

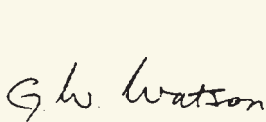
Consolidated Balance Sheets

As at December 31

	2005	2004
Assets		
Capital assets (note 4)	\$452,076,153	\$235,199,298
Cash and cash equivalents (note 3)	4,885,126	4,168,071
Accounts receivable	544,683	189,320
Income tax receivable	–	214,897
Other assets (note 5)	6,058,020	723,577
Deferred financing costs (net)	4,767,996	1,022,929
Future income taxes (note 11)	1,184,547	1,327,609
	\$469,516,525	\$242,845,701
Liabilities and Shareholders' Equity		
Mortgages and loans payable (note 6)	\$302,821,105	\$159,900,874
Convertible debentures (note 7)	40,718,111	–
Credit facility (note 8)	16,943,000	–
Accounts payable & accrued liabilities	7,057,797	2,967,334
Income tax payable	173,139	–
Security deposits	1,349,199	644,943
Future income taxes (note 11)	5,610,506	1,358,006
	374,672,857	164,871,157
Shareholders' Equity		
Capital stock (note 9)	92,900,223	77,809,075
Contributed surplus (note 9)	405,420	233,984
Other paid-in capital (note 7)	1,601,693	–
Deficit	(63,668)	(68,515)
	94,843,668	77,974,544
	\$469,516,525	\$242,845,701

See accompanying notes

On behalf of the Board



G. Wayne Watson
Director



Philip Fraser
Director

Consolidated Statements of Income and Deficit

For the year ended December 31

	2005	2004
Revenue		
Rental income	\$47,764,779	\$18,774,676
Interest income	165,813	193,317
Other income	425,790	55,173
	48,356,382	19,023,166
Property expenses		
Property operating expenses	20,191,154	7,988,349
	28,165,228	11,034,817
Mortgage and loan interest	12,989,928	5,196,286
Convertible debenture interest	1,912,038	–
Depreciation	9,864,194	3,502,271
Amortization of deferred financing	548,362	351,891
General and administrative	2,013,776	1,273,388
Professional fees	256,984	186,923
Provincial capital taxes	209,250	100,000
Interest and bank charges	93,966	45,691
	27,888,498	10,656,450
Income before income taxes	276,730	378,367
Provision for income taxes (note 11)		
– current	(59,028)	–
– future	(212,855)	(144,234)
Net income	4,847	234,133
Deficit, beginning of year	(68,515)	(67,372)
Adjustment to opening balance (note 2)	–	(235,276)
Deficit, end of year	\$ (63,668)	\$ (68,515)
Net income per share (note 13)		
– basic	\$ 0.0001	\$ 0.0040
– diluted	\$ 0.0001	\$ 0.0040

See accompanying notes

Consolidated Statements of Cash Flows

For the year ended December 31

	2005	2004
Operating Activities		
Net income	\$ 4,847	\$ 234,133
Add items not affecting cash		
Depreciation and amortization	10,412,556	3,854,162
Non-cash debenture interest	119,804	–
Non-cash compensation expense	172,669	–
Future income taxes	212,855	144,234
Funds from operations	10,922,731	4,232,529
Net change in non-cash working capital items related to operations	3,992,949	1,699,489
Cash provided by operating activities	14,915,680	5,932,018
Financing Activities		
Issue of common shares for cash (net of issue costs)	14,549,924	42,752,508
Issuance of convertible subordinated debentures	42,200,000	–
Increase in deferred financing	(4,293,429)	(976,963)
Increase in credit facility	16,943,000	–
Issuance of long-term debt	108,927,109	83,790,860
Repayment of long-term debt	(8,386,193)	(8,505,483)
Cash provided by financing activities	169,940,411	117,060,922
Investing Activities		
Purchase of capital assets	(184,139,036)	(132,008,429)
Cash used in investing activities	(184,139,036)	(132,008,429)
Net increase (decrease) in cash and cash equivalents	717,055	(9,015,489)
Cash and cash equivalents, beginning of period	4,168,071	13,183,560
Cash and cash equivalents, end of period	\$ 4,885,126	\$ 4,168,071
Cash interest paid	\$ 14,301,365	\$ 4,815,016
Cash taxes paid	\$ 4,905	\$ 385,834

Notes to Consolidated Financial Statements

1. Incorporation

Killam Properties Inc. (the "Company") is a real estate corporation specializing in the acquisition and management of multi-residential apartment buildings and manufactured home communities. The Company is incorporated under the Canada Business Corporations Act.

2. Summary of Significant Accounting Policies

Basis of presentation

These financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries.

Use of accounting estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Cash and cash equivalents

Cash and cash equivalents consist of cash, restricted cash and short-term investments. Short-term investments consist of short-term monetary investments with maturities not exceeding three months and are recorded at cost which approximates fair market value.

Revenue recognition

Revenue from rental properties is recognized when a tenant commences occupancy of a rental suite and rent is due. The Company retains all of the benefits and risks of ownership of its rental properties and therefore accounts for leases with its tenants as operating leases. Rental revenue includes rent, laundry, parking and other sundry revenues.

Income taxes

The Company follows the liability method of accounting for income taxes. Under this method future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the future tax assets and liabilities are expected to be realized or settled. The effect of a change in income tax rates on future income tax assets and liabilities is recognized in income in the period that the change occurs.

Capital assets

Revenue producing real estate properties held as ongoing investments are recorded at cost less accumulated amortization and net of any impairment loss. Cost includes all expenditures incurred in connection with the acquisition of real estate property including all direct costs. All costs associated with capital improvements, other than ordinary repairs and maintenance, are capitalized and amortized over terms appropriate to the expenditure.

2. Summary of Significant Accounting Policies (continued)

Amortization

Capital assets are amortized at rates designed to amortize the cost of the properties over their useful lives as follows:

Buildings	2% – 2.5%	straight-line, 40 – 50 years
Roads & driveways	4%	declining balance
Water & sewer	6%	declining balance
Suite renovations	20%	declining balance
Project improvements	10%	declining balance
Other assets	5% – 30%	declining balance

Deferred financing costs

Financing fees and other costs incurred in connection with debt financing are amortized on a straight-line basis over the term of such financing. Upon refinancing, any financing costs associated with previous mortgages are written off to income. Canadian Mortgage and Housing insurance premiums are amortized over the mortgage amortization period.

Stock-based compensation

Effective January 1, 2004 the Company retroactively adopted, without restatement, CICA Handbook section 3870, Stock Based Compensation and Other Stock Based Payments which requires the expensing of the fair value of stock options. The impact of adopting the Handbook section was a charge to January 1, 2004 opening retained earnings of \$235,276 and a corresponding increase in contributed surplus representing the fair value of options granted subsequent to January 1, 2002 and vested as of January 1, 2004. The Company determines the fair value of the options at the date of grant using the Black-Scholes option pricing model and recognizes the fair value over the vesting period as compensation expense and contributed surplus. When stock options are exercised, the corresponding contributed surplus is transferred to capital stock.

Net income per share

Diluted net income per share is calculated using the treasury stock method which recognizes the use of proceeds that could be obtained upon exercise of stock options. This method assumes that any proceeds would be used to purchase common shares at the average market price during the period.

Convertible subordinated debentures

On issuance of subordinated debentures convertible into common shares of the Company, the fair value of the holders' conversion option is reflected as "Other paid-in capital". The Company's obligation to debenture holders for future interest and principal payments is reflected as a liability carried at amortized cost. If the holders exercise their conversion option, common shares issued on conversion will be recorded at an amount equal to the aggregate carrying value of the liability and conversion option extinguished, with no gain or loss recognized.

Derivative instruments

Periodically, the Company enters into oil futures contracts to hedge its exposure to rising oil prices. Hedge accounting is applied in accordance with CICA Accounting Guideline 13 "Hedging Relationships" and any realized gains or losses resulting from the settlement of these contracts are expensed in the period of settlement.

3. Cash and Cash Equivalents

	2005	2004
Cash	\$1,211,738	\$2,006,934
Tenant security deposits	539,589	397,788
Restricted cash	3,133,799	1,763,349
	\$4,885,126	\$4,168,071

Restricted cash includes deposits on real estate properties and property tax reserves.

4. Capital Assets

	2005		2004	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Land	\$ 45,525,506	\$ –	\$ 23,905,349	\$ –
Buildings	319,637,430	8,499,728	185,521,711	2,727,714
Roads and driveways	36,924,444	1,303,561	11,941,998	314,694
Water and sewer	36,950,269	1,947,734	11,969,000	472,306
Suite renovations	6,819,881	1,003,152	1,708,817	252,691
Project improvements	14,690,865	714,438	2,544,731	148,530
Other assets	5,473,155	476,784	1,688,895	165,268
	\$466,021,550	\$13,945,397	\$239,280,501	\$4,081,203
Less: accumulated amortization	(13,945,397)		(4,081,203)	
	\$452,076,153		\$235,199,298	

During the year ended December 31, 2005, the Company capitalized indirect costs of \$1.3 million (2004 – \$0.3 million) as part of its project improvement and suite renovation program. In addition, \$0.1 million of interest expense was capitalized as part of the Company's repositioning project of two properties (2004 – \$Nil).

5. Other Assets

	2005	2004
Prepaid	\$1,203,535	\$686,336
Deferred charges	354,485	37,241
Goodwill	4,500,000	–
	\$6,058,020	\$723,577

Goodwill presented above is the tax effect of the Company's acquisition of two properties through share purchase transactions. The offsetting liability is presented in Note 11, income taxes.

6. Mortgages and Loans Payable

Mortgages payable of \$291,760,750 (December 2004 – \$154,085,874) bear interest at fixed rates from 3.32% to 8.47% with maturity dates ranging from May 2006 to July 2019. Vendor mortgages and loans payable of \$11,060,355 (December 2004 – \$5,815,000) bear interest at fixed rates from 0.00% to 7.25% with maturity dates ranging from April 2006 to September 2010. Mortgages are secured by a first or second charge on the properties of the Company and vendor mortgages are secured by either a second charge on the property or a general corporate guarantee.

The weighted average mortgage rate at December 31, 2005 was 5.6% (2004 – 5.9%).

Principal repayments of mortgages and loans are due as follows:

Year	
2006	\$ 20,063,909
2007	14,170,936
2008	48,088,869
2009	65,072,172
2010	47,571,955
Thereafter	107,853,264
	<hr/> \$302,821,105 <hr/>

7. Convertible Subordinated Debentures

The Company's \$42.2 million convertible subordinated debentures bear interest at a fixed rate of 6.5% payable semi-annually to their maturity at May 2012. The debentures are convertible into common shares of the Company at a share price of \$3.10 at any time after May 2007. At the time of issuance, the fair value of the Company's obligation to make principal and interest payments was \$40.6 million and the fair value of the holders' conversion option was \$1.6 million (which is reflected in "other paid-in capital"). The effective rate of interest on the liability component is calculated at 7.2%.

8. Credit Facilities

The Company has negotiated credit facilities set out as follows:

Operating Facility

Consists of a \$500,000 revolving demand facility for general business purposes, bearing interest at the lender's prime plus 1%. As at December 31, 2005 the Company had a \$Nil balance (2004 – \$Nil) related to this facility. The agreement includes certain restrictive covenants and undertakings of which the Company is in compliance.

Acquisition Bridge Facility

This agreement consists of two facilities:

- (a) \$20,000,000 senior revolving facility to fund asset acquisitions, bearing interest at the greater of prime plus 3.75% or 8.0% plus a 0.6% fee on undrawn amounts (expensed monthly). As at December 31, 2005 the Company had a \$16,943,000 balance outstanding (2004 – \$Nil) related to this facility. The agreement includes certain restrictive covenants and undertakings of which the Company is in compliance.
- (b) \$20,000,000 revolving senior secured facility to fund asset acquisitions bearing interest at the greater of prime plus 5.0% or 9.25%. As at December 31, 2005, the Company had a \$Nil balance outstanding (2004 – \$Nil) related to this facility. The agreement includes certain restrictive covenants and undertakings of which the Company is in compliance.

9. Capital Stock and Contributed Surplus

Capital Stock

Authorized:

Unlimited number of common shares.

Unlimited number of preferred shares, issuable in series.

Issued:

The following table summarizes the changes in issued common shares of the Company:

	2005		2004	
	Number of Shares	Value	Number of Shares	Value
Balance, beginning of year	74,856,631	\$77,809,075	48,038,674	\$30,687,095
Issued for cash ⁽ⁱ⁾	6,000,000	14,476,668	22,080,000	39,277,383
Issued on property acquisitions ⁽ⁱⁱ⁾	84,906	223,931	1,616,457	3,338,738
Stock options exercised ⁽ⁱⁱⁱ⁾	392,000	73,256	330,000	90,730
Warrants exercised ^(iv)	–	–	2,791,500	3,384,395
Tax benefit of issuance costs	–	317,293	–	1,030,734
Balance, end of year	81,333,537	\$92,900,223	74,856,631	\$77,809,075

(i) Net of issuance costs of \$823,332 (2004 – \$2,674,617)

(iii) Net of issuance costs of \$10,577 (2004 – \$Nil)

(ii) Net of issuance costs of \$1,070 (2004 – \$11,490)

(iv) Net of issuance costs of \$Nil (2004 – \$122,055)

The shares issued on property acquisitions formed a portion of the total purchase price of the acquisition negotiated with third parties. The amount allocated to share capital was the residual of the total purchase price less cash considerations.

Contributed Surplus

	2005	2004
Balance, beginning of year	\$233,984	\$ –
Adjustment ⁽ⁱ⁾	–	235,276
Stock options expensed	172,669	2,938
Stock options exercised	(1,233)	(4,230)
Balance, end of year	\$405,420	\$233,984

(i) Adjustment upon adoption of CICA Handbook Section 3870, see Note 2.

10. Stock Options and Warrants

Under the terms of the stock option plan:

- (i) the Company designates from time to time eligible participants to whom options will be granted, and the number of shares to be optioned to each;
- (ii) eligible participants are persons who are employees, officers, directors and consultants of the Company;
- (iii) shares to be optioned shall not exceed 5,500,000 (December 31, 2004 – 2,525,000) and the total number of shares to be optioned to any eligible participant shall not exceed 10% of the issued and outstanding shares of the class as at the date such option is granted;
- (iv) the option price for the shares is determined at the time of granting of the option but cannot be less than the fair market value of the shares at the time the option is granted less any applicable discount permitted by the Toronto Stock Exchange; and
- (v) the term during which any option granted may be exercised is determined by the Company at the time the option is granted but may not exceed the maximum period permitted from time to time by the Toronto Stock Exchange.

10. Stock Options and Warrants (continued)

Options granted and exercised during the year are as follows:

	2005		2004	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, beginning of year	1,732,000	\$0.47	2,052,000	\$0.43
Granted	1,779,500	2.05	10,000	2.00
Exercised	(392,000)	0.21	(330,000)	0.26
Expired/cancelled	(11,000)	1.92	–	–
Outstanding, end of year	3,108,500	\$1.40	1,732,000	\$0.47

The fair value of each option granted was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants:

	2005	2004
Expected volatility	29.1%	53.5%
Risk-free interest rate	2.5%	3.5%
Expected lives	5 Years	1–5 Years
Expected dividend yield	Nil	Nil

The following table summarizes the stock options outstanding at December 31:

	2005		2004	
Exercise prices	Number of Options Outstanding	Remaining Contractual Life	Number of Options Outstanding	Remaining Contractual Life
\$0.20	–	–	350,000	.95 years
\$0.30	471,000	1.40 years	513,000	2.40 years
\$0.30	10,000	1.44 years	10,000	2.44 years
\$0.56	200,000	2.44 years	200,000	3.44 years
\$0.65	608,500	2.44 years	609,500	3.44 years
\$1.30	10,000	2.92 years	10,000	3.92 years
\$1.69	29,500	2.96 years	29,500	3.96 years
\$2.00	10,000	3.92 years	10,000	4.92 years
\$2.05	1,769,500	4.42 years	–	–
	3,108,500		1,732,000	

Included in the above figures are 1,528,052 options at an average exercise price of \$2.04, that were not exercisable at December 31, 2005, as they had not vested (2004 – 15,600 options at an average exercise price of \$1.50).

Warrants

The Company has issued warrants as part of certain financing and equity arrangements as follows:

	2005		2004	
Exercise price	Number of Options Outstanding	Remaining Contractual Life	Number of Options Outstanding	Remaining Contractual Life
\$0.95	500,000	2.66 years	500,000	3.66 years

The outstanding warrants consist of 500,000 warrants at \$0.95 issued upon obtaining the credit facility which expire August 27, 2008.

11. Income Taxes

The income tax provisions differ from that computed using the statutory rates for the following reasons:

	2005		2004	
Net income before income taxes	\$276,730		\$378,367	
Income taxes at statutory rates	\$102,943	37.2%	\$139,996	37.0%
Non-deductible share compensation	64,233	23.2%	–	–
Non-deductible debenture interest	44,567	16.1%	–	–
Other differences	1,112	0.4%	4,238	1.1%
Future tax expense	212,855	76.9%	144,234	38.1%
Federal large corporation tax	59,028		–	
	\$271,883		\$144,234	

Future income taxes reflect the net effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future income tax assets and liabilities are as follows:

	2005	2004
Share issue costs	\$ 1,184,547	\$1,327,609
Capital assets	(1,110,506)	(1,358,006)
Goodwill	(4,500,000)	–
Net future income tax liability	\$(4,425,959)	\$ (30,397)

12. Segmented Information

The Company operates in two segments of the multi-family residential industry; multi-family apartments and manufactured home communities.

The accounting policies of these segments are the same as those described in the summary of significant accounting policies. The segments are analyzed based on earnings from property operations before amortization. The operating results and capital assets of the segments as at and for the years ended December 31, 2005 and 2004 are set out as follows:

As at and for the year ended December 31, 2005

	Multi-family Apartments	Manufactured Home Communities	Corporate	Total
Revenue	\$39,267,338	\$8,822,121	\$266,923	\$48,356,382
Property operating expenses	17,001,309	3,189,845	–	20,191,154
Earnings from property operations	\$22,266,029	\$5,632,276	\$266,923	\$28,165,228
Capital assets (net)	\$369,791,124	\$81,562,201	\$722,828	\$452,076,153

As at and for the year ended December 31, 2004

	Multi-family Apartments	Manufactured Home Communities	Corporate	Total
Revenue	\$16,424,809	\$2,401,678	\$196,679	\$19,023,166
Property operating expenses	7,133,453	854,896	–	7,988,349
Earnings from property operations	\$9,291,356	\$1,546,782	\$196,679	\$11,034,817
Capital assets (net)	\$208,544,930	\$26,283,045	\$371,323	\$235,199,298

13. Per Share Information

Net income per share has been calculated based on the weighted average number of shares outstanding as follows:

	2005	2004
Basic	78,862,486	60,680,934
Fully diluted	81,064,082	63,968,302

The diluted share amounts presented above exclude the convertible debentures as the effect would have been anti-dilutive.

14. Financial Instruments

The Company is exposed to financial risk that arises from, among other factors, fluctuation in interest rates and the credit quality of its tenants. These risks are managed as follows:

(i) *Interest rate risk*

Interest rate risk is minimized through management's periodic review of its mortgage portfolio. If market conditions warrant, the Company will renegotiate its existing debt to take advantage of lower interest rates. The Company will also structure its debt so as to stagger the debt maturities, thereby minimizing the Company's exposure to interest rate fluctuations.

(ii) *Credit risk*

Credit risk arises from the possibility that tenants may experience financial difficulty and be unable to fulfill their lease term commitments. The Company mitigates the risk of credit loss through the diversification of its existing portfolio and limiting its exposure to any one tenant. Credit assessments are conducted with respect to all new leasing and the Company also obtains a security deposit to assist in potential recovery requirements.

Fair Value

Financial instruments are defined as a contractual right to receive or deliver cash or another financial asset. The fair values of the Company's financial instruments, except for long-term debt, approximate their recorded values at December 31, 2005 and December 31, 2004 due to their short-term nature and or the credit terms of those instruments.

The fair value of the mortgages payable has been determined by discounting the cash flows using current market rates of similar investments. These estimates are subjective in nature and therefore cannot be determined with precision. The fair value of long-term debt is approximately \$313,950,000 (2004 – \$162,165,500) compared to its book value of \$302,821,105 (2004 – \$159,900,874).

As at December 31, 2005, the Company had \$167,729 worth of oil futures contracts outstanding.

15. Related Party Transactions

During 2005 the Company paid real estate commissions of \$103,750 and construction and management fees of \$47,995 to a Company controlled by a Director (2004 – real estate commissions of \$39,000 and construction management fees of \$67,400). The commissions and management fees were based on market rates and there is no continuing contractual obligation to use the service of the related party.

16. Subsequent Events

During the period of January 1 to March 7, 2006 the Company completed 8 property acquisitions representing 664 units. The total purchase price of \$32.5 million was satisfied through mortgages totaling \$23.2 million and \$9.3 million from the Company's cash and acquisition facilities. In addition, the Company has increased financing on certain properties by \$0.7 million.

On January 5 and March 17, 2006 the Company completed \$5 million private placements of unsecured subordinated debentures and warrants. The debentures and warrants have terms of seven years. The debentures bear coupon rates of 5.92% and 6.06% respectively. The warrants are convertible into common shares of the Company at exercise prices of \$3.60 and \$3.80 per share respectively.

17. Comparative Figures

Certain comparative figures have been reclassified to conform to the presentation adopted for 2005.