Condensed Consolidated Interim Financial Statements of

# DIVERSIFIED ROYALTY CORP.

Three months ended March 31, 2019 and 2018

**DIVERSIFIED ROYALTY CORP.**
Condensed Consolidated Interim Statements of Financial Position
(Unaudited)
(Expressed in thousands of Canadian dollars)

| | Note | March 31, 2019 | December 31, 2018 |
|---|---|---|---|
| **Assets** | | | |
| Current assets: | | | |
| Cash and cash equivalents | 4 | $ 78,920 | $ 78,342 |
| Royalties and management fees receivable | 6 | 3,727 | 3,965 |
| Amounts receivable | | 153 | 153 |
| Prepaid expenses and other | | 111 | 89 |
| | | 82,911 | 82,549 |
| Intangible assets | | 235,674 | 235,674 |
| | | $ 318,585 | $ 318,223 |
| **Liabilities and Shareholders' Equity** | | | |
| Current liabilities: | | | |
| Accounts payable and accrued liabilities | | $ 1,516 | $ 832 |
| | | 1,516 | 832 |
| Long-term bank loans, net of deferred financing charges | 7 | 64,884 | 64,856 |
| Convertible debentures | 8 | 52,246 | 51,940 |
| Deferred income tax liability | 9 | 8,802 | 7,738 |
| Interest rate swap liabilities | | 673 | 137 |
| Shareholders' equity: | | | |
| Share capital | | 185,397 | 184,528 |
| Contributed surplus | | 26,365 | 25,974 |
| Equity component of convertible debentures | | 2,938 | 2,938 |
| Accumulated deficit | | (24,236) | (20,720) |
| | | 190,464 | 192,720 |
| | | $ 318,585 | $ 318,223 |

Nature of operations (note 1)
Subsequent events (note 15)

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**DIVERSIFIED ROYALTY CORP.**
Condensed Consolidated Interim Statements of Net Income and Comprehensive Income
(Unaudited)
(Expressed in thousands of Canadian dollars, except per share amounts)

| | Note | | Three months ended March 31, 2019 | | 2018 |
|---|---|---|---|---|---|
| Royalty income | 5 | $ | 6,325 | $ | 5,939 |
| Management fees | | | 78 | | 77 |
| | | | 6,403 | | 6,016 |
| Expenses | | | | | |
| Salaries and benefits | | | 409 | | 405 |
| Share-based compensation | 10 | | 391 | | 296 |
| General and administration | | | 125 | | 117 |
| Professional fees | | | 53 | | 56 |
| Litigation | | | - | | 285 |
| | | | 978 | | 1,159 |
| Income from operations | | | 5,425 | | 4,857 |
| Interest expense on credit facilities | | | (1,446) | | (1,245) |
| Other finance income, net | 12 | | 105 | | 54 |
| Fair value adjustment on interest rate swaps | | | (536) | | 128 |
| Income before income taxes | | | 3,548 | | 3,794 |
| Income tax expense | 9 | | 1,064 | | 1,164 |
| Net income and comprehensive income | | $ | 2,484 | $ | 2,630 |
| Basic weighted average number of shares outstanding | | | 107,840,033 | | 106,558,192 |
| Diluted weighted average number of shares outstanding | | | 108,773,613 | | 107,346,220 |
| Basic income per share | 11 | $ | 0.02 | $ | 0.02 |
| Diluted income per share | 11 | $ | 0.02 | $ | 0.02 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**DIVERSIFIED ROYALTY CORP.**
Condensed Consolidated Interim Statements of Changes in Equity
(Unaudited)
(Expressed in thousands of Canadian dollars, except for share amounts)

| | Common shares | Share capital | Contributed surplus | Equity component of convertible debentures | Accumulated deficit | Total equity |
|---|---|---|---|---|---|---|
| Balance, January 1, 2019 | 107,768,300 | $ 184,528 | $ 25,974 | $ 2,938 | $ (20,720) | $192,720 |
| Common shares issued on DRIP | 291,720 | 869 | - | - | - | 869 |
| Share-based compensation | - | - | 391 | - | - | 391 |
| Dividends declared | - | - | - | - | (6,000) | (6,000) |
| Comprehensive income | - | - | - | - | 2,484 | 2,484 |
| Balance, March 31, 2019 | 108,060,020 | $ 185,397 | $ 26,365 | $ 2,938 | $ (24,236) | $190,464 |

| | Common shares | Share capital | Contributed surplus | Equity component of convertible debentures | Accumulated deficit | Total equity |
|---|---|---|---|---|---|---|
| Balance, January 1, 2018 | 106,481,937 | $ 180,906 | $ 25,265 | $ 2,938 | $ (6,982) | $202,127 |
| IFRS 2 amendments | - | - | 218 | - | - | 218 |
| | 106,481,937 | 180,906 | 25,483 | 2,938 | (6,982) | 202,345 |
| Common shares issued on DRIP | 225,659 | 729 | - | - | - | 729 |
| Restricted share units settled | 169,763 | 391 | (391) | - | - | - |
| Share-based compensation | - | - | 296 | - | - | 296 |
| Dividends declared | - | - | - | - | (5,935) | (5,935) |
| Comprehensive income | - | - | - | - | 2,630 | 2,630 |
| Balance, March 31, 2018 | 106,877,359 | $ 182,026 | $ 25,388 | $ 2,938 | $ (10,287) | $200,065 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

**DIVERSIFIED ROYALTY CORP.**
Condensed Consolidated Interim Statements of Cash Flows
(Unaudited)
(Expressed in thousands of Canadian dollars)

| | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Cash flows from (used in) operating activities: | | |
| Net income | $ 2,484 | $ 2,630 |
| Adjustments for: | | |
| Deferred income taxes | 1,064 | 1,164 |
| Share-based compensation | 391 | 296 |
| Fair value adjustments on interest rate swaps | 536 | (128) |
| Interest expense on credit facilities | 1,446 | 1,245 |
| Other finance income, net | (105) | (54) |
| Foreign exchange gain (loss) | (4) | 5 |
| Interest paid | (691) | (489) |
| Interest received | 443 | 362 |
| Changes in non-cash operating items: | | |
| Royalties and management fees receivable | 238 | 433 |
| Amounts receivable | - | 17 |
| Prepaid expenses and other | (22) | (19) |
| Accounts payable and accrued liabilities | (71) | 34 |
| Net cash from operating activities | 5,709 | 5,496 |
| Cash flows used in financing activities: | | |
| Payment of dividends | (5,131) | (5,206) |
| Net cash used in financing activities | (5,131) | (5,206) |
| Net increase in cash and cash equivalents | 578 | 290 |
| Cash and cash equivalents, beginning of period | 78,342 | 85,816 |
| Cash and cash equivalents, end of period | $ 78,920 | $ 86,106 |

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

Diversified Royalty Corp. ("DIV"), formerly BENEV Capital Inc. and prior to that Bennett Environmental Inc., is a company domiciled in Canada and incorporated on July 29, 1992 under the Canada Business Corporation Act. The condensed consolidated interim financial statements of DIV as at and for the three months ended March 31, 2019 are composed of DIV and its subsidiaries (together referred to as the "Company"). The Company's common shares are listed on the Toronto Stock Exchange ("TSX") and traded under the symbol "DIV". The registered office of the Company is located at 902-510 Burrard Street, Vancouver, BC, V6C 3A8.

## 1. Nature of operations:

The current business of DIV is to acquire royalties from well-managed multi-location businesses and franchisors in North America ("Royalty Partners").

On June 19, 2015, the Company indirectly acquired, through SGRS Royalties Limited Partnership ("SGRS LP") (an entity controlled by the Company), all of the Canadian and U.S. trademarks and certain other intellectual property rights utilized by Sutton Group Realty Services Ltd. ("Sutton") in its residential real estate franchise business (the "SGRS Rights"). The Company granted Sutton the licence to use the SGRS Rights for a term ending on December 31, 2114 in exchange for a royalty payment initially equal to $56.25 per agent per month (the "Sutton Royalty Rate") for the number of agents included in the royalty pool (the "Sutton Royalty Pool"). Effective July 1, 2018, the Sutton Royalty Rate was increased to $59.693 per agent per month.

On August 19, 2015, the Company indirectly acquired through ML Royalties Limited Partnership ("ML LP") (an entity controlled by the Company), the trademarks and certain other intellectual property rights (the "ML Rights") from Mr. Lube Canada Limited Partnership ("Mr. Lube"). The Company granted Mr. Lube the licence to use the ML Rights for a term ending on August 19, 2114 in exchange for a royalty payment initially equal to 6.95% of system sales of Mr. Lube locations in the royalty pool (the "Mr. Lube Royalty Pool"). Effective September 18, 2017, ML LP amended its licence and royalty agreement with Mr. Lube (the "ML LRA Amendment") in connection with Mr. Lube's new retail tire program. Pursuant to the ML LRA Amendment, ML LP has agreed to charge an effective royalty rate payable on system sales derived from the sale of tires and rims of 2.5% (compared to 6.95% on all other system sales) for the locations in the Mr. Lube Royalty Pool. On May 1, 2018, the Mr. Lube royalty rate on non-tire sales was increased by 0.5% from 6.95% to 7.45%.

On August 25, 2017, the Company indirectly acquired through AM Royalties Limited Partnership ("AM LP") (a wholly owned subsidiary of the Company), the Canadian AIR MILES trademarks and certain Canadian intellectual property rights (collectively, the "AIR MILES Rights") from a subsidiary of Aimia Inc. ("Aimia"). In accordance with the terms of two license agreements with LoyaltyOne Co. (collectively the "AIR MILES Licenses") acquired by AM LP as part of acquisition of the AIR MILES Rights, LoyaltyOne Co. has an exclusive right to use the AIR MILES Rights for the purposes of operating the AIR MILES reward program in Canada (the "AIR MILES Program") for an indefinite term in exchange for a royalty payment equal to 1% of gross billings from the AIR MILES Program.

Substantially all of the Company's operating revenues are earned from the receipt of royalties and management fees from its Royalty Partners. Accordingly, the revenues of the Company and its ability to pay dividends to shareholders are dependent on the ongoing ability of its Royalty Partners to generate cash and pay royalties and management fees to the Company.

## 2. Basis of preparation:

(a) Statement of compliance:

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting*. Certain information and note disclosures normally included in the annual consolidated financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") have been omitted or condensed. Accordingly, these condensed consolidated interim financial statements should be read in conjunction with the Company's annual consolidated financial statements for the year ended December 31, 2018.

These condensed consolidated interim financial statements were authorized and approved for issue by the Company's Board of Directors on May 9, 2019.

**2. Basis of preparation (continued):**

(b) Basis of measurement:

These financial statements have been prepared on the historical cost basis except for the interest rate swaps, which are measured at fair value.

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. The critical judgments and key estimates and assumptions are the same as described in the Company's annual financial statements for the year ended December 31, 2018.

(c) Functional and presentation currency:

These condensed consolidated interim financial statements are presented in Canadian dollars, which is the Company's functional currency.

**3. Significant accounting policies:**

These condensed consolidated interim financial statements have been prepared using the same accounting policies as the annual financial statements for the year ended December 31, 2018, except as described below.

On January 1, 2019, the Company adopted IFRS 16, *Leases* ("IFRS 16"). This standard introduces a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of a low value. A lessee is required to recognize a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. The Company does not have any leases within the scope of IFRS 16, therefore the adoption of IFRS 16 did not have an impact on the Company's accumulated deficit as at January 1, 2019.

**4. Cash and cash equivalents:**

| | | March 31, 2019 | | December 31, 2018 |
|---|---|---|---|---|
| Cash | $ | 1,237 | $ | 1,024 |
| Cash equivalents | | 77,683 | | 77,318 |
| | $ | 78,920 | $ | 78,342 |

**5. Royalty pools:**

(a) Mr. Lube:

Royalty income from Mr. Lube was as follows:

| Expressed in thousands of Canadian dollars, except for number of locations | | Three months ended March 31, 2019 | | 2018 |
|---|---|---|---|---|
| Locations in the Mr. Lube Royalty Pool at period end | | 118 | | 117 |
| Mr. Lube Royalty Pool system sales | $ | 49,752 | $ | 47,062 |
| Royalty income | | 3,663 | | 3,260 |

During the three months ended March 31, 2019, royalty income from Mr. Lube did not have any make-whole payments. During the three months ended March 31, 2018, royalty income from Mr. Lube includes make-whole payments totaling $0.01 million on lost system sales of $0.2 million.

**5. Royalty pools (continued):**

(b) Sutton:

Royalty income from Sutton was as follows:

| Expressed in thousands of Canadian dollars, except for number of agents | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Agents in the Sutton Royalty Pool at period end | 5,400 | 5,400 |
| Royalty income | $ 967 | $ 948 |

(c) AIR MILES:

Royalty income related to the AIR MILES Program was as follows:

| Expressed in thousands of Canadian dollars | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Gross billings | $ 169,506 | $ 173,127 |
| Royalty income | 1,695 | 1,731 |

**6. Royalties and management fees receivable:**

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| Mr. Lube | $ 1,468 | $ 1,242 |
| Sutton | 347 | 347 |
| AIR MILES | 1,912 | 2,376 |
| | $ 3,727 | $ 3,965 |

**7. Borrowings:**

As at March 31, 2019, the Company had the following term loan facilities and operating lines of credit:

| Term loan facilities | Interest rate | Maturity date | Face value | Carrying value |
|---|---|---|---|---|
| SGRS LP term loan | BA + 2.00% | Jun 30, 2022 | $ 6,300 | $ 6,248 |
| ML LP term loan | BA + 1.95% | Jul 31, 2022 | 41,600 | 41,376 |
| AM LP term loan | BA + 2.25% | Sep 6, 2022 | 17,400 | 17,260 |
| | | | $ 65,300 | $ 64,884 |

| Operating lines of credit | Interest rate | Maturity date | Maximum available | Available for use |
|---|---|---|---|---|
| SGRS LP line of credit | BA + 2.00% | Jun 30, 2022 | $ 500 | $ 500 |
| ML LP line of credit | Prime + 0.25% | Jul 31, 2022 | 1,000 | 1,000 |
| AM LP line of credit | BA + 2.25% | Sep 6, 2022 | 3,000 | 3,000 |
| | | | $ 4,500 | $ 4,500 |

As at March 31, 2019, SGRS LP, ML LP and AM LP were in compliance will all financial covenants.

(Tabular amounts expressed in thousands of Canadian dollars)

## 8. Convertible debentures:

The following table reconciles the principal amount of the convertible debentures to the carrying value of the liability component.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| Principal amount | $ 57,500 | $ 57,500 |
| Equity component of debentures | (4,312) | (4,312) |
| Unamortized deferred financing fees | (1,964) | (2,080) |
| Accretion on liability component of debentures | 1,022 | 832 |
| | $ 52,246 | $ 51,940 |

## 9. Deferred income taxes:

| | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Deferred income tax expense | $ 1,064 | $ 1,164 |
| | $ 1,064 | $ 1,164 |

The tax effect of temporary differences that gives rise to the net deferred tax liability are as follows:

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| Non-capital losses | $ 502 | $ 1,016 |
| Financing and share issuance costs | 86 | 185 |
| Intangible assets | 277 | 282 |
| Investment tax credits | 199 | 199 |
| Other | 182 | 37 |
| Convertible debentures | (888) | (939) |
| Intangible assets | (9,160) | (8,518) |
| Net deferred tax liability | $ (8,802) | $ (7,738) |

As at March 31, 2019, the Company has non-capital loss carry forwards of $1.9 million (December 31, 2018 - $3.8 million), which can be carried forward and applied against future taxable income. The deferred tax liability as at March 31, 2019 is largely associated with the temporary differences on the Company's intangible assets, which have an undepreciated capital cost allowance of approximately $147.9 million (December 31, 2018 - $150.3 million).

(Tabular amounts expressed in thousands of Canadian dollars)

## 10. Share-based compensation:

(a) Restricted share units:

The number of RSUs outstanding is as follows:

| | March 31, 2019 | | |
|---|---|---|---|
| | Number of RSUs | | Weighted average grant-date fair value |
| Balance, beginning of period | 921,521 | $ | 3.30 |
| Granted | 7,174 | | 2.75 |
| Dividends earned | 16,909 | | 3.07 |
| Balance, end of period | 945,604 | $ | 3.30 |
| Unvested | 907,479 | $ | 3.30 |
| Vested | 38,125 | $ | 3.08 |

(b) Share options:

The following table summarizes the changes in the Company's share options during the three months ended March 31, 2019:

| | March 31, 2019 | | |
|---|---|---|---|
| | Number of options | | Weighted average exercise price |
| Balance, beginning and end of period | 2,300,000 | $ | 3.26 |

The following table summarizes information relating to outstanding and exercisable options as at March 31, 2019:

| | Options outstanding | | | | Options exercisable | | |
|---|---|---|---|---|---|---|---|
| Exercise prices | Number of options | Weighted average remaining life (years) | | Weighted average exercise price per share | Number exercisable | | Weighted average exercise price per share |
| $ 3.22 - $ 3.53 | 2,300,000 | 3.55 | $ | 3.26 | - | $ | - |

(Tabular amounts expressed in thousands of Canadian dollars)

## 11. Income per share:

| | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Net income for the period | $ 2,484 | $ 2,630 |
| Weighted average number of shares outstanding – basic | 107,840,033 | 106,558,192 |
| Dilutive adjustment for share options | - | 57,154 |
| Dilutive adjustment for RSUs | 933,580 | 730,874 |
| Weighted average number of shares outstanding – diluted | 108,773,613 | 107,346,220 |
| Net income per common share: | | |
| Basic | $ 0.02 | $ 0.02 |
| Diluted | $ 0.02 | $ 0.02 |

## 12. Other finance income (costs), net:

| | Three months ended March 31, 2019 | 2018 |
|---|---|---|
| Finance income | $ 443 | $ 362 |
| Foreign exchange gain (loss) | (4) | 5 |
| Amortization of deferred financing charges | (144) | (136) |
| Accretion expense | (190) | (177) |
| | $ 105 | $ 54 |

## 13. Financial instruments:

The Company must classify fair value measurements according to a hierarchy that reflects the significance of the inputs used in performing such measurements. The Company's fair value hierarchy comprises the following levels:

- Level 1 – quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 – pricing inputs are other than quoted in active markets included in Level 1. Prices in Level 2 are either directly or indirectly observable as of the reporting date.
- Level 3 – valuations in this level are those with inputs for the asset or liability that are not based on observable data.

The carrying value of current financial assets and liabilities approximate their fair value due to their short-term nature. The carrying value of the long-term bank loans approximates their fair value as these facilities bear interest at floating market interest rates. The fair value of the restricted share unit obligation is measured using Level 1 inputs. The fair value of the convertible debentures of $57.1 million is measured using Level 1 inputs. The fair value of the interest rate swap assets (liabilities) are measured using Level 2 inputs.

(Tabular amounts expressed in thousands of Canadian dollars)

## 13. Financial instruments (continued):

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

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| Assets carried at amortized cost: | | |
| Cash and cash equivalents | $ 78,920 | $ 78,342 |
| Royalties and management fees receivable | 3,727 | 3,965 |
| Amounts receivable | 153 | 153 |
| | $ 82,800 | $ 82,460 |
| Liabilities carried at amortized cost: | | |
| Accounts payable and accrued liabilities | $ 1,516 | $ 832 |
| Long-term bank loans | 64,884 | 64,856 |
| Convertible debentures | 52,246 | 51,940 |
| | $ 118,646 | $ 117,628 |
| Liabilities carried at fair value: | | |
| Interest rate swap liabilities | $ 673 | $ 137 |

## 14. Supplemental cash flow information:

The following table reconciles the movements in liabilities to cash flows arising from financing activities:

| | Long-term debt (note 7) | Debentures (note 8) | Total |
|---|---|---|---|
| Balance, December 31, 2018 | $ 64,856 | $ 51,940 | $ 116,796 |
| Liability-related other changes: | | | |
| Amortization of deferred financing charges | 28 | 116 | 144 |
| Accretion expense | - | 190 | 190 |
| Balance, March 31, 2019 | $ 64,884 | $ 52,246 | $ 117,130 |

## 15. Subsequent events:

On May 1, 2019, the Mr. Lube Royalty Pool has been adjusted to include the royalties from four new Mr. Lube locations. With the adjustment for these four openings, the Mr. Lube Royalty Pool now includes 122 locations. The initial consideration paid to Mr. Lube for the estimated additional royalty revenue is $2.7 million, representing 80% of the total estimated consideration of $3.4 million. DIV elected to pay the initial consideration to Mr. Lube in cash.

The remaining consideration payable for the additional royalty revenue of the four new Mr. Lube locations added to the Mr. Lube Royalty Pool on May 1, 2019 will be paid to Mr. Lube on May 1, 2020, the next adjustment date, and will be adjusted to reflect the actual system sales of these four new locations for the year ending December 31, 2019.

The actual system sales of the two new Mr. Lube locations added to the Mr. Lube Royalty Pool on May 1, 2018 have now been determined for the year ended December 31, 2018. The total consideration payable to Mr. Lube for the net additional royalty revenue of these two locations based on their actual system sales for the year ended December 31, 2018 is $1.1 million. After taking into account the $0.9 million previously paid on May 1, 2018, DIV paid Mr. Lube the remaining $0.2 million of cash consideration on May 1, 2019.