased to 50. The yield and weighted average unit price used in the calculation of the multiplier is the same as that of the Class B adjustment previously discussed of 9.0% and \$9.87, respectively. As a result of the contribution of the additional net sales to the Royalty Pool, Pizza Pizza's Class D Exchange Multiplier increased fractionally by 80% of the total adjustment or 5.58750; the new Class D Multiplier is 5.5870. This adjustment will also increase the entitlement of the holders of the Class D Units to distributions of cash and allocations of income from the Partnership. The second adjustment to the Class D Exchange Multiplier will be adjusted

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

to be effective January 1, 2008, once the actual performance of the new restaurants is determined in early 2009. As a result of the Adjusted Class D Exchange Multiplier, Pizza Pizza will hold Class D Partnership units exchangeable into 558,750 Fund units.

*Pizza Pizza's Ownership of the Fund*

In exchange for adding the 37 net, new restaurants to the Royalty Pool, Pizza Pizza has received 399,357 additional Class B equivalent units and 558,750 Class D equivalent units. These units represent 80% of the full Class B and Class D entitlements (499,196 and 698,437 units, respectively, represent 100%), with the balance to be received when the 2008 sales performance is known with certainty.

Including the 958,107 exchangeable units described above, Pizza Pizza owns equivalent, exchangeable units equal to 21.5% of the Fund's fully diluted units.

Units outstanding & issuable on January 1, 2008	Issued & Outstanding units, and Exchangeable Equivalent units
Public float	21,818,392
Class B units held by Pizza Pizza	4,908,915
Pizza Pizza additional units - Holdback as of December 31, 2007	122,427
Additional Pizza Pizza Class B equivalent units as of January 1, 2008	399,357
Additional Class D equivalent units issued to Pizza Pizza on January 1, 2008	558,750
Number of fully diluted units	27,807,841
 Proportion of all units outstanding available for exchange by Pizza Pizza	21.5%

**OUTLOOK**

The 2007 acquisition of Pizza 73 has proven to be accretive to unitholders and we look for continued sales growth from this dominant, Alberta brand.

For the last four years, same store sales growth, the key driver of yield growth for Fund unitholders, has averaged nearly 5% for Pizza Pizza and 20% for the Pizza 73 brand.

Pizza Pizza management has advised the Trustees that in 2008 it expects to grow the number of restaurants by 4% and to continue researching strategic acquisition opportunities. Organically, Pizza Pizza expects to grow outside its largely Ontario markets by opening additional Montreal locations, as well as beginning site selection in other provinces. Also, Pizza 73 locations will be added in the Alberta marketplace to better service the growing western Canada customer base.

Historically, during economic downturns, Pizza Pizza has not been materially impacted due to the nature of the quick service segment in which it operates as well as Pizza Pizza's marketing leadership, its large market share and its operational excellence. The quick service segment has been viewed by consumers as being affordable, offering good value, of high quality, and convenience and has in past economic downturns, been the beneficiary of consumers trading down from more expensive segments of the food service industry.

## **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.

During the fourth quarter ending December 31, 2007, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As of December 31, 2007, an evaluation of the design of the Fund's disclosure 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 Pizza Pizza and Pizza 73 Rights, the valuation of the Fund's investment is based primarily upon the valuation of intangible assets in the Partnership. The Pizza Pizza and Pizza 73 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 December 31, 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 \$298,000 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 (loss), 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,

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

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.

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 (loss).

#### iii) Comprehensive Income

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

Accumulated other comprehensive income (loss) is a separate component of unitholders' equity. The Consolidated Statement of Accumulated Other Comprehensive Income (Loss) reflects changes in accumulated other comprehensive income (loss), 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 changes 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 12.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

#### *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 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 earnings 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.

## **PIZZA PIZZA ROYALTY INCOME FUND**

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

#### *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.

### **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 earnings.

#### **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, Pizza Pizza franchisees and Pizza 73 operators 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 and Pizza 73 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. For additional information concerning the performance of Pizza Pizza, please refer to the Pizza Pizza MD&A which is available at [www.sedar.com](http://www.sedar.com) and [www.pizzapizzaroyaltyincomefund.com](http://www.pizzapizzaroyaltyincomefund.com).

#### **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 eligible for the new enhanced dividend tax credit if paid or allocated to a resident of Canada. This 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.

## PIZZA PIZZA ROYALTY INCOME FUND

### Management's Discussion & Analysis

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:

	2007 Tax Measures	2011 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 <sup>(4)</sup>	\$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 into law in June 2007. The tax consequences of these proposals 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 these proposals to their investment in units, with reference to their particular circumstances.

### Litigation

In the fourth quarter of 2007, the Fund received an update from Pizza Pizza Limited ("PPL") regarding a potential claim disclosed in the Fund's 2005 initial public offering prospectus and PPL's subsequent financial statement filings.

The claim, which does not name the Fund or its subsidiaries, was formally served on PPL and certain of its associates by Lawrence Austin, a former consultant to PPL. 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 PPL and its associates.

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

### Other

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

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

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 and should be considered in conjunction with the other risks and uncertainties described in the Fund's Annual Information Form. The Fund assumes no obligation to update these forward looking statements, except as required by applicable securities laws.

**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<sup>(1)</sup>  
Robert Nobes<sup>(1)</sup>  
Terence Reid<sup>(1)</sup>  
Elizabeth Wright

(1) Denotes Audit Committee member

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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  
Robert Nobes  
Michael Overs<sup>(1)</sup>  
Terence Reid  
Daniel Vukovich<sup>(1)</sup>  
Elizabeth Wright

(1) Denotes Pizza Pizza Limited appointees