

Condensed Consolidated Interim Financial Statements of

DIVERSIFIED ROYALTY CORP.

Three and six months ended June 30, 2018 and 2017

DIVERSIFIED ROYALTY CORP.

Condensed Consolidated Interim Statements of Financial Position
(Unaudited)
(Expressed in thousands of Canadian dollars)

	Note	June 30, 2018	December 31, 2017
Assets			
Current assets:			
Cash and cash equivalents	5	\$ 81,128	\$ 85,816
Royalties and management fees receivable	7	3,896	4,008
Amounts receivable		120	150
Prepaid expenses and other		146	96
		85,290	90,070
Interest rate swap assets	11	232	160
Intangible assets	8	235,674	225,475
		\$ 321,196	\$ 315,705
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable and accrued liabilities		\$ 780	\$ 1,354
Restricted share unit obligation	3(c)	-	218
		780	1,572
Long-term bank loans, net of deferred financing charges	10	64,798	57,772
Convertible debentures	12	51,343	50,771
Deferred income tax liability	13	5,889	3,463
Shareholders' equity:			
Share capital		183,169	180,906
Contributed surplus		25,483	25,265
Equity component of convertible debentures		2,938	2,938
Accumulated deficit		(13,204)	(6,982)
		198,386	202,127
		\$ 321,196	\$ 315,705

Nature of operations (note 1)
Contingencies (note 9)

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 June 30,		Six months ended June 30,	
		2018	2017	2018	2017
Royalty income	6	\$ 6,704	\$ 4,459	\$ 12,643	\$ 8,531
Management fees		77	76	154	152
		6,781	4,535	12,797	8,683
Expenses					
Salaries and benefits		416	326	821	676
Share-based compensation	15	372	169	668	331
General and administration		158	186	275	335
Professional fees		54	54	110	107
Litigation	9	187	47	472	94
		1,187	782	2,346	1,543
Income from operations		5,594	3,753	10,451	7,140
Interest expense on credit facilities		(1,292)	(367)	(2,537)	(730)
Other finance income, net	16	56	155	110	319
Fair value adjustment on interest rate swaps		(56)	128	72	124
Income before income taxes		4,302	3,669	8,096	6,853
Income tax expense	13	1,262	979	2,426	1,850
Net income and comprehensive income		\$ 3,040	\$ 2,690	\$ 5,670	\$ 5,003
Weighted average number of shares outstanding					
Basic		107,045,438	105,810,224	106,885,697	105,673,619
Diluted		107,833,324	106,247,555	107,689,584	106,357,066
Income per share					
Basic	14	\$ 0.03	\$ 0.03	\$ 0.05	\$ 0.05
Diluted	14	0.03	0.03	0.05	0.05

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, December 31, 2017	106,481,937	\$ 180,906	\$ 25,265	\$ 2,938	\$ (6,982)	\$ 202,127
IFRS 2 amendments (note 3(c))	-	-	218	-	-	218
Balance, January 1, 2018	106,481,937	180,906	25,483	2,938	(6,982)	202,345
Common shares issued on DRIP	446,269	1,416	-	-	-	1,416
Restricted share units settled	228,159	557	(602)	-	-	(45)
Stock options exercised	129,900	290	(58)	-	-	232
Share-based compensation	-	-	660	-	-	660
Dividends declared	-	-	-	-	(11,892)	(11,892)
Comprehensive income	-	-	-	-	5,670	5,670
Balance, June 30, 2018	107,286,265	\$ 183,169	\$ 25,483	\$ 2,938	\$ (13,204)	\$ 198,386

	Common shares	Share capital	Contributed surplus	Equity component of convertible debentures	Accumulated deficit	Total equity
Balance, December 31, 2016	105,481,136	\$ 178,256	\$ 25,161	\$ -	\$ 5,024	\$ 208,441
Common shares issued on DRIP	363,444	916	-	-	-	916
Restricted share units settled	102,975	236	(179)	-	-	57
Share-based compensation	-	-	200	-	-	200
Dividends declared	-	-	-	-	(11,757)	(11,757)
Comprehensive income	-	-	-	-	5,003	5,003
Balance, June 30, 2017	105,947,555	\$ 179,408	\$ 25,182	\$ -	\$ (1,730)	\$ 202,860

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)

	Six months ended June 30,	
	2018	2017
Cash flows from (used in) operating activities:		
Net income	\$ 5,670	\$ 5,003
Adjustments for:		
Deferred income taxes	2,426	1,850
Share-based compensation	668	331
Fair value adjustments on interest rate swaps	(72)	(124)
Interest expense on credit facilities	2,537	730
Other finance income, net	(110)	(319)
Foreign exchange gain (loss)	12	(4)
Interest paid	(2,988)	(730)
Interest received	725	397
Changes in non-cash operating items:		
Royalties and management fees receivable	112	(61)
Amounts receivable	30	9
Prepaid expenses and other	(50)	(37)
Accounts payable and accrued liabilities	(176)	(196)
Net cash provided by operating activities	8,784	6,849
Cash flows from (used in) financing activities:		
Proceeds from increase in long-term debt	7,000	-
Debt re-financing costs	(29)	(36)
Proceeds from exercise of share options	232	-
Payment of dividends	(10,476)	(10,841)
Net cash used in financing activities	(3,273)	(10,877)
Cash flows used in investing activities:		
Mr. Lube royalty rate increase and store roll-in	(10,199)	-
Net cash used in investing activities	(10,199)	-
Net decrease in cash and cash equivalents	(4,688)	(4,028)
Cash and cash equivalents, beginning of period	85,816	74,974
Cash and cash equivalents, end of period	\$ 81,128	\$ 70,946

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

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

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 and six months ended June 30, 2018 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 \$58.693 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, 2017.

These condensed consolidated interim financial statements were authorized and approved for issue by the Company’s Board of Directors on August 9, 2018.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

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 and restricted share unit obligation, 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, 2017.

(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, 2017, except as described below.

(a) *IFRS 15, Revenue from Contracts with Customers*:

On January 1, 2018, the Company adopted IFRS 15, *Revenue from Contracts with Customers* ("IFRS 15"). The standard contains a single model that applies to contracts with customers. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. IFRS 15 supersedes IAS 18, *Revenue*, and related interpretations.

The Company adopted IFRS 15 using the cumulative effect method with the effect of initially applying this standard recognized at the date of initial application, January 1, 2018. The adoption of IFRS 15 did not have an impact on the Company's accumulated deficit as at January 1, 2018.

The adoption of IFRS 15 did not have an impact on the Company's condensed consolidated interim statement of financial position as at June 30, 2018 and condensed consolidated interim statement of net income and comprehensive income and condensed consolidated interim statement of cash flows for the six months ended June 30, 2018.

Details of the new significant accounting policies and the nature of the changes to the previous accounting policies in relation to the Company's two revenue streams, royalty income and management fee revenue, are set out below.

- **Royalty income:** The Company licenses its intellectual property rights to third parties in exchange for royalty payments. The royalty income is recognized based on the usage or sales that have occurred during the period. IFRS 15 did not have an impact on the Company's revenue recognition policies for royalty income.
- **Management fee revenue:** The Company provides strategic and other services to certain royalty partners in exchange for a fixed monthly fee. Management fee is recognized as earned over the term of the agreement. IFRS 15 did not have an impact on the Company's revenue recognition policies for management fee revenue.

Royalty income and management fees for Mr. Lube and Sutton are usually receivable within 21 days after the calendar month. Royalty income for the AIR MILES Program is usually receivable within 14 days after the calendar quarter.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

3. Significant accounting policies (continued):

(b) IFRS 9, Financial Instruments:

On January 1, 2018, the Company adopted IFRS 9, *Financial Instruments* (“IFRS 9”) on a retrospective basis. IFRS 9 sets out the requirements for recognizing and measuring financial assets and liabilities. IFRS 9 replaced IAS 39, *Financial Instruments: Recognition and Measurement* (“IAS 39”).

Under IFRS 9, financial assets are classified and measured based on the business model in which they are held and the characteristics of their cash flows. The following table and the accompanying notes explain the original measurement categories under IAS 39 and the new measurement categories under IFRS 9 for each class of the Company’s financial assets and liabilities.

	Original classification under IAS 39	New classification under IFRS 9
Cash and cash equivalents	Loans and receivables	Amortized cost
Royalties and management fees receivable	Loans and receivables	Amortized cost
Amounts receivable	Loans and receivables	Amortized cost
Interest rate swap assets	FVTPL	FVTPL
Accounts payable and accrued liabilities	Financial liabilities at amortized cost	Amortized cost
Long-term bank loans	Financial liabilities at amortized cost	Amortized cost
Convertible debentures	Financial liabilities at amortized cost	Amortized cost

At initial recognition, financial assets classified as amortized cost and fair value through other comprehensive income (“FVOCI”) are measured at fair value plus transaction costs that are directly attributable to its acquisition.

- Financial assets at amortized cost: A financial asset is measured at amortized cost if it meets both of the following conditions and is not designated as FVTPL: it is held in a business model whose objective is to hold the asset to collect contractual cash flows and the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Financial assets within this category are subsequently measured at amortized cost using the effective interest method. Interest income, foreign exchange gains and losses, impairment losses and gain or loss on de-recognition are recognized in profit or loss.
- Debt investments at FVOCI: A debt instrument is classified as FVOCI if it meets both of the following conditions and is not designated as FVTPL: it is held in a business model whose objective is achieved by collecting contractual cash flows and the sale of the financial asset and the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Financial assets within this category are subsequently measured at fair value. Interest income, dividend income, foreign exchange gains and losses are recognized in profit or loss. Other gains and losses are recognized in other comprehensive income (“OCI”) and are reclassified to profit or loss on de-recognition.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

3. Significant accounting policies (continued):

(b) IFRS 9, Financial Instruments (continued):

- Equity investments at FVOCI: On initial recognition of an equity instrument that is not held for trading, the Company may irrevocably elect to present subsequent changes in the investment's fair value in OCI. This election is made on an investment-by-investment basis. Financial assets within this category are subsequently measured at fair value. Dividend income and foreign exchange gains and losses are recognized in profit or loss. Other gains and losses are recognized in OCI and are never reclassified to profit or loss.
- Fair value through profit and loss ("FVTPL"): Financial assets not classified as amortized cost or FVOCI are measured at FVTPL. This includes all derivative financial instruments. On initial recognition, the Company may irrevocably designate a financial asset that otherwise meets the requirements to be measured at amortized cost or at FVOCI at FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise. These assets are subsequently measured at fair value, with net gains or losses, including any interest or dividend income, recognized through profit or loss.

IFRS 9 retains the existing requirements in IAS 39 for the classification of financial liabilities as amortized cost or FVTPL. Once the classification of a financial liability has been determined, reclassification is not permitted. Under IFRS 9, for financial liabilities that have been designated by the entity as FVTPL, changes in credit risk will be recognized in other comprehensive income, with the remainder of the changes recognized in profit or loss. However, if this requirement creates or enlarges an accounting mismatch in profit or loss, the entire change in fair value will be recognized in profit or loss.

IFRS 9 replaces the "incurred loss" model in IAS 39 and has an expected credit loss ("ECL") impairment model. The new impairment model applies to financial assets measured at cost, contract assets and debt investments at FVOCI, but not to investments in equity instruments. The Company will elect to use the lifetime ECL approach. Under this approach, the impairment allowance is recorded as a result of all possible default events over the expected life of the financial asset. ECLs are a probability-weighted estimate of credit losses. Credit losses are measured as the present value of all cash shortfalls (i.e. the difference between the cash flows due to the Company in accordance with the contract and the cash flows that the Company expects to receive) and are discounted at the effective interest rate of the financial asset. The Company considers reasonable and supportable information when assessing the credit risk of a financial asset and in estimating the ECLs. The adoption of IFRS 9 did not result in any additional impairment allowance.

The Company has elected as an accounting policy choice for non-substantial modifications of variable or fixed rate debt, if certain criteria are met, to adjust the carrying amount of the financial liability on modification for directly attributable transaction costs and any consideration paid to or received from the counterparty. The effective interest rate is then adjusted to amortize the difference between the revised carrying amount and the expected cash flows over the life of the modified instrument. No gain or loss is recognized in profit or loss. This accounting policy applies to variable or fixed rate debt that had an insignificant original issue discount that can be prepaid at par, or prepaid with insignificant prepayment fees, to the extent that modification has the effect of repricing the debt to a market rate of interest.

The adoption of IFRS 9 did not have an impact on the Company's accumulated deficit as at January 1, 2018.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

3. Significant accounting policies (continued):

(c) Amendments to IFRS 2, Share-Based Payments:

On January 1, 2018, the Company adopted the amendments to IFRS 2, *Share-Based Payments* ("IFRS 2"). The amendments to IFRS 2 address three main areas: the effects of vesting conditions on the measurement of a cash-settled share-based payment transaction, the classification of a share-based payment transaction with net settlement features for withholding tax obligations, and accounting where a modification to the terms and conditions of a share-based payment transaction changes its classification from cash-settled to equity-settled.

On January 1, 2018, as a result of adopting the amendments to IFRS 2, the Company reclassified \$0.2 million related to its restricted share unit obligation from liabilities to contributed surplus. The Company ceased to apply mark-to-market accounting on share-based payment transactions with a net settlement feature for withholding tax obligations.

4. New standards applicable in future periods:

In January 2016, the IASB issued IFRS 16, *Leases*. 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 mandatory effective date of IFRS 16 is for annual periods beginning on or after January 1, 2019. The Company is currently evaluating the impact of IFRS 16 on its consolidated financial statements.

5. Cash and cash equivalents:

	June 30, 2018	December 31, 2017
Cash	\$ 1,310	\$ 1,263
Cash equivalents	79,818	84,553
	<u>\$ 81,128</u>	<u>\$ 85,816</u>

6. 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 June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Locations in the Mr. Lube Royalty Pool at period end	118	117	118	117
Mr. Lube Royalty Pool system sales	\$ 52,683	\$ 50,593	\$ 99,745	\$ 95,621
Royalty income	3,784	3,530	7,044	6,673

Effective May 1, 2018, the royalty rate paid by Mr. Lube on non-tire sales at flagship locations has been increased by 0.5% from 6.95% to 7.45% (note 8). In addition, the Mr. Lube Royalty Pool was adjusted to include the royalties from two new Mr. Lube locations and to remove one Mr. Lube location that has been permanently closed. With the adjustment for these two new locations and one closure, the Mr. Lube Royalty Pool had 118 locations effective May 1, 2018 (note 8).

During the six months ended June 30, 2018, royalty income from Mr. Lube includes make-whole payments totaling \$0.02 million (2017 - \$0.03 million) on lost system sales of \$0.3 million (2017 - \$0.4 million). With the adjustment of the two new locations and one closure, the Company ceased to receive make-whole payments from Mr. Lube effective May 1, 2018.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

6. 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 June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Number of agents at period end	5,400	5,400	5,400	5,400
Sutton Royalty Rate (per agent per month)	\$ 58.523	\$ 57.375	\$ 58.523	\$ 57.375
Royalty income	948	929	1,896	1,858

Effective July 1, 2018, the Sutton Royalty Rate was increased from \$58.523 per agent to \$59.693 per agent, representing the 2.0% annual contractual increase in the Sutton Royalty Rate for 2018.

(c) AIR MILES:

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

Expressed in thousands of Canadian dollars	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Gross billings	\$ 197,240	n / a	\$ 370,367	\$ n / a
Royalty income	1,972	-	3,703	-

7. Royalties and management fees receivable:

	June 30, 2018	December 31, 2017
Mr. Lube	\$ 1,327	\$ 1,175
Sutton	340	340
AIR MILES	2,229	2,493
	\$ 3,896	\$ 4,008

8. Intangible assets:

	SGRS Rights	ML Rights	AIR MILES Program	Total
Balance, January 1, 2018	\$ 32,273	\$ 139,225	\$ 53,977	\$ 225,475
Mr. Lube Royalty Rate increase and store roll-in	-	10,199	-	10,199
Balance, June 30, 2018	\$ 32,273	\$ 149,424	\$ 53,977	\$ 235,674

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

8. Intangible assets (continued):

In connection with the acquisition of the ML Rights, ML LP issued 100,000,000 Class B, Class C, Class D, Class E, and Class F units to Mr. Lube. These units will become exchangeable into common shares of the Company through the exchange agreement dated August 19, 2015 among Mr. Lube, ML Royalties GP Inc. and the Company (the "Mr. Lube Exchange Agreement") upon the satisfaction of certain performance criteria. The Class B LP units of ML LP become exchangeable into common shares of the Company upon adding Mr. Lube locations to the ML Royalty Pool. The Class C, Class D, Class E, and Class F LP units become exchangeable into common shares of the Company on increases in the ML Royalty Rate of 0.5% increments four times during the life of the royalty, in accordance with the partnership agreement dated August 19, 2015 among Mr. Lube, the Company, and ML Royalties GP Inc.

On May 1, 2018, the Mr. Lube royalty rate increased by 0.5% from 6.95% to 7.45%. In exchange for increasing the Mr. Lube royalty rate, Mr. Lube received the right to exchange Class C LP units of ML LP for common shares of DIV. DIV elected to pay for the Mr. Lube royalty rate increase in cash, in lieu of common shares of DIV, which was partially financed by an increase in the term loan facility of ML LP (note 10). The total consideration paid to Mr. Lube for the royalty rate increase was \$9.2 million.

On May 1, 2018, the Mr. Lube Royalty Pool was adjusted to include two new Mr. Lube locations and to remove one Mr. Lube location that was permanently closed. The initial consideration payable to Mr. Lube for the estimated net additional royalty revenue is \$0.9 million, representing 80% of the total estimated consideration of \$1.2 million. In exchange for the net addition to the Mr. Lube Royalty Pool, Mr. Lube received the right to exchange Class B LP units of ML LP for common shares of DIV. DIV elected to pay for the initial consideration to Mr. Lube in cash, which was partially financed by an increase in the term loan facility of ML LP (note 10). The remaining consideration payable for the net additional royalty revenue will be paid to Mr. Lube on May 1, 2019, the next adjustment date, and will be adjusted to reflect the actual system sales of the two new locations added to the Mr. Lube Royalty Pool for the year ending December 31, 2018, as determined through an audit.

9. Contingencies:

In 2008, Sevenson Environmental Services Inc. ("Sevenson"), a prime contractor on a U.S. Federal Government project filed a complaint against the Company and many other persons in a U.S. court.

In 2009, the Court stayed all proceedings in this matter pending the conclusion of the Antitrust Division of the United States Department of Justice investigation into the same matter. On November 18, 2014, the stay was lifted.

On February 11, 2015, Sevenson filed its third amended complaint against the Company. The complaint alleges that employees of the Company conspired with an employee of the prime contractor relating to, among other things, the awarding of contracts during the years 2002 through 2004. Of the 21 counts in the complaint, only six name the Company as a defendant. The complaint seeks not less than approximately \$1.1 million U.S. plus the value of additional gratuities from the Company and punitive damages.

Counsel for the Company brought a motion to dismiss the third amended complaint for failure to plead enough facts to state a claim for relief that is plausible on its face. In October 2015, the Company filed a counterclaim against Sevenson. In December 2015, the Company and Sevenson agreed to non-binding mediation. This mediation was unsuccessful in resolving this issue.

On March 16, 2018, Sevenson filed a brief in a U.S. court requesting an award of approximately \$3.2 million U.S. plus interest. On the same date, the Company filed its own brief requesting summary judgment to dismiss all claims.

Management intends to defend against this claim vigorously and has prepared a significant portion of its defense and counterclaim against Sevenson. Management considers that it is not probable that a liability will result and no amount has been recorded in the Company's financial statements in respect of the complaint.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

10. Borrowings:

As at June 30, 2018, the Company had the following non-amortizing 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	\$ 6,237
ML LP term loan	BA + 1.95%	Jul 31, 2022	41,600	41,330
AM LP term loan	BA + 2.25%	Sep 6, 2022	17,400	17,231
			\$ 65,300	\$ 64,798

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

On May 1, 2018, ML LP amended its credit agreement with a Canadian chartered bank to increase its term loan facility from \$34.6 million to \$41.6 million. The increase in the term loan facility was used to partially finance the consideration paid to Mr. Lube for the increase in the Mr. Lube Royalty Rate and the net addition to the Mr. Lube royalty pool (note 8).

As at June 30, 2018, SGRS LP, ML LP and AM LP were in compliance with all financial covenants.

11. Interest rate swaps:

The Company has interest rate swap agreements that entitle the Company to receive interest at floating rates and effectively pay interest at fixed rates for 100% of the SGRS LP term loan facility, 83% of the ML LP term loan facility, and 50% of the AM LP term loan facility.

The interest rate swaps are re-measured at fair value at the end of each reporting period with fair values calculated as the present value of contractual cash flows based on quoted forward curves and discount rates incorporating the applicable yield curve. The following table summarizes the interest rate swap agreements the Company has entered into as of June 30, 2018:

	Effective date	Maturity date	Fixed interest rate	Notional amount
SGRS LP	Jun 19, 2018	Jun 21, 2021	4.64%	\$ 6,300
ML LP	Oct 14, 2015	Aug 13, 2018	3.07%	34,600
ML LP	Aug 13, 2018	Jul 31, 2022	4.17%	34,600
AM LP	Sep 6, 2017	Aug 19, 2022	4.42%	8,700

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

12. Convertible debentures:

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

	June 30, 2018	December 31, 2017
Principal amount	\$ 57,500	\$ 57,500
Equity component of debentures	(4,312)	(4,312)
Unamortized deferred financing fees	(2,306)	(2,522)
Accretion on liability component of debentures	461	105
	\$ 51,343	\$ 50,771

13. Deferred income taxes:

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

	June 30, 2018	December 31, 2017
Non-capital losses	\$ 1,426	\$ 2,225
Financing and share issuance costs	443	704
Intangible assets	293	304
Investment tax credits	199	199
Other	(63)	16
Convertible debentures	(1,040)	(1,136)
Intangible assets	(7,147)	(5,775)
Net deferred tax liability	\$ (5,889)	\$ (3,463)

As at June 30, 2018, the Company has non-capital loss carry forwards of \$5.3 million (December 31, 2017 - \$8.2 million), which can be carried forward and applied against future taxable income. The deferred tax liability as at June 30, 2018 is largely associated with the temporary differences on the Company's intangible assets, which have an undepreciated capital cost allowance of approximately \$155.3 million (December 31, 2017 - \$160.4 million).

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

14. Income per share:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Income for the period	\$ 3,040	\$ 2,690	\$ 5,670	\$ 5,003
Weighted average number of shares outstanding – basic	107,045,438	105,810,224	106,885,697	105,673,619
Dilutive adjustment for share options	69,580	86,094	79,332	84,658
Dilutive adjustment for RSUs	718,306	351,237	724,555	598,789
Weighted average number of shares outstanding – diluted	107,833,324	106,247,555	107,689,584	106,357,066
Net income per common share:				
Basic	\$ 0.03	\$ 0.03	\$ 0.05	\$ 0.05
Diluted	\$ 0.03	\$ 0.03	\$ 0.05	\$ 0.05

15. Share-based compensation:

(a) Restricted share units:

The number of RSUs outstanding is as follows:

		June 30, 2018
	Number of RSUs	Weighted average grant-date fair value
Balance, beginning of period	892,674	\$ 3.08
Granted	57,853	3.30
Dividends earned	24,673	3.27
Settled	(244,203)	2.54
Balance, end of period	730,997	\$ 3.28
Unvested	671,156	3.33
Vested	59,841	2.76

On March 30, 2018, a total of 10,617 RSUs were issued at a grant date fair value of \$3.43 per RSU to certain directors that elected to receive their compensation related to the three months ended December 31, 2017 in the form of RSUs. These RSUs fully vested on April 2, 2018.

On April 13, 2018, a total of 1,396 RSUs were issued at a grant date value of \$3.31 per RSU to certain directors that elected to receive their compensation related to the three months ended March 31, 2018 in the form of RSUs. These RSUs fully vest on March 25, 2021.

On April 13, 2018, a total of 45,840 RSUs were issued to five directors at a grant date fair value of \$3.27 per RSU, of which one-third vests on March 25, 2019, one-third vests on March 25, 2020 and the remainder vests on March 25, 2021.

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

15. Share-based compensation (continued):

(b) Share options:

The number of share options outstanding is as follows:

	June 30, 2018	
	Number of options	Weighted average exercise price
Balance, beginning of period	2,481,400	\$ 3.15
Exercised	(129,900)	1.79
Balance, end of period	2,351,500	\$ 3.22

The following table summarizes information relating to outstanding and exercisable options as at June 30, 2018:

Exercise prices	Options outstanding			Options exercisable	
	Number of options	Weighted average remaining life (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$ 1.50	51,500	0.00	\$ 1.50	51,500	\$ 1.50
\$ 3.22 - \$ 3.53	2,300,000	4.30	3.26	-	-
	2,351,000	4.21	\$ 3.22	51,500	\$ 1.50

16. Other finance income, net:

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Foreign exchange gain (loss)	\$ 7	\$ (3)	\$ 12	\$ (4)
Finance income	363	196	725	397
Amortization of deferred financing charges	(135)	(38)	(271)	(74)
Accretion expense	(179)	-	(356)	-
Other finance income, net	\$ 56	\$ 155	\$ 110	\$ 319

DIVERSIFIED ROYALTY CORP.

Notes to Condensed Consolidated Interim Financial Statements
(Unaudited)
(Tabular amounts expressed in thousands of Canadian dollars)

For the three and six months ended June 30, 2018 and 2017

17. Financial instruments:

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

	June 30, 2018	December 31, 2017
Assets carried at amortized cost:		
Cash and cash equivalents	\$ 81,128	\$ 85,816
Royalties and management fees receivable	3,896	4,008
Amounts receivable	120	150
	\$ 85,144	\$ 89,974
Assets carried at fair value:		
Interest rate swap assets	\$ 232	\$ 160
Liabilities carried at amortized cost:		
Accounts payable and accrued liabilities	\$ 780	\$ 1,354
Long-term bank loans	64,798	57,772
Convertible debentures	51,343	50,771
	\$ 116,921	\$ 109,897
Liabilities carried at fair value:		
Restricted share unit obligation	\$ -	\$ 218

18. Supplemental cash flow information:

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

	Long-term debt	Debentures	Total
Balance, December 31, 2017	\$ 57,772	\$ 50,771	\$ 108,543
Cash flows from (used in) financing activities:			
Proceeds from increase in long-term debt	7,000	-	7,000
Debt re-financing costs	(29)	-	(29)
Liability-related other changes:			
Amortization of deferred financing charges	55	216	271
Accretion expense	-	356	356
Balance, June 30, 2018	\$ 64,798	\$ 51,343	\$ 116,141