# 2018 Annual Report

**Quality Assets. Sustainable Dividends.**

Freehold
ROYALTIES LTD.

# Corporate Overview

Freehold Royalties Ltd. ("Freehold") is a Canadian royalty company that receives oil and natural gas revenue from approximately 300 industry operators that conduct operations on our diverse portfolio of properties in western Canada. Our business model is focused on actively managing and growing our portfolio of mineral and royalty properties. We use our free cash flow to acquire additional royalties and pay dividends to our Shareholders. Freehold's Common shares trade on the Toronto Stock Exchange under the symbol FRU.

## 2018 HIGHLIGHTS

| 8% | 0.7 | 99% | 86% |
|---|---|---|---|
| YIELD | NET DEBT/FUNDS FROM OPERATIONS | OPERATING INCOME FROM ROYALTIES | REVENUE FROM OIL & NGL |

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# PRESIDENT'S MESSAGE

2018 was another successful year for Freehold as we maintained our identity as a lower risk oil and gas investment.

We became a pure play royalty company, with royalty production averaging 10,718 boe/d for the year, representing 94% of total volumes and over 99% of operating income. Despite egress and infrastructure constraints within Canada that drove commodity prices lower, our liquids weighted royalty portfolio continues to attract capital as gross spending on our land increased by approximately 50% year-over-year. On the acquisition front, we completed $62 million in transactions adding a combination of low decline and emerging royalty assets. We are forecasting royalty production to average 9,900 boe/d - 10,300 boe/d in 2019. This does not include our non-core working interest production, which we will be continuing to reduce.

We are maintaining our monthly dividend at $0.0525 per share. This is consistent with our dividend strategy of positioning our adjusted payout between 60%-80% of funds from operations. Our forecasted adjusted payout ratio for 2019 is 76%. We continue to maintain significant financial flexibility with our year end 2019 net debt to funds from operations expected to be 0.7 times, at the lower end of our leverage thresholds.

Early in the year, we held our inaugural Investor Day, unveiling our Asset Book which highlights the quality of our asset base as well as our multi-year upside on Freehold's royalty lands. As a leading royalty company, Freehold's objective is to deliver lower risk attractive returns to shareholders over the long term, which we believe we have continued to provide during 2018.

**Thomas J. Mullane**
**President and CEO**

# MANAGEMENT'S DISCUSSION AND ANALYSIS

*The following Management's Discussion and Analysis (MD&A) was prepared as of March 7, 2019 and is management's opinion about the consolidated operating and financial results of Freehold Royalties Ltd. and its wholly-owned subsidiaries (collectively, Freehold) for the year ended December 31, 2018 and previous periods, and the outlook for Freehold based on information available as of the date hereof.*

The financial information contained herein was based on information in the consolidated financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRS), which are the Canadian generally accepted accounting principles (GAAP) for publicly accountable enterprises. All comparative percentages are between the years ended December 31, 2018 and 2017, and all dollar amounts are expressed in Canadian currency, unless otherwise noted. This MD&A should be read in conjunction with the audited financial statements and notes.

This MD&A contains the following non-GAAP financial measures: operating income, operating netback, basic payout ratio, adjusted payout ratio, free cash flow and cash costs. These are useful supplemental measures to analyze operating performance, financial leverage, and liquidity, among others. However, these terms do not have any standardized meanings prescribed by GAAP and therefore may not be comparable with the calculations of similar measures for other entities. In addition, this MD&A contains forward-looking statements that are intended to help readers better understand our business and prospects. Readers are cautioned that the MD&A should be read in conjunction with our disclosure under "Non-GAAP Financial Measures" and "Forward-Looking Statements" included at the end of this MD&A.

### MD&A CONTENTS

# Business Overview

Freehold is a dividend-paying corporation incorporated under the laws of the Province of Alberta and trades on the Toronto Stock Exchange under the symbol FRU. We receive revenue from oil and natural gas properties as reserves are produced over the economic life of the properties. Our primary focus is acquiring and managing oil and natural gas royalties.

## The Royalty Advantage

We manage one of the largest non-government portfolios of oil and natural gas royalties in Canada. Our total land holdings encompass approximately 6.4 million gross acres, greater than 98% of which are royalty lands. Our mineral title lands (including royalty assumption lands), which we own in perpetuity, cover approximately 1.1 million acres and we have gross overriding royalty interests in approximately 5.1 million acres.

We have interests in more than 44,000 wells (of which over 43,500 are royalty wells including over 23,000 unitized wells). We receive royalty income from approximately 300 industry operators. Royalty rates vary from less than 1.0% (for some gross overriding royalties) to 22.5% (for some lessor royalties). This diversity lowers our risk, and as a royalty owner, we benefit from the drilling activity of others on our lands.

As a royalty interest owner, we generally do not pay any of the capital costs to drill and equip the wells for production on most of our properties, nor do we incur costs to operate the wells, maintain production, and ultimately restore the land to its original state. Generally, all of these costs are paid by others. On the majority of our production, we receive royalty income from gross production revenue (revenue before any royalty expenses and operating costs are deducted). Our operating income is nearly 100% derived from our royalty properties which results in strong netbacks.

When Freehold was formed in 1996, all of our royalty lands were leased to third parties and producing. Over the years, our unleased mineral title acreage has grown – through acquisitions, lease expiries, surrenders, and defaults. We now have approximately 460,000 acres of unleased mineral titles.

## Our Strategy

As a leading royalty company, Freehold's objective is to deliver growth and lower risk attractive returns to shareholders over the long term. Freehold accomplishes this by:

- **Creating value**
  - Drive oil and gas development on our lands through our lease out programs.
  - Acquire royalty assets with acceptable risk profiles and long economic life.
  - Generate gross overriding royalties for revenue growth.
- **Enhancing value**
  - Maximize our royalty interests through a comprehensive audit program.
  - Manage our debt prudently with a target below 1.5 times net debt to funds from operations.
- **Delivering value**
  - Target a dividend with an adjusted payout ratio of 60%-80%.

# 2018 Highlights

2018 was another strong year for Freehold. We continue to execute on our strategy of providing shareholders with a sustainable dividend and improving netbacks, while enhancing our royalty portfolio through acquisitions. Overall, Freehold continues to position itself as a lower risk oil and gas investment with upside to commodity prices and drilling activity in western Canada.

**Annual Highlights**

| ($000s, except as noted) | 2018 | 2017 | 2016 |
|---|---|---|---|
| Royalty and other revenue | **145,236** | 151,894 | 129,968 |
| Revenue, net of royalty expense | **144,542** | 150,720 | 128,651 |
| Net income (loss) | **14,032** | 12,218 | (11,163) |
| Per share, basic and diluted ($) | **0.12** | 0.10 | (0.10) |
| Funds from operations | **121,287** | 123,788 | 94,211 |
| Per share ($) | **1.03** | 1.05 | 0.85 |
| Total assets | **888,299** | 956,284 | 1,007,450 |
| Long-term debt | **90,000** | 90,000 | 84,000 |
| Total long-term liabilities | **100,109** | 106,025 | 108,637 |
| Dividends declared | **73,928** | 68,479 | 59,502 |
| Per share ($) (1) | **0.6250** | 0.58 | 0.54 |
| Net debt | **89,375** | 68,621 | 73,161 |
| Weighted average shares outstanding, basic (000s) | **118,266** | 118,044 | 110,391 |
| Shares outstanding at year-end (000s) | **118,403** | 118,183 | 117,918 |
| Royalty production (boe/d) (2) | **10,718** | 10,963 | 9,936 |
| Total production (boe/d) (2) | **11,410** | 12,350 | 12,219 |
| Operating netback ($/boe) (3) | **33.30** | 31.00 | 24.83 |

(1) Based on the number of shares issued and outstanding at each record date.
(2) Average daily production. See Conversion of Natural Gas to Barrels of Oil Equivalent (boe).
(3) See Non-GAAP Financial Measures.

- Achieved average royalty production of 10,718 boe/d, representing a 2% decrease versus 2017 as acquisition and royalty drilling production additions did not fully offset natural declines and lower prior period adjustments. Total production averaged 11,410 boe/d, an 8% decrease versus 2017, as we completed significant dispositions within our working interest portfolio. Total production volumes were comprised of 54% oil and natural gas liquids (NGL) and 46% natural gas. Production was enhanced by the strength of our audit and compliance functions which added over 400 boe/d and $8.0 million to 2018 results.
- Funds from operations totaled $121.3 million or $1.03 per share, down from $123.8 million or $1.05 per share in 2017. The decrease year-over-year reflected a combination of lower gas prices and reduced production volumes offset by slightly higher oil prices in 2018 and lower operating expenses.
- Dividends declared totaled $73.9 million ($0.6250 per share), up from $68.5 million ($0.58 per share) in 2017. Freehold increased its monthly dividend by 5% in April 2018.

- Exited 2018 with net debt of $89.4 million, implying net debt to funds from operations of 0.7 times. At year end we had $90.0 million of available capacity within our credit facility.
- Freehold completed $61.7 million in royalty acquisitions in 2018, adding new lands in the emerging Clearwater and Duvernay plays and further bolstering our key land positions in southeast and southwest Saskatchewan.
- Proved plus probable net reserves totaled 30.9 mmboe, down from 35.3 mmboe in 2017, mostly reflecting working interest dispositions and 2018 production. A detailed review of Freehold's reserve information was provided as part of the Annual Information Form (AIF). A copy of the AIF can be found on Freehold's website at www.freeholdroyalties.com or www.sedar.com.

# Outlook

## Business Environment

2018 marked a challenging period for Canadian oil and gas producers as macroeconomic headwinds put downward pressure on prices. Challenges were primarily related to egress and infrastructure constraints specific to Canada, increasing the discount Canadian benchmarks realized versus comparable crude and natural gas reference prices including West Texas Intermediate (WTI) and NYMEX. On December 2, 2018, the Government of Alberta announced that, commencing January 1, 2019, it would mandate a short-term reduction in provincial crude oil and crude bitumen production. The first curtailment order took effect on January 1, 2019, limiting province-wide production of crude oil and crude bitumen to 3.6 million bbl/d—a reduction of approximately 8.7% of total daily average crude oil production in Alberta during December 2018. As a result of decreasing price differentials and volumes of crude oil and crude bitumen in storage, the Government of Alberta announced on January 30, 2019, that it would ease the mandatory production curtailment beginning February 1, 2019, increasing the allowable production cap by 75,000 bbl/d to a maximum output of approximately 3.6 million bbl/d. In the near-term, we expect prices both for crude oil and natural gas to be challenged until positive inroads are made in getting Canadian volumes to alternative markets.

Outside of Canada, WTI oil price improved in 2018 averaging US$64.77/bbl or 27% above the average price realized in 2017. The Edmonton Light Sweet oil price failed to realize the same level of momentum averaging $69.19/bbl in 2018, representing a 10% improvement versus 2017. Western Canadian Select (WCS) price was impacted the greatest by the lack of infrastructure, averaging $49.63/bbl, down 2% versus 2017. On the natural gas front, AECO prices averaged $1.53/mcf, down 37% year-over-year.

The Petroleum Services Association of Canada (PSAC) is currently projecting 6,600 wells drilled in 2019, down 5% versus the final revised forecast for 2018. PSAC based its 2019 forecast on average natural gas prices of $1.45/mcf AECO and a WTI price of US$69.00/bbl and the Canadian dollar averaging $0.80/US$.

## Drilling Activity

Including drilling associated with acquisitions, 719 (21.3 net) wells were drilled on our royalty lands in 2018, a 55% increase versus 2017 on a gross measure and a 4% decrease on a net measure. Of the net wells drilled, 27% were drilled on mineral title lands (139 gross non-unit wells). There was a continued shift towards oil investment on our royalty lands, with 94% of the drilling focused on oil targets. Activity continues to be driven by well-capitalized operators in the southwest

Saskatchewan Viking, southeast Saskatchewan Mississippian carbonates, central Alberta Mannville heavy and light oil plays, and west central Alberta Cardium oil. Looking into 2019, we remain optimistic that activity levels will remain strong on our royalty lands, similar to 2018, with strong results expected in the Alberta and Saskatchewan Viking.

## 2019 Guidance

The following table summarizes our key operating assumptions for 2019.

- We are assuming an average royalty production range of 9,900 boe/d to 10,300 boe/d, which is expected to be approximately 96% of our total production. Income from royalty properties is expected to be 100% of operating income. Royalty volumes are expected to be weighted approximately 58% oil and natural gas liquids (NGL) and 42% natural gas. In addition, we have forecast 400 boe/d to 500 boe/d of non-core working interest volumes.
- We are currently forecasting 20 net wells will be drilled on our lands in 2019, representing a 6% decrease over 2018.
- We are assuming WTI and Edmonton Light Sweet oil price assumptions of US$55.00/bbl and $61.00/bbl respectively, and AECO at $1.60/mcf.
- Our general and administrative expense assumption is forecast at $3.00/boe and total cash costs are forecast to be approximately $5.25/boe.
- With our monthly dividend remaining at $0.0525 per share, we expect our 2019 adjusted payout ratio ((dividends paid plus capital expenditures)/funds from operations) to be approximately 76%.
- We forecast year-end net debt to funds from operations of approximately 0.7 times based on our key operating assumptions (with no acquisition activity).

### Key Operating Assumptions

| 2019 Annual Average | | Guidance Dated Mar. 7, 2019 |
|---|---|---|
| Royalty production (excludes working interest production) | boe/d | 9,900-10,300 |
| West Texas Intermediate (WTI) crude oil | US$/bbl | 55.00 |
| AECO natural gas | Cdn$/Mcf | 61.00 |
| Exchange rate | Cdn$/US$ | 1.60 |
| Operating costs | $/boe | 0.76 |
| General and administrative costs [(1)] | $/boe | 3.00 |
| Weighted average shares outstanding | millions | 119 |

(1) Excludes share based compensation; per share cost is based on estimated total production, which includes working interest production

Recognizing the cyclical nature of the oil and gas industry, we continue to closely monitor commodity prices and industry trends for signs of changing market conditions. We caution that it is inherently difficult to predict activity levels on our royalty lands since we have no operational control. As well, significant changes (positive or negative) in commodity prices (including Canadian oil price differentials), foreign exchange rates, or production rates may result in adjustments to the dividend rate.

A sensitivity analysis of the potential impact of key variables on funds from operations per share is provided below. For the purposes of the sensitivity analysis, the effect of a change in a particular variable is calculated independently of any change in another variable. In reality, changes in one factor will contribute to changes in another, which can magnify or counteract the sensitivities. For instance, trends have shown a correlation between the movement in the foreign exchange rate of the Canadian dollar relative to the U.S. dollar and the benchmark WTI crude oil price.

| Variable [1] | Change (+/-) | Estimated Change in Funds from Operations ($/share) |
|---|---|---|
| West Texas Intermediate (WTI) crude oil | US$1.00/bbl | 0.02 |
| Canadian/U.S. dollar exchange rate | US$0.01 | 0.02 |
| Canadian oil price differential to WTI | US$1.00/bbl | 0.02 |
| AECO natural gas | Cdn$0.25/Mcf | 0.02 |
| Interest rate | 1% | 0.01 |
| Oil and NGL production | 100 bbls/d | 0.02 |
| Natural gas production | 1,000 Mcf/d | 0.004 |

(1) Calculations are performed independently and may not be indicative of actual results that would occur when multiple variables change at the same time.

## Dividend

With uncertainty around commodity prices and other macroeconomic factors in Canada, Freehold's Board of Directors (the Board) has approved maintaining its monthly dividend at $0.0525 per share or $0.63 per share annualized. We will continue to review our dividend level quarterly (see Dividend Policy). The Board has declared a dividend of $0.0525 per common share to be paid on April 15, 2019 to shareholders of record on March 31, 2019. The dividend is designated as an eligible dividend for Canadian income tax purposes.

Current payout levels are in-line with our previously stated dividend policy which outlines a 60%-80% adjusted payout ratio based on forward looking funds from operations. Based on our current guidance and commodity price assumptions, and assuming no significant changes in the current business environment, we expect to maintain the current dividend rate through 2019. However, we will continue to evaluate the commodity price environment and adjust the dividend level if necessary.

# Quarterly Performance

## Fourth Quarter Highlights

| FINANCIAL ($000s, except as noted) | Three Months Ended December 31 2018 | 2017 | Change | Twelve Months Ended December 31 2018 | 2017 | Change |
|---|---|---|---|---|---|---|
| Royalty and other revenue | **24,902** | 38,435 | -35% | **145,236** | 151,894 | -4% |
| Net income (loss) | **(4,166)** | (8,057) | -48% | **14,032** | 12,218 | 15% |
| Per share, basic and diluted ($) | **(0.04)** | (0.07) | -43% | **0.12** | 0.10 | 20% |
| Funds from operations | **18,463** | 32,023 | -42% | **121,287** | 123,788 | -2% |
| Per share, basic ($) | **0.16** | 0.27 | -41% | **1.03** | 1.05 | -2% |
| Acquisitions | **10,247** | 52,270 | -80% | **61,740** | 86,743 | -29% |
| Dividends declared | **18,643** | 17,722 | 5% | **73,928** | 68,479 | 8% |
| Per share ($) (1) | **0.1575** | 0.15 | 5% | **0.6250** | 0.58 | 8% |
| Net debt | **89,375** | 68,621 | 30% | **89,375** | 68,621 | 30% |
| Shares outstanding, period end (000s) | **118,403** | 118,183 | - | **118,403** | 118,183 | - |
| Average shares outstanding (000s) (2) | **118,348** | 118,128 | - | **118,266** | 118,044 | - |
| **OPERATING** | | | | | | |
| Royalty production (boe/d) (3) | **10,312** | 10,960 | -6% | **10,718** | 10,963 | -2% |
| Total production (boe/d) (3) | **10,929** | 12,032 | -9% | **11,410** | 12,350 | -8% |
| Oil and NGL (%) | **56** | 53 | 6% | **54** | 55 | -2% |
| Average price realizations ($/boe) (3) | **23.40** | 33.59 | -30% | **33.54** | 32.80 | 2% |
| Operating netback ($/boe) (3) (4) | **23.33** | 32.66 | -29% | **33.30** | 31.00 | 7% |

(1) Based on the number of shares issued and outstanding at each record date.
(2) Weighted average number of shares outstanding during the period, basic.
(3) See Conversion of Natural Gas to Barrels of Oil Equivalent (boe).
(4) See Non-GAAP Financial Measures.

Despite a very challenging business environment, Freehold continued to execute on its strategy in the fourth quarter of 2018. Highlights included:

- Freehold's total royalty production averaged 10,312 boe/d, down 6% versus the same period in 2017 but flat versus the previous quarter. Reduced volumes compared to Q4-2017 were driven by lower third-party production additions, natural gas and heavy oil curtailments and fewer prior period adjustments (120 boe/d in Q4-2018 versus 600 boe/d in Q4-2017).
- Royalty oil and NGL production, which has higher operating netbacks than natural gas, averaged production of 5,818 boe/d in the fourth quarter of 2018, flat compared to Q4-2017 and 4% higher than the previous quarter.
- Operating income from royalties represented over 99% of our total operating income in 2018 for both the current quarter and the full year, as we continue to divest of our working interest properties.
- Q4-2018 royalty and other revenue totaled $24.9 million, down 35% versus the previous year largely due to significantly lower realized oil prices resulting from wider Canadian oil price differentials. Freehold's average realized oil and NGL price in the quarter was $34.48/boe compared to $55.18/boe in Q4-2017.

- Q4-2018 net loss was $4.2 million as low revenues affected our results. This compared to an $8.1 million net loss in Q4-2017, which included an impairment charge of $16.2 million on Freehold's working interest properties.
- Funds from operations for Q4-2018 totaled $18.5 million, a decrease of 42% versus the same period in 2017. This was largely due to lower revenues caused by lower oil prices, including wider Canadian oil price differentials. On a per share basis, funds from operations totaled $0.16 per share in Q4-2018, down from $0.27 per share in Q4-2017.
- Freehold closed an acquisition of 77,000 gross royalty acres and 11,200 gross acres of mineral title in southwest Saskatchewan for a purchase price of $8.9 million. The royalty assets currently produce approximately 55 boe/d (100% oil) and provide a low expected decline (<10%) adding to the sustainability of our production and dividend.
- At December 31, 2018, net debt totaled $89.4 million, up from $78.7 million at September 30, 2018, implying a net debt to 12-month trailing funds from operations ratio of 0.7 times. The increase in net debt over the previous quarter reflected the funds allocated towards acquisitions, as there was no excess free cash flow (1) over and above our dividend in Q4-2018.
- Wells drilled on our royalty lands totaled 220 (7.4 net) in the quarter, up from 175 (6.3 net) in the previous quarter and 112 (5.7 net) during the same period in 2017.
- In Q4-2018, Freehold issued 26 leases associated with our unleased mineral title lands; 102 leases were issued in 2018, compared to 100 leases in 2017.
- Dividends declared for Q4-2018 totaled $0.1575 per share, unchanged from the previous quarter and up from $0.15 per share in Q4-2017.
- Basic payout ratio (dividends declared/funds from operations) for Q4-2018 totaled 101% while the adjusted payout ratio ((dividends paid plus capital expenditures)/funds from operations) was 105%.

## 2018 Performance Compared to Guidance

**Compared to our original March 2018 and revised November 2018 guidance:**

- Average production for the year at 11,410 boe/d was within our most recent guidance range but 590 boe/d lower than the midpoint of our original guidance due to weaker than expected royalty production additions, working interest dispositions and production curtailment associated with weakness in natural gas and heavy oil pricing.
- Average commodity prices for WTI, Edmonton Light Sweet, WCS and AECO were similar to our November 2018 guidance but oil prices outpaced our expectations and gas prices disappointed when compared to our original guidance.
- Operating costs at $1.41/boe met our expectations from both our original and most recent guidance.
- General and administrative costs at $2.70/boe were slightly higher than guidance figures due to lower than forecast production volumes and costs related to acquisition and disposition activity.
- The 2018 final royalty drilling count was 21.3 net wells compared to our original and revised estimates of 25 and 20 net wells respectively.
- Our 2018 adjusted payout ratio ((dividends paid plus capital expenditures)/funds from operations) was 64%, identical to the revised guidance but higher than our original estimate of 61%, largely due to lower production.
- Net debt to funds from operations ended the 2018 year at 0.7 times, which is higher than our original guidance at 0.4 times, as acquisition activity is not reflected in our guidance.

**2018 Key Operating Assumptions**

| 2018 Annual Average | | 2018 Actual Results | Nov. 14, 2018 | Mar. 8, 2018 |
|---|---|---|---|---|
| Total production | boe/d | 11,410 | 11,250-11,500 | 11,750-12,250 |
| West Texas Intermediate crude oil | US$/bbl | 64.77 | 65.00 | 60.00 |
| Edmonton Light Sweet crude oil | Cdn$/bbl | 69.19 | 70.00 | N/A |
| Western Canadian Select crude oil | Cdn$/bbl | 49.63 | 50.00 | 45.00 |
| AECO natural gas | Cdn$/Mcf | 1.53 | 1.55 | 2.00 |
| Exchange rate | Cdn$/US$ | 0.77 | 0.77 | 0.80 |
| Operating costs | $/boe | 1.41 | 1.45 | 1.45 |
| General and administrative costs (1) | $/boe | 2.70 | 2.50 | 2.50 |
| Weighted average shares outstanding | millions | 118 | 118 | 118 |

(1) Excludes share based compensation.

## Quarterly Performance and Seasonality

Quarterly variances in revenues, net income (loss) and funds from operations are caused mainly by fluctuations in commodity prices and production volumes. Crude oil prices are generally determined by global supply and demand factors, and the variances do not have seasonal predictability. Natural gas is a typically seasonal, weather-dependent fuel; demand is generally higher during the winter (for heating) and summer (for cooling), and lower during the spring and fall. Over most of the past eight quarters, this seasonality has been muted by ample supply.

Our financial results over the last eight quarters were influenced by the following significant changes:

- Oil prices are impacted significantly by global supply and demand factors, with OPEC decisions and U.S. production growth having the largest effects. In 2018, there has been negative effects on realized prices in western Canada due to transportation constraints, with the effects at their worst in Q4-2018.
- Fluctuations in the U.S./Canadian exchange rate affects our oil price realizations, resulting in positive or negative impacts on our Canadian dollar oil revenues relative to the benchmark WTI, which is referenced in U.S. dollars. The higher value of the Canadian dollar in late 2017 and early 2018 had a negative effect on our oil price realizations.
- AECO natural gas price worsened in 2018 as it continues to be negatively impacted by transportation constraints and supply outstripping demand.
- The largest effect on setting our dividends is funds from operations, which is mainly a function of revenues and cash expenses; however, the timing of dividend adjustments is dependent on forward projections and the decisions of our Board. Improvement in oil prices led to the dividend increases in 2017 and 2018.
- Production has been affected by drilling activity, curtailments, acquisitions and working interest dispositions, as well as prior period adjustments. We use government reporting databases and past production receipts to estimate revenue accruals. Due to the large number of wells in which we have royalty interests, the nature of royalty interests, the lag in receiving production receipts, and our audit program, our reported royalty volumes usually include both positive and negative adjustments related to prior periods.
- Over the past eight quarters, we have acquired $148 million of royalty assets in Alberta and Saskatchewan. Freehold also disposed of $41 million of working interest properties over the same period. This activity affects our revenues, operating costs, percentage royalty interests, oil, NGL and natural gas production mix and debt levels, among others.

- Net income (loss) is affect by fluctuations in our revenue and costs but may also be affected by large unique items in any given period. Freehold had a $6 million impairment reversal in Q1-2017, a $15 million gain on working interest dispositions in Q2-2017 and a $16 million impairment in Q4-2017.

The accompanying table illustrates the fluctuations experienced over the past eight quarters and the resulting effect on our financial results. Additional information about our quarterly results is provided in our interim reports, copies of which are available on SEDAR and on our website.

## Quarterly Review

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q4 | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| **Financial** ($000s, except as noted) | | | | | | | | |
| Revenue, net of royalty expense | 24,837 | 40,587 | 39,961 | 39,157 | 38,235 | 33,763 | 38,036 | 40,686 |
| Funds from operations | 18,463 | 35,900 | 34,540 | 32,384 | 32,023 | 27,927 | 31,769 | 32,069 |
| Per share, basic ($) | 0.16 | 0.30 | 0.29 | 0.27 | 0.27 | 0.24 | 0.27 | 0.27 |
| Net income (loss) | (4,166) | 8,389 | 5,386 | 4,423 | (8,057) | 103 | 13,084 | 7,088 |
| Per share, basic and diluted ($) | (0.04) | 0.07 | 0.05 | 0.04 | (0.07) | - | 0.11 | 0.06 |
| Dividends declared | 18,643 | 18,634 | 18,625 | 18,026 | 17,722 | 17,714 | 17,705 | 15,338 |
| Per share ($) (1) | 0.16 | 0.16 | 0.16 | 0.15 | 0.15 | 0.15 | 0.15 | 0.13 |
| Basic payout ratio (%) (2) | 101 | 52 | 54 | 56 | 55 | 63 | 56 | 48 |
| Operating Income (2) | 23,452 | 39,225 | 38,331 | 37,658 | 36,149 | 31,246 | 35,235 | 37,084 |
| Operating income from royalties (%) | 102 | 99 | 100 | 99 | 97 | 99 | 97 | 91 |
| Acquisitions | 10,247 | 17,915 | 2,697 | 30,881 | 52,270 | (146) | 1,267 | 33,352 |
| Working interest dispositions | 581 | 1 | 7 | 8,130 | 354 | 2,969 | 28,808 | 288 |
| Net debt | 89,375 | 78,657 | 77,908 | 89,567 | 68,621 | 38,274 | 49,819 | 76,030 |
| **Shares outstanding** | | | | | | | | |
| Weighted average, basic (000s) | 118,348 | 118,293 | 118,238 | 118,183 | 118,128 | 118,073 | 118,018 | 117,956 |
| At quarter end (000s) | 118,403 | 118,348 | 118,293 | 118,238 | 118,183 | 118,128 | 118,073 | 118,018 |
| **Operating** ($/boe, except as noted) | | | | | | | | |
| Royalty production (boe/d) (3) | 10,312 | 10,322 | 11,052 | 11,197 | 10,960 | 10,919 | 11,270 | 10,701 |
| Total production (boe/d) (3) | 10,929 | 11,002 | 11,721 | 12,002 | 12,032 | 12,036 | 12,589 | 12,753 |
| Royalty interest (%) | 94 | 94 | 94 | 93 | 91 | 91 | 90 | 84 |
| Average selling price | 23.40 | 38.95 | 36.96 | 34.52 | 33.59 | 29.67 | 32.98 | 34.88 |
| Operating netback (2) | 23.33 | 38.74 | 35.94 | 34.86 | 32.66 | 28.22 | 30.76 | 32.31 |
| Operating expenses | 1.38 | 1.35 | 1.53 | 1.39 | 1.88 | 2.27 | 2.45 | 3.14 |
| General and administrative expenses (4) | 2.74 | 2.06 | 2.36 | 3.60 | 2.59 | 1.88 | 2.27 | 3.01 |
| **Benchmark Prices** | | | | | | | | |
| West Texas Intermediate crude oil (US$/bbl) | 58.81 | 69.50 | 67.88 | 62.87 | 55.40 | 48.21 | 48.29 | 51.91 |
| Exchange rate (Cdn$/US$) | 0.76 | 0.77 | 0.77 | 0.79 | 0.79 | 0.80 | 0.74 | 0.76 |
| Edmonton Light Sweet crude oil (Cdn$/bbl) | 42.78 | 81.62 | 80.47 | 71.88 | 69.14 | 56.73 | 61.84 | 64.00 |
| Western Canadian Select crude oil (Cdn$/bbl) | 25.13 | 61.81 | 62.82 | 48.77 | 54.87 | 47.89 | 49.99 | 49.38 |
| AECO natural gas (Cdn$/Mcf) | 1.90 | 1.35 | 1.03 | 1.85 | 1.96 | 2.04 | 2.77 | 2.94 |
| **Share Trading Performance** | | | | | | | | |
| High ($) | 11.58 | 12.78 | 14.01 | 14.85 | 16.41 | 15.15 | 14.37 | 14.75 |
| Low ($) | 7.68 | 10.97 | 11.81 | 11.71 | 13.77 | 12.51 | 11.96 | 12.22 |
| Close ($) | 8.27 | 11.14 | 12.40 | 12.35 | 14.05 | 14.74 | 13.05 | 13.48 |
| Volume (000s) | 24,314 | 17,864 | 19,975 | 15,635 | 13,985 | 13,428 | 13,890 | 17,059 |

(1) Based on the number of shares issued and outstanding at each record date.
(2) See Non-GAAP Financial Measures.
(3) Reported production for a period may include adjustments from previous production periods.
(4) Excludes share based compensation.

# Revenues

## Production

As we hold royalty interests in over 43,500 wells, obtaining timely production data is extremely difficult. Thus, we use government reporting databases and past production receipts to estimate revenue accruals. Due to the large number of wells in which we have royalty interests, the nature of royalty interests, the lag in receiving production receipts, and our audit program, our reported royalty volumes usually include both positive and negative adjustments related to prior periods.

Freehold's total production was down 8% in 2018 primarily associated with working interest dispositions but also affected by acquisitions and royalty drilling production additions not offsetting natural declines. Production was enhanced by the strength of our audit and compliance functions which added over 400 boe/d and $8 million to 2018 results. Production volumes were comprised of 46% natural gas, 12% heavy oil, 34% light and medium oil, and 8% NGL's.

Royalty interests comprised 94% of total production in 2018, up from 89% in 2017 as we continue to enhance our royalty focus. Royalty production volumes averaged 10,718 boe/d, a 2% decrease over the previous year.

Working interest production declined 50% in 2018 versus 2017. The reduction in working interest volumes was largely the result of the continued effects of working interest dispositions throughout the past two years and continued low development expenditures.

### Production Summary (1)

| (boe/d) | 2018 | 2017 | Change |
|---|---|---|---|
| Royalty interest | 10,718 | 10,963 | -2% |
| Working interest | 692 | 1,387 | -50% |
| Total | 11,410 | 12,350 | -8% |

(1) On certain properties where we have both a royalty interest and a working interest, production is allocated based on the applicable royalty and working interest percentages.

**Average Daily Production by Product Type**

| | 2018 | 2017 | Change |
|---|---|---|---|
| **Royalty interest** [(1)] | | | |
| Light and medium oil (bbls/d) | 3,843 | 3,664 | 5% |
| Heavy oil (bbls/d) | 1,116 | 1,381 | -19% |
| NGL (bbls/d) | 896 | 913 | -2% |
| Natural gas (Mcf/d) | 29,177 | 30,028 | -3% |
| Oil equivalent (boe/d) | 10,718 | 10,963 | -2% |
| **Working interest** [(1)] | | | |
| Light and medium oil (bbls/d) | 87 | 394 | -78% |
| Heavy oil (bbls/d) | 217 | 314 | -31% |
| NGL (bbls/d) | 53 | 126 | -58% |
| Natural gas (Mcf/d) | 2,009 | 3,318 | -39% |
| Oil equivalent (boe/d) | 692 | 1,387 | -50% |
| **Total** | | | |
| Light and medium oil (bbls/d) | 3,930 | 4,058 | -3% |
| Heavy oil (bbls/d) | 1,333 | 1,695 | -21% |
| NGL (bbls/d) | 949 | 1,039 | -9% |
| Natural gas (Mcf/d) | 31,186 | 33,346 | -6% |
| Oil equivalent (boe/d) | 11,410 | 12,350 | -8% |

(1) On certain properties where we have both a royalty interest and a working interest, production is allocated based on the applicable royalty and working interest percentages.

## Product Prices

In Canada, exploration and production companies continue to deal with a number of egress issues which widened the differential between WTI and WCS to record levels of nearly US$40.00 in Q4-2018. For the year, WTI prices averaged US$64.77/bbl or 27% above the average WTI price realized in 2017, whereas WCS was 2% down at $49.63 in 2018 versus 2017. Edmonton Light Sweet price did not realize the same significant gain as WTI in 2018 averaging $69.19/bbl, representing a 10% increase versus 2017. On the natural gas front, AECO prices averaged $1.53/mcf, down 37% versus last year.

**Average Benchmark Prices**

| | 2018 | 2017 | Change |
|---|---|---|---|
| West Texas Intermediate crude oil (US$/bbl) | 64.77 | 50.95 | 27% |
| Exchange rate (Cdn$/US$) | 0.77 | 0.77 | - |
| Edmonton Light Sweet crude oil (Cdn$/bbl) | 69.19 | 62.93 | 10% |
| Western Canadian Select crude oil (Cdn$/bbl) | 49.63 | 50.53 | -2% |
| AECO natural gas (Cdn$/Mcf) | 1.53 | 2.43 | -37% |

The price we receive for our oil production is primarily driven by the U.S. dollar price of WTI. It is also affected by the US$/Cdn$ exchange rate, with a decrease in the value of the Canadian dollar relative to the U.S. dollar increasing the revenue received. Our average realized oil prices also reflect product quality and transportation differences from benchmark prices. Our natural gas price realizations are discounted compared to AECO pricing as they include transportation and processing fees netted from certain natural gas royalty payments. On a boe basis, our total average selling price was 2% higher in 2018 reflecting stronger oil and NGL prices offset somewhat by lower natural gas prices.

**Average Realized Prices**

| | 2018 | 2017 | Change |
|---|---|---|---|
| Oil ($/bbl) | 57.53 | 53.14 | 8% |
| NGL ($/bbl) | 43.00 | 36.86 | 17% |
| Oil and NGL ($/bbl) | 55.31 | 50.65 | 9% |
| Natural gas ($/Mcf) | 1.25 | 1.83 | -32% |
| Oil equivalent ($/boe) | 33.54 | 32.80 | 2% |

## Marketing and Hedging

Our production remained unhedged in 2018. Our hedging policy is reviewed quarterly with the Board.

Our royalty lands consist of a large number of properties with generally small volumes per property. Many of our leases and royalty agreements allow us to take our share of oil and natural gas in-kind. As part of our risk mitigation program we carefully monitor our royalty receivables and may choose to take our royalty in-kind if there are benefits in doing so. Currently we take in-kind and market approximately 18% of our total royalty production using 30-day contracts.

## Royalty and Other Revenue

Total royalty and other revenue of $145.2 million in 2018 was down from $151.9 million or 4% relative to 2017. Total royalty revenue was up 3% largely due to higher oil prices, offset by slightly lower royalty production and lower gas prices year-over-year. Bonus consideration and lease rentals at $3.9 million for 2018 increased by $1.7 million or 80% over 2017 as a result of the continued efforts of our leasing team. Working interest revenues were down 61% versus 2017 largely as a result of the continued effects of working interest dispositions throughout the past two years.

**Royalty and Other Revenue**

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Royalty interest revenue from oil, NGL and natural gas (1) | 134,304 | 131,678 | 2% |
| Bonus consideration and lease rentals | 3,851 | 2,144 | 80% |
| Total royalty revenue | 138,155 | 133,822 | 3% |
| Working interest revenue | 7,081 | 18,072 | -61% |
| Total royalty and other revenue | 145,236 | 151,894 | -4% |

(1) Includes potash royalties and other.

**Royalty and Other Revenue by Product**

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Oil | 110,513 | 111,569 | -1% |
| NGL | 14,895 | 13,975 | 7% |
| Natural gas | 14,248 | 22,294 | -36% |
| Potash | 1,400 | 1,528 | -8% |
| Bonus consideration and lease rentals | 3,851 | 2,144 | 80% |
| Other | 329 | 384 | -14% |
| Total royalty and other revenue | 145,236 | 151,894 | -4% |

The following table demonstrates the net effect of price and volume variances on royalty and other revenue. In summary, the 2018 strength in oil and NGL prices versus 2017 was offset by the effect of reduced natural gas prices and a decrease in production year-over-year. Although the decrease in oil and NGL production had a significant effect on revenue, most of the reduction was from the higher cost working interest properties.

**Royalty and Other Revenue Variances**

| ($000s) | 2018 vs. 2017 | 2017 vs. 2016 |
|---|---|---|
| **Oil and NGL** | | |
| Production decrease | (11,700) | (6,326) |
| Price increase | 11,564 | 25,302 |
| Net increase (decrease) | (136) | 18,976 |
| **Natural gas** | | |
| Production increase (decrease) | (986) | 1,757 |
| Price increase (decrease) | (7,060) | 233 |
| Net increase (decrease) | (8,046) | 1,990 |
| **Other** (1) | 1,524 | 960 |
| Gross revenue increase (decrease) | (6,658) | 21,926 |

(1) Other includes potash, sulphur, bonus consideration, lease rentals, processing fees, interest and other.

## Royalty Expense and Mineral Taxes

Oil and gas producers pay royalties to the owners of mineral rights from whom they have acquired leases. These are paid to the Crown (provincial and federal governments) and freehold mineral title owners. Crown royalty rates are tied to commodity prices and the level of oil and gas sales.

We do not incur royalty expense on production from our royalty interest lands, other than minor freehold mineral taxes. As the royalty owner, we receive the royalty as income from other companies. Royalty expense decreased by 41% in 2018 mainly due to reduced working interest revenue and production as a result of the continued effects of working interest dispositions throughout the past two years.

**Royalty Expense** (1)

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Total royalty expense | 694 | 1,174 | -41% |
| Per boe ($) | 0.17 | 0.26 | -35% |

(1) Royalty expense includes both Crown charges and royalty payments to third parties.

# Expenses

## Operating Expenses

Operating expenses are comprised of direct costs incurred and costs allocated to oil, natural gas, and NGL production activities. Overhead recoveries associated with operated properties are included in operating expenses and accounted for as a reduction to general and administrative expenses. A portion of operating expense is fixed and, as such, per boe operating expenses are highly variable to production volumes.

The year-over-year decrease in operating expenses to $5.9 million from $11.0 million was largely the result of the of the working interest dispositions occurring over the past two years.

**Operating Expenses** (1)

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Total operating expenses | 5,876 | 11,006 | -47% |
| Per boe ($) | 1.41 | 2.44 | -42% |

(1) We do not incur operating expenses on production from our royalty lands.

## Netback Analysis

As a royalty owner, we share in production revenue without incurring the operational costs, risks, and responsibilities typically associated with oil and natural gas operations. The following tables demonstrate the advantage of our royalty lands, which have no operating or royalty expenses other than minor freehold mineral taxes. Royalty interests accounted for 95% of royalty and other revenue in 2018 and more importantly contributed nearly 100% of operating income. A 7% improvement in the 2018 operating netback to $33.30/boe is a function of higher oil prices and lower working interest production which has higher costs.

**2018 Operating Income** (1)

| ($000s) | Royalty Interest | Working Interest | Total |
|---|---|---|---|
| Royalty and other revenue (2) | 138,155 | 7,081 | 145,236 |
| Royalty expense (3) | (66) | (628) | (694) |
| Net revenue | 138,089 | 6,453 | 144,542 |
| Operating expense | - | (5,876) | (5,876) |
| Operating income | 138,089 | 577 | 138,666 |
| Percentage by category | 99.6% | 0.4% | 100% |

(1) See Non-GAAP Financial Measures.

(2) Royalty interest revenue includes potash, sulphur, bonus consideration, lease rentals, interest and other. Working interest revenue includes processing fees.

(3) Royalty expense includes both Crown charges and royalty payments to third parties.

**2018 Operating Netback** (1)

| ($ per boe) | Royalty Interest | Working Interest | **Total** |
|---|---|---|---|
| Royalty and other revenue | 35.32 | 28.03 | **34.88** |
| Royalty expense (2) | (0.02) | (2.49) | **(0.17)** |
| Net revenue | 35.30 | 25.54 | **34.71** |
| Operating expense | - | (23.26) | **(1.41)** |
| Operating netback | 35.30 | 2.28 | **33.30** |

(1) See Non-GAAP Financial Measures.

(2) Royalty expense includes both Crown charges and royalty payments to third parties.

**2018 vs. 2017 Operating Netback** (1)

| ($ per boe) | **2018** | 2017 | Change |
|---|---|---|---|
| Royalty interest | **35.30** | 33.41 | 6% |
| Working interest | **2.28** | 11.88 | -81% |
| Total | **33.30** | 31.00 | 7% |

(1) See Non-GAAP Financial Measures.

## General and Administrative Expenses

We have significant land administration, accounting and auditing requirements to administer and collect royalty payments, including systems to track development activity on our royalty lands. General and administrative (G&A) expenses include direct costs and reimbursement of G&A expenses incurred by Rife Resources Management Ltd. (the Manager) on behalf of Freehold (see Related Party Transactions).

In 2018, on a total dollar basis G&A expenses were up slightly to $11.2 million. On a per boe basis costs were up 11% year-over-year to $2.70/boe mainly due to reduced working interest production volumes.

**General and Administrative Expenses**

| ($000s, except as noted) | **2018** | 2017 | Change |
|---|---|---|---|
| General and administrative expenses, | | | |
| before capitalized and overhead recoveries | **12,846** | 12,608 | 2% |
| Less: capitalized and overhead recoveries | **(1,608)** | (1,593) | 1% |
| General and administrative expenses | **11,238** | 11,015 | 2% |
| Per boe ($) | **2.70** | 2.44 | 11% |

## Management Fees

The Manager (see Related Party Transactions) receives a management fee in Freehold common shares. The amended and restated management agreement dated November 9, 2015 (the Management Agreement) capped the management fee at 55,000 Freehold common shares per quarter for 2018, with the fee decreasing to 5,500 shares by 2023. The ascribed value associated with the management fee was down 20% compared to 2017 reflecting lower Freehold common share prices in 2018. The quarterly management fee for 2019 will be 55,000 Freehold common shares per quarter.

**Management Fees (paid in shares)**

| | 2018 | 2017 | Change |
|---|---|---|---|
| Shares issued in payment of management fees | 220,000 | 220,000 | - |
| Ascribed value ($000s) (1) | 2,429 | 3,043 | -20% |
| Per boe ($) | 0.58 | 0.68 | -15% |

(1) The ascribed value of the management fees is based on the closing share price at the end of each quarter.

## Share Based Compensation

**LONG-TERM INCENTIVE PLANS**

In 2017, Freehold adopted a new long-term incentive plan (new LTIP) to replace the previous LTIP for the employees of Rife Resources Ltd. (see Related Party Transactions). Both the new and the previous LTIP are share based and cash settled. Grants will no longer be made under the previous plan and pre-existing grants vested and paid out in early 2019. Freehold's long-term incentive compensation consists of grants of performance share units (PSUs) and restricted share units (RSUs) under the new LTIP.

Under both the new and previous LTIP, compensation expense is based on Freehold’s share price, the number of share-based awards outstanding at each period end, an estimated performance multiplier, if applicable, and an estimated forfeiture rate. Compensation expense is recognized over the vesting period.

The 2015 grants under the previous LTIP valued at $0.2 million vested and were paid out in 2018 (2014 grants vested in 2017 and $0.1 million was paid out). One-third of the granted 2017 RSUs vested in 2018 and a total of $0.2 million was paid out upon vesting in 2018. During 2018, there were 114,100 RSUs and PSUs granted under the new LTIP (after estimated forfeitures).

The total recovered for the year ended December 31, 2018 was $0.8 million (2017 expensed - $1.2 million), largely the result of the decrease in Freehold’s share price.

**DEFERRED SHARE UNIT PLAN**

Pursuant to our deferred share unit plan, fully-vested deferred share units (DSUs) are granted annually in the first quarter to non-management directors and are redeemable for an equal number of Freehold common shares (less tax withholdings if necessary) after the director’s retirement. Dividends declared prior to redemption are assumed to be reinvested in notional share units on the dividend payment date. In 2018 Freehold expensed $0.6 million (2017 - $0.4 million) of share based compensation with a corresponding offset to contributed surplus.

On January 1, 2018 the Board granted 34,519 DSUs to eligible directors and 58,646 DSUs were granted on January 1, 2019. As at December 31, 2018, there were 160,192 DSUs outstanding, and at March 7, 2019, there were 221,125 DSUs outstanding (including notional DSUs granted as a result of dividends paid on our common shares).

**Share Based Compensation**

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Gross LTIP | (997) | 1,446 | -169% |
| Less: capitalized portion | 159 | (246) | -165% |
| Net LTIP | (838) | 1,200 | -170% |
| Deferred share unit plan | 581 | 391 | 49% |
| Share based and other compensation expense (recovery) | (257) | 1,591 | -116% |
| Per boe ($) | (0.06) | 0.35 | -117% |

## Related Party Transactions

Freehold does not have any employees. Rife Resources Management Ltd. (the Manager) is the manager of Freehold. The Manager is a wholly-owned subsidiary of Rife Resources Ltd. (Rife). Rife is 100% owned by the CN Pension Trust Funds (the pension funds for the employees of the Canadian National Railway Company), which in turn is a shareholder of Freehold. Canpar Holdings Ltd. (Canpar) is also managed by Rife and owned 100% by the CN Pension Trust Funds. Two of Rife and Canpar's directors are also directors of Freehold.

The Manager recovers its general and administrative costs and a portion of its long-term incentive plan costs (provided that under Freehold's new LTIP, Freehold's portion of long-term incentive compensation is issued directly by Freehold instead of Rife receiving reimbursement for such compensation), and receives a quarterly management fee paid in shares.

### a. Rife Resources Management Ltd.

The Manager provides certain services for a fee based on a specified number of shares per quarter, pursuant to the amended and restated Management Agreement. The Management Agreement capped the management fee at 55,000 shares per quarter for 2018. For the year ended December 31, 2018, Freehold issued 220,000 shares (2017 – 220,000) as payment of the management fee to the Manager pursuant to the Management Agreement. For the year ended December 31, 2018, the ascribed value of $2.4 million (2017 – $3.0 million) was based on the closing price of the shares on the last trading day of each quarter.

For the year ended December 31, 2018, the Manager charged $9.8 million in general and administrative costs (2017 – $9.5 million). At December 31, 2018, there was $0.7 million (2017 – $0.6 million) in accounts payable and accrued liabilities relating to these costs.

### b. Rife Resources Ltd.

Freehold maintains ownership interests in certain oil and gas properties operated by Rife. A portion of net operating revenues and capital expenditures represent joint operations amounts from Rife. At December 31, 2018, there was $nil (2017 - $nil) in accounts receivable related to these transactions. At December 31, 2018, there was $0.1 million (2017 - $0.1 million) in accounts payable and accrued liabilities relating to these transactions.

In addition, Freehold receives royalties from Rife pursuant to various royalty agreements. For the year ended December 31, 2018, Freehold received royalties of approximately $0.6 million (2017 – $0.9 million). At December 31, 2018, there was $nil (2017 - $0.1 million) in accounts receivable relating to these transactions.

**c. Canpar Holdings Ltd.**

Freehold and Canpar share mineral title ownership rights in a substantial land base in western Canada. Generally, Canpar owns mineral rights that were below the deepest producing formation at the time that Freehold was created, and Freehold holds the balance of the mineral rights. Given the nature of the mineral rights, which are dependent upon hydrocarbon pool formation classification as well as third-party drilling data which is subject to change and revision, uncertainty can exist with respect to the royalty ownership of wells drilled and completed on lands where both Freehold and Canpar hold the mineral rights.

At December 31, 2018, there was $nil (2017 – $nil) in accounts receivable relating to transactions with Canpar. At December 31, 2018, there was $nil (2017 – $0.1 million) in accounts payable and accrued liabilities relating to transactions with Canpar.

All amounts owing to/from the Manager, Rife, and Canpar are unsecured, non-interest bearing and due on demand. All transactions were in the normal course of operations and were measured at the amount of consideration established and agreed to by both parties.

## Key Management Personnel Compensation

Expenses relating to compensation for key management personnel, considered to be Freehold's Board of Directors and executive officers, are as follows:

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Short-term benefits (including employee wages and directors fees) | 1,368 | 1,143 |
| Share based compensation | 320 | 705 |
| Total | 1,688 | 1,848 |

## Interest and Financing

In 2018 interest and financing expense increased due to higher average debt levels and a slight interest rate increase. The average effective interest rate on advances under our credit facilities during 2018 was 3.3% (2017 – 2.9%).

**Interest and Financing**

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Interest on operating line or other | - | 1 | -100% |
| Interest on long-term debt | 3,705 | 2,603 | 42% |
| Interest and financing expense | 3,705 | 2,604 | 42% |
| Per boe ($) | 0.89 | 0.58 | 53% |

## Depletion and Depreciation

Petroleum and natural gas interests, including the costs of production equipment, future capital costs, estimated decommissioning costs, and directly attributable general and administrative costs, are depleted on the unit-of-production method based on estimated proved plus probable oil and gas reserves (see Critical Accounting Estimates). Reserves are independently evaluated at year-end. For December 31, 2018, the estimate of proved plus probable reserves was based on the independent evaluation effective at December 31, 2018. The decrease in depletion from 2018 to 2017 is a result of decreased production volumes and the effect of acquisitions and dispositions on our reserves.

**Depletion and Depreciation**

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Depletion and depreciation | 102,042 | 108,227 | -6% |
| Per boe ($) | 24.50 | 24.01 | 2% |

## Income Tax

As a corporation, taxable income is based on revenues (which will vary depending on commodity prices and production volumes) less allowable expenses including claims for both accumulated tax pools and tax pools associated with current year expenditures. In 2018 corporate federal and provincial income tax rates for Freehold were approximately 27% (2017 – 27%).

In 2018, Freehold had no current tax expense (2017 - $nil) and deferred tax expense was $5.1 million (2017 - $4.8 million), as the use of tax pools offset Freehold's taxable income. At December 31, 2018, Freehold had a deferred income tax asset of $16.4 million (2017 - $21.5 million), as a result of accumulated tax pools.

### Tax Pools

We are entitled to claim certain tax deductions available to all owners of oil and gas properties. Freehold's tax pools decreased to $904.9 million at the end 2018 (from $966.4 million at the end of 2017), as additions through acquisitions did not offset their application against 2018 taxable income. The tax pools below are deductible at various rates.

**Tax Pools** (1)

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Canadian oil and gas property expense (10% declining balance) | 705,718 | 728,439 | -3% |
| Canadian development expense (30% declining balance) | 31,344 | 44,004 | -29% |
| Capital cost allowance (generally 25%) | 9,900 | 14,287 | -31% |
| Share issue costs | 6,277 | 12,097 | -48% |
| Non-capital losses | 151,668 | 167,615 | -10% |
| Total | 904,907 | 966,442 | -6% |

(1) These amounts, subject to review by Canada Revenue Agency, represent Freehold's direct tax pools as well as the tax pools of its subsidiaries.

## Impairment, Impairment Reversal and Gain on Working Interest Dispositions

At December 31, 2018, there were no indicators of impairment or impairment reversal. As a result, no impairment or impairment reversal testing was conducted.

For the year ended December 31, 2018, Freehold closed the sale of its Pembina Cardium Unit No. 9 working interest property in exchange for cash proceeds of $8.7 million (including final adjustments) and an acquisition of a new 4% gross overriding royalty on the same property valued at $1.9 million. At December 31, 2017, this working interest property was classified as assets held for sale as it was highly probable that its carrying value would be received through a sales transaction rather than continued use. At December 31, 2017, this working interest asset was recorded at the lower of carrying value and management's best estimate of its fair value less costs to sell, resulting in Freehold recording an impairment of $6.3 million. Freehold reclassified its new recoverable estimated net book value of $13.8 million from its Other Working Interest cash generating unit (CGU) in petroleum and natural gas interests to assets held for sale. In addition, Freehold reclassified its proportionate share of decommissioning liabilities of $3.7 million to liabilities related to assets held for sale. These assets and related liabilities held for sale were removed in 2018 when the transaction closed.

For the year ended December 31, 2017, Freehold closed the sale of working interest properties in its Southeast Saskatchewan Working Interest CGU for proceeds of $29.0 million. In conjunction with these transactions, Freehold recognized a gain on working interest dispositions of $14.9 million. The gain was based on $29.1 million of proceeds received, minor adjustments of $0.1 million, the removal of assets held for sale of $18.9 million and the removal of liabilities related to assets held for sale of $4.8 million. In addition, based on sale proceeds, Freehold reviewed the carrying value of the Southeast Saskatchewan Working Interest CGU for any reversal of impairment, as this CGU had a previous impairment charge. The recoverable amount was estimated using a fair value less cost to sell calculation based on the sales price. As a result, there was an impairment reversal of $5.6 million recognized at the time of disposition, representing the maximum amount of impairment reversal able to be taken, made up of the original $8.0 million impairment estimate recorded in 2015 net of $2.4 million depletion calculated as if the impairment never occurred.

At December 31, 2017, Freehold tested its Other Working Interest CGU for impairment due to existing market conditions. Freehold estimated the recoverable amount as the value in use based on discounted future net cash flows of proved and probable reserves using forecast prices and costs, discounted between 15% and 25% (pre-tax). In determining the discount rate, Freehold considered the resource composition of the remaining assets including reserve type, operating expense and future development plans. The estimated recoverable amount was based on Freehold's December 31, 2017 external reserve report. Management recognizes that all assumptions and estimates affecting the value are subject to a high degree of uncertainty.

Freehold recognized a non-cash impairment charge of $9.9 million as the carrying value exceeded the estimated value in use. The Other Working Interest CGU contains all of Freehold's working interest properties widespread across western Canada. The estimated recoverable amount of this CGU at December 31, 2017 was $14.7 million.

The following table summarizes impairments and impairment reversal for 2017:

| ($000s) | **Cash Generating Unit** | **Impairment (reversal)** |
|---|---|---|
| Southeast Saskatchewan working interest properties | Southeast Saskatchewan Working Interest | (5,625) |
| Pembina Cardium Unit No. 9 | Other Working Interest | 6,323 |
| Year-end impairment | Other Working Interest | 9,911 |
| Total | | 10,609 |

# Liquidity and Capital Resources

We define capital (and capitalization) as long-term debt, shareholders' equity, and working capital. We manage our capital structure taking into account operating activities, debt levels, debt covenants, acquisitions, capital expenditures, dividend levels, and taxes, among others. We also consider changes in economic conditions and commodity prices as well as the risk characteristics of our assets. We have a depleting asset base, and ongoing development activities and acquisitions are necessary to replace production and extend reserve life. From time to time, we may issue shares or adjust capital spending to manage current and projected debt levels.

## Operating Activities

In 2018 Freehold generated net income of $14.0 million compared to $12.2 million net income in 2017. The 15% increase in net income was largely the result of decreases in operating expenses and depletion and depreciation expense year-over-year offset by lower revenues. In addition, 2017 had a $14.9 million gain on working interest dispositions which was offset by a $10.6 million net impairment expense.

Funds from operations in 2018 decreased 2% to $121.3 million from $123.8 million in 2017. Lower revenue had a negative effect on 2018 funds from operations with reduced production volumes and lower natural gas prices offset somewhat by higher oil and NGL prices. However, lower operating expenses in 2018 offset most of the decrease in revenue.

We consider funds from operations to be a key measure of operating performance as it demonstrates Freehold's ability to generate necessary funds to fund capital expenditures, sustain dividends and repay debt. We believe that such a measure provides a useful assessment of Freehold's operations on a continuing basis by eliminating certain non-cash charges. Funds from operations per share is calculated based on the weighted average number of shares outstanding consistent with the calculation of net income per share.

| ($000s, except as noted) | 2018 | 2017 | Change |
|---|---|---|---|
| Net income | 14,032 | 12,218 | 15% |
| Per share, basic and diluted ($) | 0.12 | 0.10 | 20% |
| Funds from operations | 121,287 | 123,788 | -2% |
| Per share ($) | 1.03 | 1.05 | -2% |

## Financing Activities

We retain working capital (calculated as current assets less current liabilities) primarily to fund capital expenditures or acquisitions and reduce bank indebtedness. In the oil and gas industry, accounts receivable from industry partners are typically settled in the following month. However, due to administrative issues, payments to royalty owners are often delayed longer. Also, working capital can fluctuate significantly due to volume and price changes at each period end, unpaid capital expenditures and asset and liability reclassifications.

Working capital at December 31, 2018 was $0.6 million, down $20.7 million from year-end 2017. Accounts receivable decreased $13.0 million due to low oil prices used to estimate outstanding accounts receivable relating to periods at the end of 2018. Working capital also decreased as the Pembina Cardium Unit No. 9 disposition resulted in the recognition of assets held for sale and liabilities related to assets held for sale at December 31, 2017 which were removed upon closing of the sale in 2018 (see Impairment, Impairment Reversal and Gain on Working Interest Dispositions).

**Components of Working Capital**

| | As at December 31 | | |
|---|---|---|---|
| ($000s) | **2018** | 2017 | Change |
| Cash | **1,262** | 284 | 344% |
| Accounts receivable | **12,938** | 25,952 | -50% |
| Assets held for sale | **-** | 13,810 | - |
| Current assets | **14,200** | 40,046 | -65% |
| Dividends payable | **(6,215)** | (5,908) | 5% |
| Accounts payable and accrued liabilities | **(4,610)** | (7,206) | -36% |
| Current portion of share based compensation | **(466)** | (399) | 17% |
| Current portion of decommissioning liabilities | **(2,284)** | (1,444) | 58% |
| Liabilities related to assets held for sale | **-** | (3,710) | - |
| Current liabilities | **(13,575)** | (18,667) | -27% |
| Working capital | **625** | 21,379 | -97% |

At December 31, 2018 Freehold had a committed $165 million secured revolving credit facility with a syndicate of four Canadian chartered banks. In addition, Freehold had available a $15 million senior secured operating facility. At December 31, 2018 $90 million was drawn on these facilities.

In May 2018 Freehold amended its credit agreement. The current maturity date of the credit facilities is May 31, 2021 and Freehold may annually request an extension to the maturity date. The credit facilities are not reserve-based but are secured with $400 million first charge demand debentures over all of Freehold's assets. The credit agreement contains non-financial covenants and two financial covenants. The first financial covenant is that long-term debt to EBITDA on royalty interest properties (calculated as earnings on royalty interest properties before non-cash charges including, but not limited to, interest, taxes, depletion and depreciation and amortization) shall not exceed 3.5 times, for which our calculation was 0.7 times at December 31, 2018. The second financial covenant is that the long-term debt to capitalization (the aggregate of long-term debt and shareholders' equity) ratio shall not exceed 55%, for which our calculation was 10% at December 31, 2018.

Borrowings under the credit facilities bear interest at the bank's prime lending rate, bankers' acceptance or LIBOR rates plus applicable margins and standby fees, dependent on Freehold's long-term debt to EBITDA on royalty interest properties. At December 31, 2018 and December 31, 2017, the fair values of the long-term debt approximated its carrying values, as the long-term debt carries interest at prevailing market rates. In 2018, the average effective interest rate on advances under Freehold's credit facilities was 3.3% (2017 – 2.9%).

In 2018 net debt increased to $89.4 million at year end from $68.6 million a year prior. Net debt was affected by our acquisitions, dispositions, free cash flow in excess of our dividends and the change in working capital mentioned above.

**Debt Analysis**

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Long-term debt | 90,000 | 90,000 | - |
| Short-term debt (operating line) | - | - | - |
| Total debt | 90,000 | 90,000 | - |
| Working capital | (625) | (21,379) | -97% |
| Net debt | 89,375 | 68,621 | 30% |

Freehold's 2018 net debt to funds from operations ratio was 0.7 times (2017 – 0.6 times) and well within our debt management strategy target of below 1.5 times. This ratio is a financial leverage measure that reflects cash available to pay back our debts. It represents the number of years it would take Freehold to reduce its net debt to zero if funds from operations was held constant and there were no other cash outflow obligations required such as dividends and acquisitions, among others. Freehold's long-term debt of $90 million did not change year-over-year primarily due to continued acquisition activity and therefore the 17% increase from 2017 is a direct result of changes in working capital.

Freehold defines capital (and capitalization) as net debt plus shareholders' equity. The net debt to capitalization ratio is a financial leverage measure that shows the portion of capital relating to debt. Freehold's ratio in 2018 of 10% (2017 – 8%) reflects its low debt levels and resulting low financial risk.

**Financial Leverage Ratios**

| | 2018 | 2017 | Change |
|---|---|---|---|
| Net debt to funds from operations (times) | 0.7 | 0.6 | 17% |
| Net debt to capitalization (%) | 10 | 8 | 25% |

## Non-Derivative Financial Liabilities

Freehold's non-derivative financial liabilities include its dividends payable, accounts payable and accrued liabilities, share based compensation payable, decommissioning liability and long-term debt. Freehold has no derivative financial liabilities.

The following table outlines cash flows associated with contractual maturities of Freehold's non-derivative financial liabilities as at December 31, 2018.

| ($000s) | Less than 1 Year | 2-3 Years | Total |
|---|---|---|---|
| Dividends payable | 6,215 | - | 6,215 |
| Accounts payable and accrued liabilities | 4,610 | - | 4,610 |
| Share based compensation payable | 466 | 487 | 953 |
| Decommissioning liability | 2,284 | 1,825 | 4,109 |
| Long-term debt | - | 90,000 | 90,000 |
| Total | 13,575 | 92,312 | 105,887 |

## Shareholders' Capital

As at December 31, 2018 and March 7, 2019 there were 118,402,667 shares outstanding. During 2018, Freehold issued 220,000 shares (2017– 220,000) for payment of the management fee (see Related Party Transactions). During 2018 there were no shares issued for the redemption of DSUs and in 2017 there were 44,393 shares issued on redemption of DSUs (see Share Based Compensation).

**Shareholders' Capital**

| | December 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Shares | Amount ($000s) | Shares | Amount ($000s) |
| Balance, beginning of year | 118,182,667 | 1,267,591 | 117,918,274 | 1,263,796 |
| Issued for payment of management fee | 220,000 | 2,429 | 220,000 | 3,043 |
| Issued for deferred share unit plan redemption | - | - | 44,393 | 752 |
| Balance, end of year | 118,402,667 | 1,270,020 | 118,182,667 | 1,267,591 |

**Shares Outstanding**

| | 2018 | 2017 | Change |
|---|---|---|---|
| Weighted average | | | |
| Basic | 118,266,297 | 118,044,473 | - |
| Diluted | 118,421,937 | 118,162,099 | - |
| At December 31 | 118,402,667 | 118,182,667 | - |

## Dividend Policy

The Board reviews and determines the monthly dividend rate on a quarterly basis, or as conditions necessitate, after considering expected commodity prices, foreign exchange rates, economic conditions, production volumes, tax payable, and our capacity to finance operating and investing obligations. The dividend rate is established with the intent of absorbing short-term market volatility over several months. It also recognizes our intention to fund capital expenditures primarily through funds from operations and to maintain a strong balance sheet to take advantage of acquisition opportunities and withstand potential commodity price declines.

The payment of dividends by a corporation is governed by the liquidity and insolvency tests described in the *Business Corporations Act* (Alberta) (ABCA). Pursuant to the ABCA, after the payment of a dividend, we must be able to pay our liabilities as they become due and the realizable value of our assets must be greater than our liabilities and the legal stated capital of our outstanding securities. As at December 31, 2018 and 2017 our legal stated capital was $1.0 billion.

**2018 Dividends Declared**

| Record Date | Payment Date | Dividend Amount ($ per share) |
|---|---|---|
| January 31, 2018 | February 15, 2018 | 0.0500 |
| February 28, 2018 | March 15, 2018 | 0.0500 |
| March 31, 2018 | April 16, 2018 | 0.0525 |
| April 30, 2018 | May 15, 2018 | 0.0525 |
| May 31, 2018 | June 15, 2018 | 0.0525 |
| June 30, 2018 | July 16, 2018 | 0.0525 |
| July 31, 2018 | August 15, 2018 | 0.0525 |
| August 31, 2018 | September 17, 2018 | 0.0525 |
| September 30, 2018 | October 15, 2018 | 0.0525 |
| October 31, 2018 | November 15, 2018 | 0.0525 |
| November 30, 2018 | December 17, 2018 | 0.0525 |
| December 31, 2018 | January 15, 2019 | 0.0525 |
| **Total** | | **0.6250** |

Dividends declared in 2018 totaled $73.9 million ($0.625 per share), up from $68.5 million ($0.58 per share) in 2017. The monthly dividend increased by 5% from $0.05 per share to $0.0525 per share for the dividend declared on March 31, 2018. From inception of Freehold Royalty Trust in 1996 to December 31, 2018, Freehold distributed $1.6 billion ($31.68 per share) to our shareholders. Freehold's dividends are designated as eligible dividends for Canadian income tax purposes.

**Accumulated Dividends**(1)

| | **2018** | 2017 | Change |
|---|---|---|---|
| Dividends declared ($000s) | **73,928** | 68,479 | 8% |
| Accumulated, beginning of year | **1,553,952** | 1,485,473 | 5% |
| Accumulated, end of year | **1,627,880** | 1,553,952 | 5% |
| Dividends per share ($) (2) | **0.6250** | 0.58 | 8% |
| Accumulated, beginning of year | **31.050** | 30.47 | 2% |
| Accumulated, end of year | **31.675** | 31.05 | 2% |

(1) Accumulated dividends reflect distributions paid on trust units of Freehold Royalty Trust (the predecessor of Freehold) from 1996 through 2010 and dividends paid on common shares of Freehold from 2011 onwards.

(2) Based on the number of shares issued and outstanding at each record date.

The following tables show reconciliations of funds from operations and dividends. In 2018 Freehold's basic payout ratio was 61% and its adjusted payout ratio was 64%, exhibiting that dividend payments are being made within our means, with excess free cash flow (see Non-GAAP Financial Measures) being used to repay debt and fund acquisitions.

**Dividends Analysis**

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Total dividends paid (1) | 73,713 | 67,307 | 10% |
| Dividends declared | 73,928 | 68,479 | 8% |
| Funds from operations | 121,287 | 123,788 | -2% |
| Capital expenditures | 3,993 | 4,864 | -18% |
| | | | |
| Basic payout ratio (2) | 61% | 55% | 11% |
| Adjusted payout ratio (3) | 64% | 58% | 10% |

(1) Based on the dividend payment date which is generally on the 15th day of the month following the month it was declared.

(2) Dividends declared as a percentage of funds from operations (see Non-GAAP Financial Measures).

(3) Dividends paid plus capital expenditures as a percentage of funds from operations (see Non-GAAP Financial Measures).

**Reconciliation of Dividends Declared**

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Funds from operations | 121,287 | 123,788 | -2% |
| Debt additions | - | 6,000 | -100% |
| Acquisitions | (61,740) | (86,743) | -29% |
| Capital expenditures | (3,993) | (4,864) | -18% |
| Working interest dispositions | 8,719 | 32,419 | -73% |
| Working capital change | 9,655 | (2,121) | - |
| Dividends declared | 73,928 | 68,479 | 8% |

# Investing Activities

## Acquisitions

Freehold's acquisition strategy targets individual properties or groups of properties to augment our production, reserves and land, with a focus on royalty interests. The key criteria are:

- quality assets;
- attractive returns;
- acceptable risk profile; and
- long economic life.

Freehold spent a total of $61.7 million on acquisitions in 2018 as follows:

- In February 2018, Freehold closed a $7.0 million royalty acquisition in Alberta including undeveloped land valued at $3.3 million.
- In March 2018, Freehold closed an acquisition of oil royalties on the Weyburn Unit in Saskatchewan and Mitsue Gilwood Sand Unit No. 1 in Alberta for $24.1 million and the assignment of certain minor working interest assets.
- In May 2018, Freehold closed an additional oil royalty acquisition on the Mitsue Gilwood Sand Unit No. 1 for $2.7 million.
- In August 2018, Freehold closed a royalty acquisition in Alberta for $5.9 million and the assignment of certain minor working interest assets.

- In September 2018, Freehold closed an undeveloped land royalty acquisition in central Alberta for $12.0 million with funds held in escrow until certain drilling milestones are met.
- In October 2018, Freehold closed an undeveloped land royalty acquisition in central Alberta for $1.3 million.
- In November 2018, Freehold closed a royalty acquisition in southwest Saskatchewan for $8.9 million.

For the year ended December 31, 2017, Freehold had royalty acquisition activity of $86.7 million including $15.9 million of undeveloped land classified as an exploration and evaluation asset.

### Capital Expenditures

In 2018, total capital expenditures of $4.0 million represented an 18% reduction from 2017 levels, as there were reduced capital commitments with the continued disposition of some of our working interest properties.

In the upstream oil and gas sector, because of the nature of reserve reporting, natural reservoir depletion, and the risks involved in capital investment, it is not possible to distinguish between capital spent on maintaining productive capacity and capital spent on growth opportunities. Therefore, maintenance capital is not disclosed separately from development capital spending.

| ($000s, except as noted) | **2018** | 2017 | Change |
|---|---|---|---|
| Development drilling and other | **3,594** | 4,049 | -11% |
| Plant and facilities | **399** | 815 | -51% |
| Total capital expenditures | **3,993** | 4,864 | -18% |

### Working Interest Dispositions

For the year ended December 31, 2018, Freehold closed the sale of its Pembina Cardium Unit No. 9 working interest property in exchange for cash proceeds of $8.7 million (including final adjustments) and an acquisition of a new 4% gross overriding royalty on the same property valued at $1.9 million (see Impairment, Impairment Reversal and Gain on Working Interest Dispositions). In 2017 working interest dispositions totaled $32.4 million.

## Decommissioning Liability

We have no decommissioning liability on our royalty interest properties. Our decommissioning liability results from our responsibility to abandon and reclaim our net share of our working interest properties. During 2018 we spent $2.0 million on decommissioning activities (2017 - $1.9 million) as we continue to address our obligations in a responsible fashion.

The undiscounted value of Freehold's total decommissioning liability is estimated to be $14.2 million (2017 – $19.3 million). Payments to settle the obligations are expected to occur over the next 49 years, with the majority being settled within 10 years. At December 31, 2018, a risk-free rate of 2.2% (2017 – 2.2%) and an inflation rate of 2.0% (2017 – 2.0%) were used to calculate the fair value. The fair value of the decommissioning liability at December 31, 2018 was $11.9 million (2017 – $15.5 million) with the current portion of liability being $2.3 million (2017 – $1.4 million).

# Business Risks and Mitigating Strategies

Our operations are subject to some of the same industry risks and conditions faced by oil and gas companies. The most significant of these include the following:

- fluctuations in commodity prices and quality differentials as a result of weather patterns, world and North American market forces or shifts in the balance between supply and demand for crude oil and gas;
- access to pipelines or other transportation methods for bringing oil and natural gas to market;
- variations in currency exchange rates;
- imprecision of reserve estimates and uncertainty of depletion and recoverability of reserves. Our reserves will deplete over time through continued production and we and our industry partners and royalty payors may not be able to replace these reserves on an economic basis;
- reliance on royalty payors to drill and produce on our lands and their ability to pay their obligations;
- industry activity levels and intense competition for land, goods and services, and qualified personnel;
- stock market volatility and the ability to access sufficient capital from internal and external sources;
- risk associated with volatility in global financial markets;
- risk associated with the renegotiation of our credit facility;
- operational or marketing risks resulting in delivery interruptions, delays or unanticipated production declines;
- changes in government regulations, taxation, and royalties; and
- safety and environmental risks.

For a more detailed description of risk factors, please see our Annual Information Form, filed on SEDAR.

We employ the following strategies to mitigate these risks:

- Our diversified revenue stream limits the size of any one property with respect to our total assets.
- We are not liable for abandonment and reclamation costs on our royalty lands.
- Due to our high percentage of royalty lands, we have one of the lowest all-in cost structures of our peer group. In addition, we maintain a focus on controlling direct costs to maximize profitability.
- We negotiate agreements that provide mechanisms to ensure that our interests are protected.
- Systems and processes are in place to identify any unpaid or incorrect revenues.
- We maintain a dedicated compliance function, with a comprehensive auditing program, to ensure that the terms of the various agreements are followed. During 2018, our audit staff issued audit exception queries amounting to $5.5 million, bringing the total amount of audit exception queries since 1997 to $91.4 million, of which we have successfully recovered $73.6 million.
- We adhere to strict investment criteria for acquisitions, seeking quality royalty properties that have attractive returns, acceptable risk profiles and long economic lives.
- We market our products to a diverse range of buyers or with our diverse range of royalty payors. Currently, we do not have any commodity price, exchange rate, or interest rate hedging programs in place.

- We employ a qualified Manager that has many years of experience and knowledge in managing our assets.
- We maintain levels of liability insurance that meet or exceed industry standards.
- We employ a conservative approach to debt management. As circumstances warrant, we allocate a portion of funds from operations to debt repayment.

## Environmental Regulation and Risk

The oil and gas industry is subject to environmental regulations pursuant to provincial and federal legislation. Such legislation provides for restrictions and prohibitions on the release or emission of various substances produced in association with certain oil and gas industry operations. In addition, such legislation requires that well and facility sites be abandoned and reclaimed to the satisfaction of provincial authorities. Compliance with such legislation can require significant expenditures and a breach of such requirements may result in suspension or revocation of necessary licenses and authorizations, civil liability for pollution damage, and the imposition of material fines and penalties. It is reasonably likely that the trend towards stricter standards in environmental legislation and regulation will continue. Given the evolving nature of the debate related to climate change and the control of greenhouse gases and resulting requirements, it is not possible to predict the impact of those requirements on our operations and financial condition. For information about climate change and other environmental regulations, see “Industry Conditions” in our Annual Information Form.

# Controls and Accounting Matters

In compliance with National Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filings* (NI 52-109), Freehold has filed certificates signed by our Chief Executive Officer (CEO) and Chief Financial Officer (CFO) that, among other things, deal with the matter of disclosure controls and procedures and internal control over financial reporting. While we believe that our disclosure controls and procedures and internal control over financial reporting provide a reasonable level of assurance, we do not expect that the controls will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objective of the control system is met.

## Disclosure Controls

As of December 31, 2018, an internal evaluation was carried out of the effectiveness of Freehold’s disclosure controls and procedures. This evaluation was performed under the supervision of, and with the participation of the CEO and the CFO. It took into consideration Freehold’s Disclosure, Insider Trading, Code of Business Conduct and Conflict of Interest, and Whistleblower policies, as well as the functioning of the Manager, the officers, the Board and Board Committees. In addition, the evaluation covered the processes, systems and capabilities relating to regulatory filings, public disclosures, and the identification and communication of material information. Based on this evaluation, management has concluded that Freehold’s disclosure controls and procedures were effective as at December 31, 2018, in ensuring that material information is made known to management in a timely manner, particularly during the period in which the annual filings were being prepared, and information required to be disclosed by Freehold in its annual filings, interim filings or other reports filed or submitted by Freehold under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation.

## Internal Control Over Financial Reporting

Our CEO and CFO are responsible for establishing and maintaining internal control over financial reporting (ICFR). They have caused ICFR to be designed under their supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. The control framework used to design ICFR is the Internal Control – Integrated Framework (2013 COSO Framework) published by The Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Under the supervision of the CEO and CFO, Freehold conducted an evaluation of the effectiveness of its ICFR as at December 31, 2018, as structured within the 2013 COSO Framework. Based on this evaluation, the CEO and CFO concluded that, as of December 31, 2018, our ICFR provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. There were no changes in our ICFR during 2018 that materially affected Freehold's ICFR.

## New Accounting Standards

### a. IFRS 9

On January 1, 2018 Freehold adopted IFRS 9 *Financial Instruments* with no material transitional impact on the financial statements. IFRS 9 contains three classifications for financial assets: amortized cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). The new classifications are based on an entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset. The previous IAS 39 *Financial Instruments: Recognition and Measurement* classifications of held-to-maturity, loans and receivables and available-for-sale have been eliminated. In addition, IFRS 9 replaces the "incurred loss" model in IAS 39 with an "expected credit loss" impairment model that applies to financial assets measured at amortized cost. Under IFRS 9, credit losses, if any, may be recognized earlier than under IAS 39. All of Freehold's financial assets (cash and accounts receivable) are measured at amortized cost and the adoption of IFRS 9 did not result in any adjustment to the carrying amount of the related assets.

There was no change to the classification of accounts payable and accrued liabilities, dividends payable and long-term debt which are classified as "other financial liabilities" and are measured at amortized cost. No financial instruments have been classified as FVOCI or FVTPL. Presently and historically, Freehold has not entered into any transactions in which hedge accounting could be applied.

### b. IFRS 15

On January 1, 2018, Freehold adopted IFRS 15 *Revenue from Contracts with Customers.* Using IFRS 15's five step model, which includes the identification of performance obligations, Freehold reviewed its various royalty and other revenue streams and underlying contracts with customers. IFRS 15 did not have a material effect on Freehold's financial statements with the exception of certain new disclosures.

## Recent Pronouncements

In January 2016, the IASB issued IFRS 16 *Leases*, which replaces IAS 17 *Leases*. The standard establishes 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 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. Other areas of the lease accounting model have been impacted, including the definition of a lease. Freehold's mineral leases are not in scope of IFRS 16. Freehold does not have an office lease in its name. All office space used by Freehold is provided by Rife Resources Management Ltd. (see Related Party Transactions). The effective date for adopting IFRS 16 in its entirety is January 1, 2019.

Freehold's assessment of IFRS 16 including a review of lease agreements has been completed. Freehold is not expecting any material impact on the consolidated financial statements.

## Critical Accounting Estimates

Our financial statements are prepared within a framework of Canadian GAAP (being IFRS) selected by management and approved by our Board. The assets, liabilities, revenues, and expenses reported in our financial statements depend to varying degrees on estimates made by management. These estimates are based on historical experience and reflect certain assumptions about the future that are believed to be both reasonable and conservative. The more significant reporting areas are crude oil and gas reserve estimation, depletion, impairment of assets, oil and gas revenue accruals, oil and gas royalty interests, decommissioning liability and income taxes. Management's judgments and estimates in these areas are based on information available from both internal and external sources, including engineers, geologists, and historical experience in similar matters. Actual results could differ from the estimates, as additional information becomes known.

An estimate is considered a critical accounting estimate if it requires management to make assumptions about matters that are highly uncertain, and if different estimates that could have been used would have a material impact. We continually evaluate the estimates and assumptions. In the normal course, changes are made to assumptions underlying all critical accounting estimates to reflect current economic conditions, and updating of historical information is used to develop the assumptions. Except as discussed in this MD&A, we are not aware of trends, commitments, events, or uncertainties that are expected to materially affect the methodology or assumptions associated with the critical accounting estimates.

## Reserve Estimates, Depletion and Impairment Testing

The current estimates of oil and gas reserves and our future capital expenditures are based on an independent evaluation conducted as of December 31, 2018. Reserve estimates are updated once a year (as at December 31) and when a significant acquisition or development is completed. At each interim reporting date, reserves are also adjusted for production. The reserve and recovery information provided are only estimates. The actual production and ultimate reserves may be greater than or less than the estimates and the differences may be material.

Petroleum and natural gas interests, including the cost of production equipment, future capital costs, estimated decommissioning costs and directly attributable general and administrative costs are depleted on the unit-of-production method based on estimated proved plus probable oil and gas reserves. Reserves are converted to equivalent units on the basis of relative energy content. An increase in estimated proved plus probable oil and gas reserves would result in a corresponding reduction in the depletion rate.

At each reporting date, Freehold assesses groups of assets or CGUs for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If any such indication of impairment exists, Freehold makes an estimate of its recoverable amount. Where the carrying amount of a group of assets exceeds its recoverable amount, the assets are considered impaired and written down. Impairments can be reversed if the impairment indicators have been reversed. Indicators and recoverable amounts are primarily estimates from independent sources. The determination of CGUs is subject to management judgment.

## Oil and Gas Revenue Accruals and Royalty Interests

Freehold follows the accrual method of accounting, making estimates in its financial and operating results. This may include estimates of revenues, royalties, production and other expenses and capital items related to the period being reported, for which actual results have not yet been received. We expect that these accrual estimates will be revised, upwards or downwards, based on the receipt of actual results. We have no operational control over our royalty lands, and we primarily hold small interests in several thousand wells. Thus, obtaining timely production data from the well operators is extremely difficult. As a result, we use government reporting databases and past production receipts to estimate revenue accruals.

Significant judgment is required to determine the interests of royalty properties in areas where mineral rights are shared with Canpar (see Related Party Transactions). We use publicly available information on geological formations to apportion revenues between the entities in accordance with the respective party's interests. As new geological information becomes available and as part of our ongoing internal audit activities, we periodically revise these allocations and consideration is transferred to reflect the changes.

## Decommissioning Liability

Freehold measures decommissioning liability as the present value of management's best estimate of the expenditure required to settle the obligation at the reporting date using a risk-free discount rate. This estimate is recognized when a legal or constructive obligation arises and is recorded as both a short and long-term liability, with a corresponding increase in the carrying value of the petroleum and natural gas working interest asset. The capitalized amount is depleted on a unit-of-production method over the life of the reserves. At each reporting date, the passage of time and changes to estimates results in liability changes and the amount of accretion is charged against current period income.

In determining our decommissioning liability, we are required to make a significant number of estimates with respect to activities that will occur in many years to come. In arriving at the recorded amount of the decommissioning liability, numerous assumptions are made with respect to ultimate settlement amounts, inflation factors, risk-free discount rates, timing of settlement and expected changes in legal, regulatory, environmental and political environments. The decommissioning liability also results in an increase to the carrying cost of capital assets. The obligation accretes to a higher amount with the passage of time as it is determined using discounted present values. A change in any one of the assumptions could affect the estimated future obligation and in return, net income. It is difficult to determine the impact of a change in any one of our assumptions. As a result, a reasonable sensitivity analysis cannot be performed.

## Income Taxes

We follow the balance sheet method of accounting for income taxes. Under this method, income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax bases, using enacted or substantially enacted income tax rates. The effect of a change in income tax rates on deferred income tax liabilities and assets is recognized in income in the period that the change occurs. The actual amount of income tax may be greater than or less than the estimates and the differences may be material.

## Forward-Looking Statements

Certain statements contained in this MD&A constitute forward-looking statements. These statements relate to future events or our expectations of future performance. All statements other than statements of historical fact may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "continue", "estimate", "expect", "may", "will", "forecast", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions (including the negatives thereof). These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. We believe the expectations reflected in those forward-looking statements are reasonable but no assurance can be given that these expectations will prove to be correct and, as such, forward-looking statements included in this MD&A should not be unduly relied upon. These forward-looking statements are provided to allow readers to better understand our business and prospects.

In particular, this MD&A contains forward-looking statements under President’s Message, 2018 Highlights, Our Strategy, Business Environment, Drilling Activity, Dividend and 2019 Guidance pertaining to the following:

- our outlook for commodity prices including supply and demand factors relating to crude oil, heavy oil, and natural gas;
- light/heavy oil price differentials;
- changing economic conditions;
- in the near-term, expecting prices both for crude oil and natural gas to be challenged until positive inroads are made in getting Canadian volumes to alternative markets;
- looking into 2019, remaining optimistic that activity levels will remain strong on our royalty lands, similar to 2018, with strong results expected in the Alberta and Saskatchewan Viking;
- cash costs forecasted at approximately $5.25/boe;
- our strategies and the expectation that those strategies will deliver growth and lower risk attractive returns to our shareholders;
- expected revenue from oil, natural gas and natural gas liquids;
- our acquisition criteria and the intent that such criteria will result in acquisitions being accretive to shareholders;
- foreign exchange rates;
- industry drilling and development activity on our royalty lands, including our estimate of 2019 net royalty wells at 20;
- development of our working interest properties;
- estimated capital budget and expenditures and the timing thereof;
- Freehold’s decommissioning liability and timing of payment thereof;
- forecast 2019 average royalty production, including product mix and percentage from royalties;
- forecast 2019 working interest production;

- continuing to reduce our working interest production;
- forecast 2019 percentage of operating income from royalties;
- forecast 2019 adjusted payout ratio;
- forecast 2019 year end net debt to funds from operations;
- key operating assumptions including operating costs and general and administrative costs;
- expected decline rates associated with certain assets;
- amounts and rates of income taxes and timing of payment thereof;
- expected production additions from our audit function;
- our tax pools and the expected tax horizon;
- our dividend policy and expectations for future dividends;
- treatment under governmental regulatory regimes and tax laws; and
- our assessment of litigation risk.

Our actual results could differ materially from those anticipated in these forward-looking statements because of many factors, the most significant of which are as follows:

- volatility in market prices for crude oil, NGL and natural gas;
- lack of pipeline capacity;
- currency fluctuations;
- the Alberta government's handling of oil curtailments;
- changes in income tax laws or changes in tax laws, regulations, royalties, or incentive programs relating to the oil and gas industry;
- reliance on royalty payors to drill and produce on our lands and their ability to pay their obligations;
- uncertainties or imprecision associated with estimating oil and gas reserves;
- stock market volatility and our ability to access sufficient capital from internal and external sources;
- a significant or prolonged downturn in general economic conditions or industry activity;
- incorrect assessments of the value of acquisitions;
- competition for, among other things, capital, acquisitions of reserves, undeveloped lands and skilled personnel;
- geological, technical, drilling, and processing problems;
- environmental risks and liabilities inherent in oil and gas operations; and
- other factors discussed in Freehold's annual MD&A, and audited financial statements for the year ended December 31, 2018 and our Annual Information Form.

Readers are cautioned that the foregoing list of factors is not exhaustive.

With respect to forward-looking statements contained in this MD&A, we have made assumptions regarding, among other things, the following:

- future crude oil, NGL and natural gas prices;
- future capital expenditure levels;
- future production levels;

- future exchange rates;
- future tax rates;
- future legislation,
- the cost of developing and expanding our assets;
- our ability and the ability of our industry partners and royalty payors to obtain equipment in a timely manner to carry out development activities;
- our ability to market our product successfully to current and new customers;
- our expectation for the consumption of crude oil, NGL and natural gas;
- our expectation for industry drilling levels on our royalty lands;
- the impact of competition;
- our ability to obtain financing on acceptable terms; and
- our ability to add production and reserves through our development and acquisition activities.

Key operating assumptions with respect to the forward-looking statements contained in this MD&A are provided in the Outlook section.

To the extent any guidance or forward-looking statements herein constitutes a financial outlook, they are included herein to provide readers with an understanding of management's plans and assumptions for budgeting purposes and readers are cautioned that the information may not be appropriate for other purposes. You are further cautioned that the preparation of financial statements in accordance with IFRS requires management to make certain judgments and estimates that affect the reported amounts of assets, liabilities, revenues, and expenses. These estimates may change, having either a positive or negative effect on net income, as further information becomes available and as the economic environment changes.

The forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement and speak only as of the date of this MD&A. Our policy for updating forward-looking statements is to update our key operating assumptions quarterly and, except as required by law, we do not undertake to update any other forward-looking statements.

## Non-GAAP Financial Measures

Within this MD&A, references are made to terms commonly used as key performance indicators in the oil and gas industry. We believe that operating income, operating netback, basic payout ratio and adjusted payout ratio, free cash flow and cash costs are useful supplemental measures for management and investors to analyze operating performance, financial leverage, and liquidity, and we use these terms to facilitate the understanding and comparability of our results of operations and financial position. However, these terms do not have any standardized meanings prescribed by GAAP and therefore may not be comparable with the calculations of similar measures for other entities.

Operating income is calculated as royalty and other revenue less royalty and operating expenses. It shows the profitability of our revenue streams as it provides the cash margin for product sold after directly related expenses. Operating netback, which is calculated as average unit sales price less royalty and operating expenses, represents the cash margin for product sold, calculated on a per boe basis. (See our Netback Analysis section for calculations.)

Payout ratios are often used for dividend paying companies in the oil and gas industry to identify its dividend levels in relation to the funds it receives and uses in its capital and operational activities. Basic payout ratio is calculated as dividends declared as a percentage of funds from operations. Adjusted payout ratio is calculated as dividends paid plus capital expenditures as a percentage of funds from operations. (See our Dividend Policy section for calculations.)

Free cash flow is calculated by subtracting capital expenditures from funds from operations. Free cash flow is a measure often used by dividend paying companies to determine cash available for payment of dividends, paying down debt or investment.

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Funds from operations | 121,287 | 123,788 | -2% |
| Capital expenditures | (3,993) | (4,864) | -18% |
| Free cash flow | 117,294 | 118,924 | -1% |

Cash costs is a total of all recurring costs in the statement of income deducted in determining funds from operations. For Freehold cash costs are identified as royalty expense, operating expense, G&A expense, interest expense and share based compensation payments. It is key to funds from operations, representing the ability to sustain dividends, repay debt and fund capital expenditures.

| ($000s) | 2018 | 2017 | Change |
|---|---|---|---|
| Royalty expense | 694 | 1,174 | -41% |
| Operating expense | 5,876 | 11,006 | -47% |
| General and administrative expenses | 11,238 | 11,015 | 2% |
| Interest expense | 3,705 | 2,604 | 42% |
| Expenditures on share based compensation | 423 | 442 | -4% |
| Total cash costs | 21,936 | 26,241 | -16% |

We refer to various per boe figures which provide meaningful information on our operational performance. We derive per boe figures by dividing the relevant revenue or cost figures by the total volume of oil, NGL and natural gas production during the period, with natural gas converted to equivalent barrels of oil as described above.

## Conversion of Natural Gas to Barrels of Oil Equivalent (boe)

To provide a single unit of production for analytical purposes, natural gas production and reserves volumes are converted mathematically to equivalent barrels of oil (boe). We use the industry-accepted standard conversion of six thousand cubic feet of natural gas to one barrel of oil (6 Mcf = 1 barrel). The 6:1 boe ratio is based on an energy equivalency conversion method primarily applicable at the burner tip. It does not represent a value equivalency at the wellhead and is not based on either energy content or current prices. While the boe ratio is useful for comparative measures, it does not accurately reflect individual product values and might be misleading, particularly if used in isolation. As well, given that the value ratio, based on the current price of crude oil to natural gas, is significantly different from the 6:1 energy equivalency ratio, using a 6:1 conversion ratio may be misleading as an indication of value.

# Management's Report

The accompanying consolidated financial statements and other financial information in this Financial Report have been prepared by management, who is responsible for their integrity, consistency, objectivity and reliability. To fulfill this responsibility, Freehold maintains policies, procedures and systems of internal control to ensure that reporting practices and accounting and administrative procedures are appropriate to provide reasonable assurance that the assets are safeguarded, transactions are properly authorized and relevant and reliable financial information is produced.

These consolidated financial statements have been prepared in conformity with International Financial Reporting Standards and, where appropriate, reflect estimates based on management's judgment. The financial information presented throughout this Financial Report is generally consistent with the information contained in the accompanying consolidated financial statements.

Independent auditors, KPMG LLP, were appointed by the shareholders to perform an examination of the corporate and accounting records so as to express an opinion on the consolidated financial statements. Their examination included tests and procedures considered necessary to provide reasonable assurance that the consolidated financial statements are presented fairly in accordance with International Financial Reporting Standards.

The consolidated financial statements have been further reviewed and approved by the Board of Directors acting through its Audit Committee, which is comprised of independent directors. The Audit Committee, which meets with the auditors and management to review the activities of each and reports to the Board of Directors, oversees management's responsibilities for the financial reporting and internal control systems. The auditors have full and direct access to the Audit Committee and meet periodically with the committee both with and without management present to discuss their audit and related findings.

| | |
|---|---|
| (signed) "*Thomas J. Mullane*" | (signed) "*Darren G. Gunderson*" |
| Thomas J. Mullane<br>President and Chief Executive Officer | Darren G. Gunderson<br>Vice-President, Finance and Chief Financial Officer |

March 7, 2019

# Independent Auditors’ Report

**To the Shareholders of Freehold Royalties Ltd.**

***Opinion***

We have audited the consolidated financial statements of Freehold Royalties Ltd. (the “Entity”), which comprise:

- the consolidated balance sheets as at December 31, 2018 and December 31, 2017
- the consolidated statements of income and comprehensive income for the years then ended
- the consolidated statements of changes in shareholders’ equity for the years then ended
- the consolidated statements of cash flows for the years then ended
- and notes to the consolidated financial statements, including a summary of significant accounting policies.

(Hereinafter referred to as the “financial statements”).

In our opinion, the accompanying financial statements present fairly, in all material respects, the consolidated financial position of the Entity as at December 31, 2018 and December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (“IFRS”).

***Basis for Opinion***

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *“Auditors’ Responsibilities for the Audit of the Financial Statements”* section of our auditors’ report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

***Other Information***

Management is responsible for the other information. Other information comprises:

- the information included in Management’s Discussion and Analysis filed with the relevant Canadian Securities Commissions.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit and remain alert for indications that the other information appears to be materially misstated.

We obtained the information included in Management’s Discussion and Analysis filed with the relevant Canadian Securities Commissions as at the date of this auditors’ report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in the auditors’ report.

We have nothing to report in this regard.

***Responsibilities of Management and Those Charged with Governance for the Financial Statements***

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

***Auditors' Responsibilities for the Audit of the Financial Statements***

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
  The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.
- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this auditors' report is Brad William Robertson.

(signed) "*KPMG LLP*"
Calgary, Canada
March 7, 2019

# Consolidated Balance Sheets

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash | $ 1,262 | $ 284 |
| Accounts receivable | 12,938 | 25,952 |
| Assets held for sale (note 5) | - | 13,810 |
| | 14,200 | 40,046 |
| Exploration and evaluation assets (note 4) | 87,453 | 75,776 |
| Petroleum and natural gas interests (note 5) | 770,248 | 818,921 |
| Deferred income tax asset (note 12) | 16,398 | 21,541 |
| | $ 888,299 | $ 956,284 |
| **Liabilities and Shareholders' Equity** | | |
| Current liabilities: | | |
| Dividends payable | $ 6,215 | $ 5,908 |
| Accounts payable and accrued liabilities | 4,610 | 7,206 |
| Current portion of share based compensation payable (note 8) | 466 | 399 |
| Current portion of decommissioning liability (note 6) | 2,284 | 1,444 |
| Liabilities related to assets held for sale (note 5) | - | 3,710 |
| | 13,575 | 18,667 |
| Decommissioning liability (note 6) | 9,622 | 14,051 |
| Share based compensation payable (note 8) | 487 | 1,974 |
| Long-term debt (note 7) | 90,000 | 90,000 |
| Shareholders' equity: | | |
| Shareholders' capital (note 9) | 1,270,020 | 1,267,591 |
| Contributed surplus | 2,569 | 2,079 |
| Deficit | (497,974) | (438,078) |
| | 774,615 | 831,592 |
| | $ 888,299 | $ 956,284 |

See accompanying notes to consolidated financial statements.

On behalf of the Board of Directors of Freehold Royalties Ltd.:

(signed) "*Marvin F. Romanow*"

Marvin F. Romanow
Director

(signed) "*Arthur N. Korpach*"

Arthur N. Korpach
Director

# Consolidated Statements of Income and Comprehensive Income

| | Year Ended December 31 | |
|---|---|---|
| ($000s, except per share and weighted average data) | 2018 | 2017 |
| Revenue: | | |
| Royalty and other revenue (note 11) | $ 145,236 | $ 151,894 |
| Royalty expense | (694) | (1,174) |
| | 144,542 | 150,720 |
| Gain on working interest dispositions (note 5) | - | 14,866 |
| Expenses: | | |
| Operating | 5,876 | 11,006 |
| General and administrative | 11,238 | 11,015 |
| Share based compensation expense (recovery) (note 8) | (257) | 1,591 |
| Interest and financing | 3,705 | 2,604 |
| Depletion and depreciation (note 5) | 102,042 | 108,227 |
| Impairment, net of impairment reversal (note 5) | - | 10,609 |
| Accretion of decommissioning liability (note 6) | 334 | 459 |
| Management fee (note 10) | 2,429 | 3,043 |
| | 125,367 | 148,554 |
| Income before taxes | 19,175 | 17,032 |
| Deferred income tax expense (note 12) | 5,143 | 4,814 |
| Net income and comprehensive income | $ 14,032 | $ 12,218 |
| Net income per share, basic and diluted | $ 0.12 | $ 0.10 |
| Weighted average number of shares: | | |
| Basic | 118,266,297 | 118,044,473 |
| Diluted | 118,421,937 | 118,162,099 |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Cash Flows

| ($000s) | Year Ended December 31 2018 | 2017 |
|---|---|---|
| Operating: | | |
| Net income | $ 14,032 | $ 12,218 |
| Items not involving cash: | | |
| Depletion and depreciation | 102,042 | 108,227 |
| Gain on working interest dispositions | - | (14,866) |
| Impairment, net of impairment reversal | - | 10,609 |
| Share based compensation expense (recovery) | (257) | 1,591 |
| Deferred income tax expense | 5,143 | 4,814 |
| Accretion of decommissioning liability | 334 | 459 |
| Management fee | 2,429 | 3,043 |
| Expenditures on share based compensation | (423) | (442) |
| Decommissioning expenditures | (2,013) | (1,865) |
| Funds from operations | 121,287 | 123,788 |
| Changes in non-cash working capital (note 15) | 11,837 | (4,521) |
| | 133,124 | 119,267 |
| Financing: | | |
| Long-term debt | - | 6,000 |
| Dividends paid | (73,713) | (67,307) |
| | (73,713) | (61,307) |
| Investing: | | |
| Acquisitions | (61,740) | (86,743) |
| Capital expenditures | (3,993) | (4,864) |
| Working interest dispositions | 8,719 | 32,419 |
| Changes in non-cash working capital (note 15) | (1,419) | 620 |
| | (58,433) | (58,568) |
| Increase (decrease) in cash | 978 | (608) |
| Cash, beginning of year | 284 | 892 |
| Cash, end of year | $ 1,262 | $ 284 |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Changes in Shareholders' Equity

| | Year Ended December 31 | |
|---|---|---|
| ($000s) | 2018 | 2017 |
| Shareholders' capital: | | |
| Balance, beginning of year | $ 1,267,591 | $ 1,263,796 |
| Shares issued for payment of management fee | 2,429 | 3,043 |
| Shares issued for deferred share unit plan redemption | - | 752 |
| Balance, end of year | 1,270,020 | 1,267,591 |
| Contributed surplus: | | |
| Balance, beginning of year | 2,079 | 2,717 |
| Share based compensation | 581 | 391 |
| Deferred share unit plan redemption | (91) | (1,029) |
| Balance, end of year | 2,569 | 2,079 |
| Deficit: | | |
| Balance, beginning of year | (438,078) | (381,817) |
| Net income and comprehensive income | 14,032 | 12,218 |
| Dividends declared | (73,928) | (68,479) |
| Balance, end of year | (497,974) | (438,078) |
| | $ 774,615 | $ 831,592 |

See accompanying notes to consolidated financial statements.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2018 and 2017

## 1. Basis of Presentation

Freehold Royalties Ltd. (Freehold) is a dividend-paying corporation incorporated under the laws of the Province of Alberta. Freehold's primary focus is acquiring and managing oil and gas royalties.

Freehold's principal place of business is located at 400, 144 – 4 Avenue SW, Calgary, Alberta, Canada T2P 3N4.

### a. Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS). A summary of Freehold's significant accounting policies under IFRS are presented in note 3.

These consolidated financial statements were approved by the Board of Directors on March 7, 2019.

### b. Basis of measurement and principles of consolidation

These consolidated financial statements have been prepared on a historical cost basis, with the exception of certain fair value measurements noted in Significant Accounting Policies, and include the accounts of Freehold and its wholly-owned subsidiaries: 1872348 Alberta Ltd., Freehold Holdings Trust and Freehold Royalties Partnership. All inter-entity transactions have been eliminated.

### c. Use of estimates and judgment

The preparation of financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses during the reporting period. Actual results could differ as a result of using estimates.

The amounts recorded for the depletion of petroleum and natural gas properties, the provision for decommissioning liability and the amounts used in the impairment calculations are based on estimates of petroleum and natural gas reserves and future costs to develop those reserves. By their nature, these estimates of reserves, costs and related future cash flows are subject to uncertainty, and the impact on the financial statements of future periods could be material.

The decommissioning liability amounts recorded are based on estimates of inflation rates, risk-free rates, timing of abandonments and future abandonment costs, all of which are subject to uncertainty. The long-term incentive plan amounts recorded include an estimate of forfeitures and certain management assumptions. Actual results could differ as a result of using estimates.

Income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax bases, using enacted or substantively enacted income tax rates. The effect of a change in income tax rates on deferred income tax liabilities and assets is recognized in income in the period that the change occurs. The actual amount of income tax may be greater than or less than the estimates and the differences may be material.

The determination of a cash generating unit (CGU) and whether an acquisition transaction constitutes a business combination is subject to management judgments. The recoverability of petroleum and natural gas interests and exploration and evaluation assets are assessed at the CGU level. A CGU is the lowest level at which there are identifiable cash inflows that are largely independent of the cash inflows of other CGUs. Each acquisition transaction is reviewed by management and judgment is used when determining if the transaction met the IFRS 3 inputs and processes criteria for business combinations.

Freehold follows the accrual method of accounting, making estimates in its financial and operating results. This may include estimates of revenues, royalties, production and other expenses and capital items related to the period being reported, for which actual results have not yet been received. It is expected that these accrual estimates will be revised, upwards or downwards, based on the receipt of actual results. Freehold has no operational control over its royalty lands and primarily holds small interests in several thousand wells. Thus, obtaining timely production data from the well operators is extremely difficult. As a result, Freehold uses government reporting databases and past production receipts to estimate revenue accruals.

Judgment is required to determine the interests of royalty properties in areas where mineral rights are shared with a related party, Canpar Holdings Ltd. (Canpar). Freehold uses publicly available information on geological formations to apportion revenues between the entities in accordance with the respective party's interests. As new geological information becomes available and as part of its ongoing internal audit activities, Freehold periodically revises these allocations and consideration is transferred to reflect the changes.

### d. Functional and presentation currency

These consolidated financial statements are presented in Canadian dollars, which is the functional currency of Freehold and its subsidiaries.

## 2. New Accounting Standards

### a. IFRS 9

On January 1, 2018 Freehold adopted IFRS 9 *Financial Instruments* with no material transitional impact on the financial statements. IFRS 9 contains three classifications for financial assets: amortized cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). The new classifications are based on an entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset. The previous IAS 39 *Financial Instruments: Recognition and Measurement* classifications of held-to-maturity, loans and receivables and available-for-sale have been eliminated. In addition, IFRS 9 replaces the "incurred loss" model in IAS 39 with an "expected credit loss" impairment model that applies to financial assets measured at amortized cost. Under IFRS 9, credit losses, if any, may be recognized earlier than under IAS 39. All of Freehold's financial assets (cash and accounts receivable) are measured at amortized cost and the adoption of IFRS 9 did not result in any adjustment to the carrying amount of the related assets.

There was no change to the classification of accounts payable and accrued liabilities, dividends payable and long-term debt which are classified as "other financial liabilities" and are measured at amortized cost. No financial instruments have been classified as FVOCI or FVTPL. Presently and historically, Freehold has not entered into any transactions in which hedge accounting could be applied.

### b. IFRS 15

On January 1, 2018, Freehold adopted IFRS 15 *Revenue from Contracts with Customers.* Using IFRS 15's five step model, which includes the identification of performance obligations, Freehold reviewed its various royalty and other revenue streams and underlying contracts with customers. IFRS 15 did not have a material effect on Freehold's financial statements with the exception of certain new disclosures included in note 3h and note 11.

## 3. Significant Accounting Policies

### a. Jointly controlled operations and jointly controlled assets

Some of Freehold's oil and gas activities involve jointly controlled assets. These consolidated financial statements include only Freehold's share of the jointly controlled assets and a proportionate share of the relevant revenue and related costs.

### b. Exploration and evaluation assets

Exploration and evaluation (E&E) costs are accounted for in accordance with IFRS 6, *Exploration for and Evaluation of Mineral Resources*. All E&E costs incurred after acquiring the "right to explore" are capitalized into a single cost pool. Upon determination of the technical feasibility and commercial viability of reserves, the associated E&E costs are assessed for impairment and the estimated recoverable amount is transferred to petroleum and natural gas interests. All costs incurred prior to acquiring the "right to explore" are expensed as incurred. At each reporting date, E&E costs are reviewed for indicators of impairment. If circumstances indicate the carrying amount exceeds its recoverable amount, the cost is written down to its recoverable amount and the difference is accounted for as an impairment expense. No depletion or depreciation is charged to E&E.

### c. Petroleum and natural gas interests

#### Petroleum and natural gas interests

Petroleum and natural gas interests are classified under International Accounting Standard (IAS) 16 as Property, Plant and Equipment and include both working and royalty interests, stated at cost, less accumulated depletion and accumulated impairment losses. All costs incurred after determining technical feasibility and commercial viability of reserves are capitalized. Subsequent expenditures are capitalized only where they enhance the economic benefits of the asset. A gain or loss on disposal of a petroleum and natural gas interest is recognized to the extent that the net proceeds exceed or are less than the appropriate portion of the capitalized costs of the asset.

#### Depletion

Petroleum and natural gas interests, including the costs of production equipment, future capital costs, estimated decommissioning liability costs, and directly attributable general and administrative costs, are depleted on the unit-of-production method based on estimated proved plus probable oil and gas reserves. Reserves are converted to equivalent units on the basis of relative energy content.

### Impairment

At each reporting date, Freehold assesses groups of assets or CGUs, for impairment whenever events or changes in circumstances indicate that the carrying value of the CGU may not be recoverable. If any such indication of impairment exists, Freehold makes an estimate of its recoverable amount. A CGU's recoverable amount is the higher of its fair value less costs of disposal (FVLCTD) and its value in use (VIU). Where the carrying amount of a CGU exceeds its recoverable amount, the CGU is considered impaired and is written down. In assessing VIU, the estimated future cash flows are adjusted for the risks specific to the CGU and are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money. FVLCTD is the amount obtainable from the sale of assets in an arm's length transaction less cost of disposal.

An assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or have decreased. If such indication exists, the recoverable amount is estimated. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the CGU's recoverable amount since the last impairment loss was recognized. If that is the case, the carrying amount of the CGU is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depletion, had no impairment loss been recognized for the CGU in prior periods. Such a reversal is recognized in profit or loss. After such a reversal, the depletion charge is adjusted in future periods to allocate the CGU's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

### d. Decommissioning liability

Freehold measures the decommissioning liability as the present value of management's best estimate of the expenditure required to settle the liability at the reporting date using a risk-free discount rate. This estimate is recognized when a legal or constructive obligation arises and is recorded as both a short and long-term liability, with a corresponding increase in the carrying value of the petroleum and natural gas working interest asset. The capitalized amount is depleted on a unit-of-production method over the life of the reserves. At each reporting date, the passage of time and changes to estimates results in liability changes, and the amount of accretion is charged against current period income.

### e. Income tax

Income tax expense comprises current and deferred tax.

Current tax is expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized on the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

### f. Share based compensation plans

**Long-term incentive plan**

In 2017, Freehold adopted a new long-term incentive plan (LTIP) to replace the previous long-term incentive plan for the employees of Rife Resources Ltd. (Rife) through the Manager of Freehold, Rife Resources Management Ltd. (see Related Party note 10). Grants will no longer be made under the previous plan but pre-existing grants will continue until vesting and payout occurs.

Freehold's new long-term incentive plan consists of grants of performance share units (PSUs) and restricted share units (RSUs). Underlying each PSU and RSU is one notional Freehold common share. The notional Freehold common shares are adjusted whenever a dividend is paid by Freehold. Upon vesting of the RSUs the holder is entitled to an amount equal in value to the notional Freehold common shares (as adjusted for dividends paid) underlying such RSUs. The value of the notional Freehold common shares is based on the volume weighted average trading price of Freehold common shares on the TSX for the five trading days prior to the settlement date of such RSUs. Generally, one-third of the granted RSUs will vest on each of the first, second and third anniversaries of the date of grant.

For PSUs, the notional Freehold common shares and value are calculated in the same manner as the RSUs, but with the additional application of a performance multiplier. The metrics used for determining the performance multiplier (which can range from 0 to 2 times) are at the discretion of Freehold’s Board of Directors at the time of grant. Generally, all of the granted PSUs will vest on the third anniversary of the date of grant.

Since participants receive a cash payment on a fixed vesting date, a liability is determined and recognized as services are rendered based on the fair value of the total rights at each period end. The valuation incorporates the consideration of the Freehold common share price, the number of notional Freehold common shares outstanding at each period end, an estimated performance multiplier, if applicable, and an estimated forfeiture rate. Compensation expense is recognized over the vesting period.

The previous LTIP uses a combination of the value of phantom Rife shares and Freehold shares as the basis for rights, which are granted annually at the discretion of the directors of Rife and vest at the end of a three-year period. Dividends to shareholders paid by Freehold during the vesting period are assumed to be reinvested in notional rights on the dividend payment date. Since participants in the LTIP receive a cash payment on a fixed vesting date, a liability is determined and recognized as services are rendered based on the fair value of the rights at each period end. The valuation incorporates the consideration of the share price, the number of rights outstanding at each period end, an estimated performance multiplier (0.25 to 1.5 times the market value) and an estimated forfeiture rate. Compensation expense is recognized over the vesting period. Freehold is responsible for funding its proportionate share of this plan.

### Deferred share unit plan

A deferred share unit (DSU) plan was established for the non-management directors of Freehold whereby fully-vested DSUs are granted annually. Under this plan, dividends to shareholders declared prior to redemption are assumed to be reinvested on behalf of the directors in notional share units on the dividend payment date. Compensation expense is recognized at the market value of Freehold's common shares at the time of grant or dividend, with a corresponding increase to contributed surplus. Upon redemption of the DSUs for Freehold's common shares, the amount previously recognized in contributed surplus is recorded as an increase to shareholders' capital.

### g. Net income per share

Basic net income per share is calculated using the weighted average number of shares outstanding for each period. Diluted net income per share is calculated using the weighted average number of diluted shares outstanding for each period. Diluted shares outstanding are calculated assuming that any proceeds received from options with a market value in excess of option price would be used to buy back shares at the average market price for the period.

### h. Revenue recognition

Royalty and other revenue is made up of royalty, working interest and other revenue earned during the period. The vast majority of royalty and other revenue represents the sale of crude oil, natural gas, natural gas liquids and other products. It was determined that Freehold has two different types of revenue streams coming from the sale of these products: royalty interest revenue and working interest revenue. These types of revenue are each recognized when the performance obligation is satisfied, which is typically on a monthly basis when the product is extracted from the lands and control of the product is transferred from Freehold, or the operator of Freehold's properties, to its customers.

Royalty and other revenue also includes bonus consideration and lease rentals which have different performance obligations. When a new mineral lease is executed Freehold gives the third-party exclusive access to specifically identified lands for a certain time period and typically receives a lump sum non-refundable payment (bonus consideration). As the payment is non-refundable and access to land is granted, the performance obligation is met, and revenue is recognized when the lease is executed, and payment is received. Lease rental revenue is recognized annually on the anniversary date of the lease execution when the payment is due and received.

Royalty and other revenue is measured at fair value of the consideration received or receivable per the terms of the various agreements. Freehold uses government reporting databases, past production receipts, historical trends and current market prices to estimate revenue accruals. Actual results could differ as a result of using estimates and any differences are recorded in the period in which actuals are received.

### i. Financial instruments

All financial instruments are recognized on the balance sheet initially at fair value. Subsequent measurement of all financial assets is measured at amortized cost, fair value through other comprehensive income (FVOCI), or fair value through profit or loss (FVTPL). Subsequent measurement of all financial liabilities is measured at amortized cost or, optionally, FVTPL.

All cash, accounts receivable, dividends payable, accounts payables and accrued liabilities, and long-term debt are measured at amortized cost using the effective interest rate method. No financial instruments have been classified as FVOCI or FVTPL. During 2018, there are no transactions in which hedge accounting could be applied.

### j. Recent pronouncements

In January 2016, the IASB issued IFRS 16 *Leases*, which replaces IAS 17 *Leases*. The standard establishes 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 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. Other areas of the lease accounting model have been impacted, including the definition of a lease. Freehold's mineral leases are not in scope of IFRS 16. Freehold does not have an office lease in its name. All office space used by Freehold is provided by Rife Resources Management Ltd. (see related party note 10). The effective date for adopting IFRS 16 in its entirety is January 1, 2019.

Freehold's assessment of IFRS 16 including a review of lease agreements has been completed. Freehold is not expecting any material impact on the consolidated financial statements.

## 4. Exploration and Evaluation Assets

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Balance, beginning of year | 75,776 | 64,019 |
| Acquisitions | 16,617 | 15,900 |
| Transfers to petroleum and natural gas interests (note 5) | (4,940) | (3,876) |
| Working interest dispositions | - | (267) |
| Balance, end of year | 87,453 | 75,776 |

In February 2018, Freehold closed a $7.0 million royalty acquisition in Alberta including undeveloped land valued at $3.3 million. In September 2018, Freehold closed an undeveloped land royalty acquisition in central Alberta for $12.0 million with funds held in escrow until certain drilling milestones are met. In October 2018, Freehold closed an undeveloped land royalty acquisition in central Alberta for $1.3 million. In 2017 Freehold had acquisition activity of $15.9 million.

There were no indicators of impairment or impairment reversal for the year ended December 31, 2018 or December 31, 2017. As a result, no impairment or impairment reversal testing was conducted.

## 5. Petroleum and Natural Gas Interests

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **Cost** | | |
| Balance, beginning of year | 1,387,283 | 1,420,836 |
| Acquisitions | 46,997 | 70,843 |
| Capital expenditures | 3,993 | 4,864 |
| Capitalized (reduced) portion of long term incentive plan | (159) | 246 |
| Transfers from exploration and evaluation assets (note 4) | 4,940 | 3,876 |
| Decommissioning liability additions and revisions (note 6) | (332) | 3,225 |
| Transfer to assets held for sale | - | (19,534) |
| Working interest dispositions | (8,285) | (97,073) |
| Balance, end of year | 1,434,437 | 1,387,283 |
| **Accumulated depletion and depreciation** | | |
| Balance, beginning of year | (568,362) | (528,716) |
| Depletion and depreciation | (102,042) | (108,227) |
| Impairment, net of impairment reversal | - | (10,609) |
| Transfer to assets held for sale | - | 5,724 |
| Accumulated depletion and depreciation of working interest dispositions | 6,215 | 73,466 |
| Balance, end of year | (664,189) | (568,362) |
| **Net book value, end of year** | 770,248 | 818,921 |

The depletion calculation included $7.2 million (2017 - $7.3 million) for estimated future development costs associated with proved plus probable undeveloped reserves.

For the year ended December 31, 2018, Freehold capitalized $1.5 million (2017 - $1.5 million) of administrative costs and reduced petroleum and natural gas interests by $0.2 million (2017 – capitalized $0.2 million) of LTIP costs directly related to development activities.

### Acquisitions

In February 2018, Freehold closed a $7.0 million royalty acquisition in Alberta including undeveloped land valued at $3.3 million. In March 2018, Freehold closed an acquisition of oil royalties on the Weyburn Unit in Saskatchewan and the Mitsue Gilwood Sand Unit No. 1 in Alberta for $24.1 million and the assignment of certain minor working interest assets. In May 2018, Freehold closed an additional oil royalty acquisition on the Mitsue Gilwood Sand Unit No. 1 for $2.7 million. In August 2018, Freehold closed a royalty acquisition in Alberta and the Deep Basin for $5.9 million and the assignment of certain minor working interest assets. In November 2018, Freehold closed a royalty acquisition in southwest Saskatchewan for $8.9 million. In addition, for the year ended December 31, 2018, Freehold had minor acquisitions and adjustments on previous acquisitions resulting in reduction of $0.2 million to petroleum and natural gas interests.

For the year ended December 31, 2017, Freehold had royalty acquisition activity of $86.7 million including $15.9 million of undeveloped land classified as an exploration and evaluation asset.

### Working Interest Dispositions

For the year ended December 31, 2018, Freehold closed the sale of its Pembina Cardium Unit No. 9 working interest property in exchange for cash proceeds of $8.7 million (including final adjustments) and an acquisition of a new 4% gross overriding royalty on the same property valued at $1.9 million. At December 31, 2017, this working interest property was classified as assets held for sale as it was highly probable that its carrying value would be received through a sales transaction rather than continued use. At December 31, 2017, this working interest asset was recorded at the lower of carrying value and management's best estimate of its fair value less costs to sell, resulting in Freehold recording an impairment of $6.3 million. Freehold reclassified its new recoverable estimated net book value of $13.8 million from its Other Working Interest cash generating unit (CGU) in petroleum and natural gas interests to assets held for sale. In addition, Freehold reclassified its proportionate share of decommissioning liabilities of $3.7 million to liabilities related to assets held for sale. These assets and related liabilities held for sale were removed in 2018 when the transaction closed.

For the year ended December 31, 2017, Freehold closed the sale of working interest properties in its Southeast Saskatchewan Working Interest CGU for proceeds of $29.0 million. In conjunction with these transactions, Freehold recognized a gain on working interest dispositions of $14.9 million. The gain was based on $29.1 million of proceeds received, minor adjustments of $0.1 million, the removal of assets held for sale of $18.9 million and the removal of liabilities related to assets held for sale of $4.8 million. In addition, based on sale proceeds, Freehold reviewed the carrying value of the Southeast Saskatchewan Working Interest CGU for any reversal of impairment, as this CGU had a previous impairment charge. The recoverable amount was estimated using a fair value less cost to sell calculation based on the sales price. As a result, there was an impairment reversal of $5.6 million recognized at the time of disposition, representing the maximum amount of impairment reversal able to be taken, made up of the original $8.0 million impairment estimate recorded in 2015 net of $2.4 million depletion calculated as if the impairment never occurred.

In addition, for the year ended December 31, 2017, Freehold sold additional minor working interest properties for $3.4 million.

### Year-end Impairment

At December 31, 2018, there were no indicators of impairment or impairment reversal. As a result no impairment or impairment reversal testing was conducted.

At December 31, 2017, Freehold tested its Other Working Interest CGU for impairment due to existing market conditions. Freehold estimated the recoverable amount as the value in use based on discounted future net cash flows of proved and probable reserves using forecast prices and costs, discounted between 15% and 25% (pre-tax). In determining the discount rate, Freehold considered the resource composition of the remaining assets including reserve type, operating expense and future development plans. The estimated recoverable amount was based on Freehold's December 31, 2017 external reserve report. Management recognizes that all assumptions and estimates affecting the value are subject to a high degree of uncertainty.

Freehold recognized a non-cash impairment charge of $9.9 million as the carrying value exceeded the estimated value in use. The Other Working Interest CGU contains all of Freehold's working interest properties widespread across western Canada. The estimated recoverable amount of this CGU at December 31, 2017 was $14.7 million. As future commodity prices continue to fluctuate, additional impairment charges or recoveries could be recorded in future periods. The value in use estimates are categorized as Level 3 according to the IFRS 13 fair value hierarchy.

The following table summarizes key benchmarks used in the 2017 impairment estimate:

| | WTI<br>US$/bbl | WCS<br>Cdn$/bbl | AECO<br>Cdn$/Mcf | Exchange rate<br>Cdn$/US$ |
|---|---|---|---|---|
| 2018 | 55.00 | 51.05 | 2.85 | 0.79 |
| 2019 | 65.00 | 59.61 | 3.11 | 0.82 |
| 2020 | 70.00 | 64.94 | 3.65 | 0.85 |
| 2021 | 73.00 | 68.43 | 3.80 | 0.85 |
| 2022 | 74.46 | 69.80 | 3.95 | 0.85 |
| 2023 | 75.95 | 71.20 | 4.05 | 0.85 |
| Average annual increase, thereafter | 2.0% | 2.0% | 2.0% | - |

The following table summarizes impairments and impairment reversal for 2017:

| ($000s) | Cash Generating Unit | Impairment (reversal) |
|---|---|---|
| Southeast Saskatchewan working interest properties | Southeast Saskatchewan Working Interest | (5,625) |
| Pembina Cardium Unit No. 9 | Other Working Interest | 6,323 |
| Year-end impairment | Other Working Interest | 9,911 |
| Total | | 10,609 |

## 6. Decommissioning Liability

Freehold has no decommissioning liability on its royalty interest properties. Freehold's decommissioning liability results from its responsibility to abandon and reclaim its net share of all working interest properties. The undiscounted value of Freehold's total decommissioning liability is estimated to be $14.2 million (2017 – $19.3 million). Payments to settle the obligations are expected to occur over the next 49 years, with the majority being settled within 10 years. At December 31, 2018, a risk-free rate of 2.2% (2017 – 2.2%) and an inflation rate of 2.0% (2017 – 2.0%) were used to calculate the fair value.

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Balance, beginning of year | 15,495 | 23,705 |
| Liabilities incurred | - | 84 |
| Liabilities settled | (2,013) | (1,865) |
| Revision in estimates | (332) | 3,141 |
| Accretion expense | 334 | 459 |
| Liabilities disposed (note 5) | (1,578) | (6,319) |
| Transfers to liabilities related to assets held for sale (note 5) | - | (3,710) |
| Balance, end of year | 11,906 | 15,495 |
| Current portion of liability | 2,284 | 1,444 |
| Long-term portion of liability | 9,622 | 14,051 |

## 7. Long-Term Debt

At December 31, 2018 Freehold had a committed $165 million secured revolving credit facility with a syndicate of four Canadian chartered banks. In addition, Freehold had available a $15 million senior secured operating facility. At December 31, 2018 $90 million was drawn on these facilities.

In May 2018 Freehold amended its credit agreement. The current maturity date of the credit facilities is May 31, 2021 and Freehold may annually request an extension to the maturity date. The credit facilities are not reserve-based but are secured with $400 million first charge demand debentures over all of Freehold's assets. The credit agreement contains non-financial covenants and two financial covenants.  The first financial covenant is that long-term debt to EBITDA on royalty interest properties (calculated as earnings on royalty interest properties before non-cash charges including, but not limited to, interest, taxes, depletion and depreciation and amortization) shall not exceed 3.5 times, for which our calculation was 0.7 times at December 31, 2018. The second financial covenant is that the long-term debt to capitalization (the aggregate of long-term debt and shareholders' equity) ratio shall not exceed 55%, for which our calculation was 10% at December 31, 2018.

Borrowings under the credit facilities bear interest at the bank's prime lending rate, bankers' acceptance or LIBOR rates plus applicable margins and standby fees, dependent on Freehold's long-term debt to EBITDA on royalty interest properties. At December 31, 2018 and December 31, 2017, the fair values of the long-term debt approximated its carrying values, as the long-term debt carries interest at prevailing market rates. In 2018, the average effective interest rate on advances under Freehold's credit facilities was 3.3% (2017 – 2.9%).

## 8. Share Based Compensation

### a. Long-term incentive plan

Freehold currently has two different share based and cash settled long-term incentive plans (new LTIP and previous LTIP) for employees of Rife through the Manager, as described in note 3f. For both plans, share based compensation expense was based on the consideration of the share price, the number of share based awards outstanding at each period end, an estimated performance multiplier (if applicable) and an estimated forfeiture rate. For the new LTIP the 2017 and 2018 PSU grants, the performance multiplier of 0 to 2 times is based 50% on an absolute total shareholder return and 50% on a relative total shareholder return over a three year performance period.

The 2014 grants under the previous LTIP valued at $0.1 million were paid out in 2017. The 2015 grants under the previous LTIP valued at $0.2 million were paid out in 2018. One-third of the granted 2017 RSUs vested in 2018 and LTIP valued at $0.2 million was paid out in 2018. During 2018, there were 114,100 RSUs and PSUs granted under the new LTIP (after estimated forfeitures).

The total recovered for the year ended December 31, 2018 was $0.8 million (2017 expensed - $1.2 million). For the year ended December 31, 2018, Freehold reduced petroleum and natural gas interests by $0.2 million (2017 – capitalized $0.2 million) of LTIP costs directly related to development activities.

The following table reconciles the change in total accrued share based incentive compensation:

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Balance, beginning of year | 2,373 | 1,065 |
| Increase (decrease) in liability | (997) | 1,446 |
| Cash payout | (423) | (138) |
| Balance, end of year | 953 | 2,373 |
| Current portion of liability | 466 | 399 |
| Long-term portion of liability | 487 | 1,974 |

The following table reconciles the incentive plan activity:

**Share Based Awards**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Balance, beginning of year (1) | 253,886 | 192,246 |
| Issued | 114,100 | 90,026 |
| Dividends reinvested (1) | 14,777 | 9,912 |
| Cash payout | (76,843) | (38,298) |
| Balance, end of year | 305,920 | 253,886 |

(1) Balances as at December 31, 2017 have been adjusted for revised estimates.

### b. Deferred share unit plan

Freehold has a deferred share unit (DSU) plan for non-management directors as described in note 3f. As at December 31, 2018, there were 160,192 DSUs outstanding (2017 – 117,429), which are redeemable for an equal number of Freehold common shares (less withholding tax if necessary) after the director's retirement.

On January 1, 2018, Freehold's Board of Directors granted a total of 34,519 DSUs to eligible directors as part of their annual compensation. Each eligible director received 5,338 DSUs and the Chair of the Board received 7,829 DSUs. In 2017, Freehold's Board of Directors granted a total of 27,521 DSUs to eligible directors as part of their annual compensation. Each eligible director received 4,234 DSUs and the Chair of the Board received 6,351 DSUs.

**Deferred Share Units**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Balance, beginning of year | 117,429 | 148,499 |
| Annual grants | 34,519 | 27,521 |
| Additional resulting from dividends | 8,244 | 4,828 |
| Redeemed | - | (63,419) |
| Balance, end of year | 160,192 | 117,429 |

For the year ended December 31, 2018, Freehold expensed \$0.6 million (2017- \$0.4 million) of share based compensation with a corresponding offset to contributed surplus.

## 9. Shareholders' Capital

Freehold has authorized an unlimited number of common shares, without stated par value. Freehold has authorized 10,000,000 preferred shares, without stated par value, of which none have been issued.

**Shares Issued and Outstanding**

| | December 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Shares | Amount ($000s) | Shares | Amount ($000s) |
| Balance, beginning of year | 118,182,667 | 1,267,591 | 117,918,274 | 1,263,796 |
| Issued for payment of management fee | 220,000 | 2,429 | 220,000 | 3,043 |
| Issued for deferred share unit plan redemption | - | - | 44,393 | 752 |
| Balance, end of year | 118,402,667 | 1,270,020 | 118,182,667 | 1,267,591 |

At December 31, 2018, a balance of 1,987,307 shares was reserved for the dividend reinvestment plan (DRIP), 238,467 shares for the management fee (note 10) and 467,344 shares for the deferred share unit plan (note 8).

## 10. Related Party Transactions

Freehold does not have any employees. Rife Resources Management Ltd. (the Manager) is the manager of Freehold. The Manager is a wholly-owned subsidiary of Rife Resources Ltd. (Rife). Rife is 100% owned by the CN Pension Trust Funds (the pension funds for the employees of the Canadian National Railway Company), which in turn is a shareholder of Freehold. Canpar Holdings Ltd. (Canpar) is also managed by Rife and owned 100% by the CN Pension Trust Funds, and two of Rife and Canpar's directors are also directors of Freehold.

The Manager recovers its general and administrative costs and a portion of its long-term incentive plan costs (provided that under Freehold's new LTIP, Freehold's portion of long-term incentive compensation is issued directly by Freehold instead of Rife receiving reimbursement for such compensation), and receives a quarterly management fee paid in shares.

### a. Rife Resources Management Ltd.

The Manager provides certain services for a fee based on a specified number of shares per quarter, pursuant to the amended and restated Management Agreement. The Management Agreement capped the management fee at 55,000 shares per quarter for 2018. For the year ended December 31, 2018, Freehold issued 220,000 shares (2017 – 220,000) as payment of the management fee to the Manager pursuant to the Management Agreement. For the year ended December 31, 2018, the ascribed value of $2.4 million (2017 – $3.0 million) was based on the closing price of the shares on the last trading day of each quarter.

For the year ended December 31, 2018, the Manager charged $9.8 million in general and administrative costs (2017 – $9.5 million). At December 31, 2018, there was $0.7 million (2017 – $0.6 million) in accounts payable and accrued liabilities relating to these costs.

### b. Rife Resources Ltd.

Freehold maintains ownership interests in certain oil and gas properties operated by Rife. A portion of net operating revenues and capital expenditures represent joint operations amounts from Rife. At December 31, 2018, there was $nil

(2017 - $nil) in accounts receivable related to these transactions. At December 31, 2018, there was $0.1 million (2017 - $0.1 million) in accounts payable and accrued liabilities relating to these transactions.

In addition, Freehold receives royalties from Rife pursuant to various royalty agreements. For the year ended December 31, 2018, Freehold received royalties of approximately $0.6 million (2017 – $0.9 million). At December 31, 2018, there was $nil (2017 - $0.1 million) in accounts receivable relating to these transactions.

### c. Canpar Holdings Ltd.

Freehold and Canpar share mineral title ownership rights in a substantial land base in western Canada. Generally, Canpar owns mineral rights that were below the deepest producing formation at the time that Freehold was created, and Freehold holds the balance of the mineral rights. Given the nature of the mineral rights, which are dependent upon hydrocarbon pool formation classification as well as third-party drilling data which is subject to change and revision, uncertainty can exist with respect to the royalty ownership of wells drilled and completed on lands where both Freehold and Canpar hold the mineral rights.

At December 31, 2018, there was $nil (2017 – $nil) in accounts receivable relating to transactions with Canpar. At December 31, 2018, there was $nil (2017 – $0.1 million) in accounts payable and accrued liabilities relating to transactions with Canpar.

All amounts owing to/from the Manager, Rife, and Canpar are unsecured, non-interest bearing and due on demand. All transactions were in the normal course of operations and were measured at the amount of consideration established and agreed to by both parties.

Expenses relating to compensation for key management personnel, considered to be Freehold's Board of Directors and executive officers, are as follows:

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Short-term benefits (including employee wages and directors fees) | 1,368 | 1,143 |
| Share based compensation (note 8a and 8b) | 320 | 705 |
| Total | 1,688 | 1,848 |

## 11. Revenues

As per note 3h, royalty and other revenue is measured at fair value of the consideration received or receivable, per the terms of various agreements. The transaction price used for crude oil, natural gas, natural gas liquids and other products is based on the commodity price in the month of production specific to the property or interest. The commodity price received or receivable is based on market benchmarks adjusted for quality, location, allowable deductions, if any, and other factors.

Freehold takes its product in kind (TIK) on certain royalty and working interest properties when deemed beneficial to do so. In this case, Freehold would receive its cash payment on or about the 25th day of the month following production. Typically, if a property is non-TIK then Freehold would receive the cash payment approximately two months following production. Bonus consideration can vary significantly period over period as it is dependent on the specific details of each lease and the number of leases issued.

**Revenue and other revenue by product**

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Oil | 110,513 | 111,569 |
| NGL | 14,895 | 13,975 |
| Natural gas | 14,248 | 22,294 |
| Potash | 1,400 | 1,528 |
| Bonus consideration and lease rentals | 3,851 | 2,144 |
| Other | 329 | 384 |
| Total royalty and other revenue | 145,236 | 151,894 |

**Revenue and other revenue by classification**

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Royalty interest revenue from oil, NGL and natural gas (1) | 134,304 | 131,678 |
| Bonus consideration and lease rentals | 3,851 | 2,144 |
| Total royalty revenue | 138,155 | 133,822 |
| Working interest revenue | 7,081 | 18,072 |
| Total royalty and other revenue | 145,236 | 151,894 |

(1) Includes potash royalties and other.

As at December 31, 2018, there was outstanding accounts receivable of $12.0 million (2017 - $25.3 million) of accrued royalty and other revenue. For the year ended December 31, 2018, Freehold had $3.5 million (2017 - $6.8 million) positive royalty and other revenue adjustments relating to prior periods. The performance obligations for these adjustments were satisfied in production periods prior to the current year.

## 12. Income Taxes

Freehold uses the balance sheet method of accounting for income taxes, as described in note 3e. The provision for taxes in the financial statements differs from the result which would have been obtained by applying the combined federal and provincial effective tax rate to Freehold's income before taxes. This difference is reconciled as follows:

| ($000s, except as noted) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Income before taxes | 19,175 | 17,032 |
| Combined federal and provincial tax rate | 27.0% | 27.0% |
| Computed expected income tax expense | 5,177 | 4,599 |
| Increase (decrease) in income tax resulting from: | | |
| True up of tax pools | (63) | 5 |
| Deferred share unit plan redemption | - | 195 |
| Miscellaneous | 29 | 15 |
| Total income taxes | 5,143 | 4,814 |

The components of deferred income tax are as follows:

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Deferred income tax assets: | | |
| Non-capital losses | 40,561 | 44,866 |
| Decommissioning liability | 3,215 | 5,185 |
| Share issue expense | 1,695 | 3,266 |
| Deferred income tax liabilities: | | |
| Petroleum and natural gas interests | (29,901) | (32,880) |
| Other | 828 | 1,104 |
| Net deferred income tax asset | 16,398 | 21,541 |

As at December 31, 2018, Freehold had approximately $152 million (2017 - $168 million) of carry-forward non-capital tax losses and approximately $753 million (2017 - $799 million) of tax pools that would be available to offset against future taxable profit. The carry-forward non-capital losses will expire between the years 2031 and 2036. Deferred income tax assets are recognized to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry-forward of unused tax losses can be utilized.

The continuity of deferred income tax is as follows:

| ($000s) | Balance December 31, 2017 | Recognized in Profit or Loss | Recognized in Equity | Balance December 31, 2018 |
|---|---|---|---|---|
| Non-capital losses | 44,866 | (4,305) | - | 40,561 |
| Decommissioning liability | 5,185 | (1,970) | - | 3,215 |
| Share issue expense | 3,266 | (1,571) | - | 1,695 |
| Petroleum and natural gas interests | (32,880) | 2,979 | - | (29,901) |
| Other | 1,104 | (276) | - | 828 |
| Total | 21,541 | (5,143) | - | 16,398 |

Freehold’s deferred tax liability relates to its assets having a higher carrying value relative to the associated tax value. Freehold’s deferred tax asset primarily relates to the non-capital losses. When combined there is an overall net deferred tax asset.

## 13. Capital Management

Freehold is a publicly traded dividend-paying corporation incorporated under the laws of the Province of Alberta. Its primary focus is acquiring and managing oil and gas royalties. Freehold receives revenue from oil and gas properties as reserves are produced, which is paid to shareholders through dividends on a regular basis over the economic life of the properties. Freehold’s objective for managing capital is to maximize long-term shareholder value by distributing to shareholders any cash partially based on what is required for financing operations or capital investment growth opportunities that may offer shareholders better value.

Freehold defines capital (or capitalization) as long-term debt, shareholders’ equity and working capital based on the consolidated financial statements. Freehold’s capital structure is managed by taking into account operating activities, debt levels, debt covenants, capital expenditures, dividend levels and taxes, among others. In addition, changes in economic conditions, commodity prices and the risk characteristics of Freehold's assets are considered. Freehold has a declining asset base, therefore ongoing development activities and acquisitions are necessary to replace production and add additional reserves. From time to time, Freehold may issue shares or adjust capital spending to manage current and projected debt levels.

Freehold retains working capital primarily to fund capital expenditures or acquisitions, pay dividends and reduce bank indebtedness. Historically, Freehold has chosen to issue its DRIP out of treasury, which increases its flexibility with the use of working capital. Effective with the August 31, 2016 dividend the Board approved the suspension of the DRIP pending further notice.

Management of Freehold's capital structure is facilitated through its financial and operating forecasting processes. The forecast of Freehold's future cash flows is based on estimates of production, commodity prices, forecast capital, royalty expenses, operating expenditures, taxes and other investing and financing activities. The forecast is regularly updated based on new commodity prices and other changes that Freehold views as critical in the current environment. Selected forecast information is frequently provided to and approved by the Board of Directors.

Freehold is bound by non-financial covenants and two financial covenants (see note 7) on its credit facilities. The covenants are monitored as part of management's internal review to ensure compliance with requirements. As at December 31, 2018, Freehold was in compliance with all such covenants.

**Capitalization**

| ($000s, except as noted) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Shareholders' equity | 774,615 | 831,592 |
| Long term debt | 90,000 | 90,000 |
| Working capital | (625) | (21,379) |
| Net debt [(1)] | 89,375 | 68,621 |
| Capitalization | 863,990 | 900,213 |
| | | |
| Cash provided by operating activities for last 12 months | 133,124 | 119,267 |
| Change in non-cash operating working capital | (11,837) | 4,521 |
| Trailing 12 months funds from operations | 121,287 | 123,788 |
| | | |
| Net debt to trailing 12 month funds from operations (times) | 0.7 | 0.6 |

(1) Net debt as presented does not have any standardized meaning prescribed by IFRS and therefore may not be comparable to a similar measure of other entities.

## 14. Financial Instrument Risk Management

Freehold has exposure to credit, liquidity and market risks from its use of financial instruments. Management employs the following strategies to mitigate these risks.

### a. Credit risk

Credit risk is the risk of financial loss to Freehold if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from Freehold's receivables. A large part of accounts receivable is with oil and gas industry operators, either as joint venture partners or as payors of various royalty agreements. These agreements provide mechanisms to ensure that Freehold's interests are protected. There are also systems and processes in place to identify any unpaid or incorrect revenues. Freehold's diversified revenue stream limits the size of any one property or industry operator with respect to total receivables. Freehold also has processes and systems in place to monitor the financial capabilities of its counterparties. Many agreements allow Freehold to take the commodity in-kind and sell directly to a purchaser rather than have Freehold's commodity flow through the operator or the royalty payor.

Freehold maintains a dedicated compliance function, with a comprehensive auditing program, to ensure that the terms of the various agreements are followed, including that royalties are paid correctly on production from Freehold's lands in accordance with the prices obtained by the royalty payor and that unwarranted or excessive deductions are not being taken. Freehold also audits its working interest properties to ensure that capital costs, operating expenses and production volumes are properly allocated.

The carrying amounts of accounts receivable and cash represent Freehold's maximum credit exposure. Freehold did not have an allowance for doubtful accounts as at December 31, 2018 or 2017, and did not provide for any doubtful accounts and was not required to write off any significant receivables during the years ended December 31, 2018 or 2017. Freehold considers all material amounts greater than three months to be past due. Due to the nature of Freehold's royalty income assets, there are amounts over three months which require significant time and effort to collect. Estimates of amounts owed for various time periods are as follows:

| ($000s) | Less than 3 months | 4-12 months | over 1 year | Total |
|---|---|---|---|---|
| Accounts receivable | 10,799 | 1,473 | 666 | 12,938 |

Freehold markets approximately 80% of its total production along with the operator or royalty payor under the terms of a diverse number of agreements. Freehold takes a portion of its total production in kind (approximately 20%) and sells to three primary purchasers.

### b. Liquidity risk

Liquidity risk is the risk that Freehold will not be able to meet financial obligations as they come due. Management maintains a conservative approach to debt management that aims to provide maximum financial flexibility with respect to acquisitions and development expenditures, while maintaining stable dividend payments. At December 31, 2018, there was $90 million of available capacity under the credit facilities. As circumstances warrant, management allocates a portion of funds from operations to debt repayment. Management prepares annual capital expenditure and operating budgets, which are regularly monitored and updated. In addition, dividend levels are monitored and adjusted as necessary, to levels that are supported by Freehold's funds from operations.

Freehold's non-derivative financial liabilities include its dividends payable, accounts payable and accrued liabilities, share based compensation payable, current portion of decommissioning liability and long-term debt. Freehold has no derivative financial liabilities. The following table outlines cash flows associated with the contractual maturities of Freehold's non-derivative financial liabilities as at December 31, 2018:

| ($000s) | Less than 1 Year | 2-3 Years | Total |
|---|---|---|---|
| Dividends payable | 6,215 | - | 6,215 |
| Accounts payable and accrued liabilities | 4,610 | - | 4,610 |
| Share based compensation payable | 466 | 487 | 953 |
| Decommissioning liability | 2,284 | 1,825 | 4,109 |
| Long-term debt | - | 90,000 | 90,000 |
| Total | 13,575 | 92,312 | 105,887 |

### c. Market risk

Market risk is the risk that changes in market prices, such as foreign currency exchange rates, commodity prices and interest rates, will affect net income or the value of financial instruments. The Board reviews the potential use of derivative contracts on a quarterly basis. For short-term investments, if any, Freehold selects counterparties based on strong credit ratings and monitors all investments to ensure a stable return.

#### Foreign currency exchange rate risk

Freehold does not sell or transact in any foreign currency; however, the underlying market prices in Canada for oil and natural gas are influenced by changes in the exchange rate between the Canadian and U.S. dollar. During the years ended December 31, 2018 and 2017, Freehold had no foreign exchange related derivative contracts in place. Assuming all other variables held constant, a $0.01 change (plus or minus) in the U.S./Canadian dollar exchange rate for the year ended December 31, 2018, would have resulted in a corresponding change to income before taxes of approximately $1.6 million (2017 - $1.6 million).

#### Commodity price risk

Commodity price risk is the risk that the fair value of future cash flows will fluctuate with changes in commodity prices. Commodity prices for oil and natural gas are influenced by the relationship between the Canadian and U.S. dollar as well as macroeconomic events that dictate the levels of supply and demand. During the years ended December 31, 2018 and 2017, Freehold had no commodity price related derivative contracts in place. Assuming all other variables held constant, a US$1.00 change (plus or minus) in the West Texas Intermediate crude oil price for the year ended December 31, 2018, would have resulted in a corresponding change to income before taxes of approximately $1.9 million (2017 - $2.4 million). A $0.25 change (plus or minus) in the AECO natural gas price would have resulted in a corresponding change to income before taxes of approximately $2.3 million (2017 - $2.3 million).

#### Interest rate risk

Freehold is exposed to interest rate risk on outstanding bank debt, which has a floating interest rate, and fluctuations in interest rates would impact future cash flows. Assuming all other variables held constant, a 1% change (plus or minus) in the interest rate for the year ended December 31, 2018 would have resulted in a corresponding change to income before taxes of approximately $0.9 million (2017 - $0.7 million).

## 15. Supplemental Disclosure

### a. Statements of income and comprehensive income presentation

Freehold's consolidated statements of income and comprehensive income are prepared by nature of expense.

### b. Supplemental cash flow disclosure

**Changes in Non-Cash Working Capital Balance**

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Accounts receivable | 13,014 | (1,888) |
| Accounts payable and accrued liabilities | (2,596) | (2,013) |
| | 10,418 | (3,901) |
| Operating | 11,837 | (4,521) |
| Investing | (1,419) | 620 |
| | 10,418 | (3,901) |

**Cash Expenses**

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Interest | 3,761 | 2,705 |
| Taxes | - | - |

### c. Net debt

| ($000s) | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Long-term debt | 90,000 | 90,000 |
| Working capital | (625) | (21,379) |
| Net debt (1) | 89,375 | 68,621 |

(1) Net debt as presented does not have any standardized meaning prescribed by IFRS and therefore may not be comparable to a similar measure of other entities.

## TEN-YEAR REVIEW

| (unaudited) ($millions, except as noted) | **2018** | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Financial** (1) | | | | | | | | | | |
| Royalty and other revenue | **145.2** | 151.9 | 130.0 | 135.7 | 199.9 | 181.6 | 168.1 | 157.9 | 138.2 | 120.0 |
| Net income (loss) (1) | **14.0** | 12.2 | (11.2) | (4.1) | 66.4 | 57.9 | 46.3 | 55.3 | 49.3 | 31.7 |
| Per share ($) (2) | **0.12** | 0.10 | (0.10) | (0.05) | 0.94 | 0.86 | 0.71 | 0.92 | 0.85 | 0.63 |
| Funds from operations | **121.3** | 123.8 | 94.2 | 103.8 | 138.4 | 119.4 | 103.9 | 128.2 | 107.0 | 95.1 |
| Per share ($) (2) | **1.03** | 1.05 | 0.85 | 1.15 | 1.95 | 1.79 | 1.60 | 2.14 | 1.83 | 1.90 |
| Dividends declared | **73.9** | 68.5 | 59.5 | 90.1 | 119.8 | 112.5 | 109.6 | 101.0 | 98.1 | 70.5 |
| Per share ($) (2) (3) | **0.63** | 0.58 | 0.54 | 1.00 | 1.68 | 1.68 | 1.68 | 1.68 | 1.68 | 1.40 |
| Acquisitions | **61.7** | 86.7 | 162.6 | 411.4 | 248.3 | 10.1 | 60.9 | 7.5 | 38.6 | 9.5 |
| Capital expenditures | **4.0** | 4.9 | 5.2 | 22.3 | 33.7 | 29.3 | 36.7 | 25.6 | 18.1 | 15.5 |
| Working interest dispositions | **8.7** | 32.4 | - | - | - | - | - | - | - | - |
| Long-term debt | **90.0** | 90.0 | 84.0 | 152.0 | 139.0 | 49.0 | 18.0 | 48.0 | 65.0 | 45.0 |
| **Operating** | | | | | | | | | | |
| Production (boe/d) | **11,410** | 12,350 | 12,219 | 10,945 | 9,180 | 8,913 | 8,850 | 7,476 | 7,615 | 7,302 |
| Royalty Interest (%) | **94** | 89 | 81 | 76 | 74 | 70 | 71 | 75 | 73 | 70 |
| Oil and NGL (%) | **54** | 55 | 58 | 62 | 63 | 64 | 64 | 63 | 62 | 64 |
| Land (gross acres, millions) | **6.4** | 5.9 | 6.1 | 3.7 | 3.2 | 3.1 | 3.0 | 2.7 | 2.8 | 2.4 |
| Net reserves (Mmboe) (4) | **30.9** | 35.3 | 38.3 | 36.1 | 29.7 | 23.1 | 24.4 | 22.2 | 23.6 | 24.1 |
| Reserve life index (years) | **9.0** | 9.6 | 10.1 | 9.9 | 9.0 | 8.5 | 8.5 | 9.1 | 9.5 | 9.7 |
| **Share Data** | | | | | | | | | | |
| High ($) | **14.85** | 16.41 | 15.16 | 20.62 | 28.15 | 24.88 | 22.45 | 23.28 | 21.14 | 17.00 |
| Low ($) | **7.68** | 11.96 | 8.29 | 8.73 | 17.02 | 21.00 | 17.25 | 14.51 | 15.08 | 6.87 |
| Close ($) | **8.27** | 14.05 | 14.17 | 10.86 | 19.12 | 22.11 | 22.40 | 19.41 | 20.49 | 15.09 |
| Volume (millions) | **77.8** | 58.4 | 79.6 | 75.3 | 43.6 | 25.8 | 28.6 | 28.1 | 25.8 | 30.0 |
| Outstanding (millions) | | | | | | | | | | |
| At period end | **118.4** | 118.2 | 117.9 | 98.9 | 74.9 | 67.7 | 66.3 | 61.1 | 59.2 | 57.5 |
| Weighted average | **118.3** | 118.0 | 110.4 | 90.5 | 71.2 | 66.9 | 64.9 | 60.0 | 58.3 | 50.0 |

(1) Freehold's IFRS transition date was January 1, 2010 and reflects adjustments due to IFRS. Comparative information for 2009 has not been restated.

(2) Prior to conversion to a corporation on December 31, 2010, Freehold had trust units outstanding instead of shares.

(3) Based on the number of shares issued and outstanding at each record date.

(4) Net proved plus probable reserves.

# NOTES

NOTES

# Corporate Information

## BOARD OF DIRECTORS

MARVIN F. ROMANOW
Chair of the Board

GARY R. BUGEAUD [1] [2]
Corporate Director

PETER T. HARRISON
Manager, Oil and Gas Investments
CN Investment Division

J. DOUGLAS KAY [2][3]
Corporate Director

ARTHUR N. KORPACH [1][2]
Corporate Director

SUSAN M. MACKENZIE [2][3]
Corporate Director

THOMAS J. MULLANE
President and Chief Executive Officer
Rife Resources Ltd.

AIDAN M. WALSH [1][3]
Chief Executive Officer
Baccalieu Energy Inc.

(1) Audit Committee
(2) Governance, Nominating and Compensation Committee
(3) Reserves Committee

## OFFICERS

MARVIN F. ROMANOW
Chair of the Board

THOMAS J. MULLANE
President and Chief Executive Officer

DARREN G. GUNDERSON
Vice-President, Finance and Chief Financial Officer

ROBERT E. LAMOND
Vice-President, Exploration

DAVID M. SPYKER
Vice-President, Production

MICHAEL J. STONE
Vice-President, Land

MICHAEL J. MOGAN
Controller

KAREN C. TAYLOR
Corporate Secretary

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## THE MANAGER

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## INVESTOR RELATIONS

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## AUDITORS

KPMG LLP

## BANKERS

Canadian Imperial Bank of Commerce

Bank of Montreal

Royal Bank of Canada

The Toronto-Dominion Bank

## LEGAL COUNSEL

Burnet, Duckworth & Palmer LLP

## RESERVE EVALUATORS

Trimble Engineering Associates Ltd.

## STOCK EXCHANGE AND TRADING SYMBOL

Toronto Stock Exchange (TSX)
Common Shares: FRU

## TRANSFER AGENT AND REGISTRAR

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