

# 2018 ANNUAL REPORT



5  
years

**MELCOR** | REIT

# MELCOR | REIT

## 2018

**Melcor REIT** is an unincorporated, open-ended real estate investment trust. We own, acquire, manage and lease quality retail, office and industrial income-generating properties. Our portfolio is currently made up of interests in 37 properties representing approximately 2.87 million square feet of gross leasable area located in and around Edmonton, Calgary, Lethbridge and Red Deer, Alberta; Regina, Saskatchewan; and Kelowna, British Columbia.

Backed by Melcor Development's 95 year history, Melcor REIT was borne out of a proud tradition of real estate excellence in western Canada. Our growth potential is a true competitive advantage, with the right to acquire Melcor's pipeline of newly constructed, high quality retail, industrial and office projects. Subsequent to the initial acquisition, we have vended-in over 1 million sf from Melcor, and there is a further 6.5 million sf in current and future projects to be built over the next 5 to 15 years.

### FACTS & DATA

**37**

ASSETS

**\$70.2M**

REVENUE

**\$709.6M**

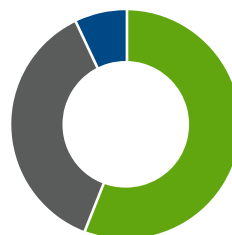
ASSET FAIR VALUE

**99%**

PAYOUT RATIO



GLA BY  
PROPERTY TYPE



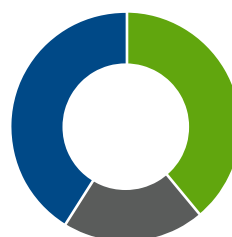
Office 56%  
Retail 37%  
Industrial 7%

GLA BY  
REGION



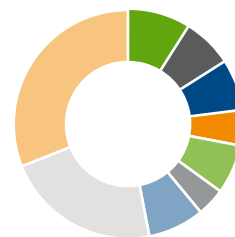
Northern Alberta 58%  
Southern Alberta 29%  
BC & SK 13%

GLA BY  
TENANT PROFILE



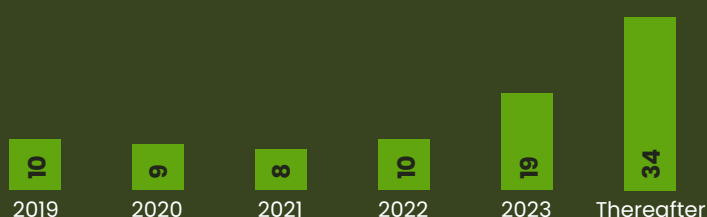
Local 39%  
Regional 20%  
National 41%

GLA BY  
TENANT INDUSTRY

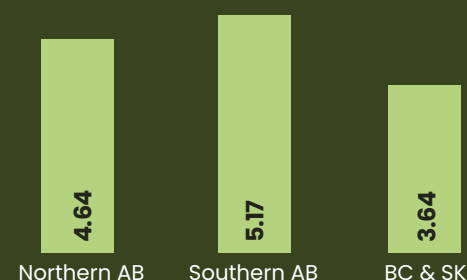


Finance 9%  
Oil & Gas 4%  
Government 7%  
Other 8%  
Hospitality 7%  
Professional 22%  
Industrial 5%  
Retail 31%  
Medical 7%

GROSS LEASABLE AREA EXPIRING (%)



WEIGHTED AVERAGE LEASE TERM  
REMAINING (YEARS)

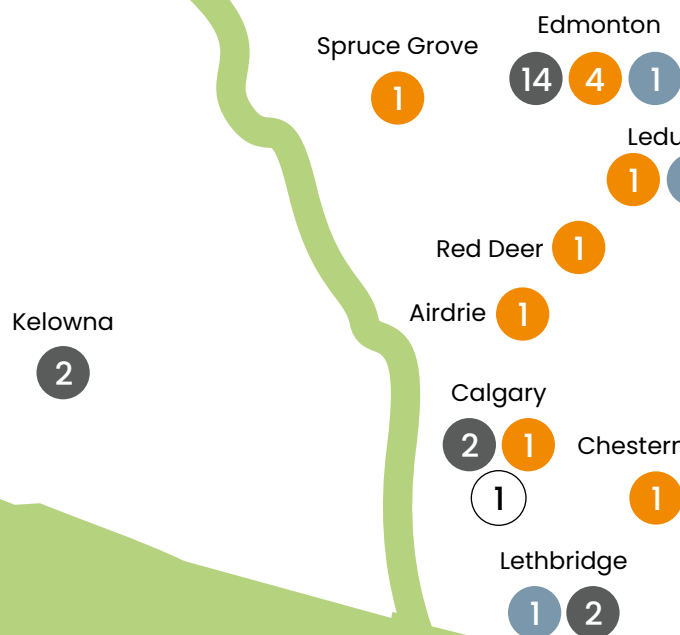




2.87M  
OWNED  
SQUARE  
FEET

BRITISH  
COLUMBIA

ALBERTA



**MELCOR** | REIT

Our goal is to provide stable monthly cash distributions to unitholders by acquiring high quality properties and diversifying our portfolio.

## SASKATCHEWAN

Regina

2 3

OFFICE BUILDINGS	LOCATION	GLA	OCC %
100 Street Place	Edmonton	44,295	83
Birks Building	Edmonton	35,106	97
Capilano Centre	Edmonton	45,486	84
Crowfoot Business Centre	Calgary	67,293	86
Executive Terrace	Regina	42,843	53
Kelowna Business Centre	Kelowna	72,076	98
Kensington Road Building	Calgary	24,044	90
LFS Building	Lethbridge	33,196	100
Melcor Centre	Lethbridge	449,862	94
Melton Building	Edmonton	114,612	76
Parliament Place	Regina	24,411	90
Princeton Place	Edmonton	59,081	57
Richter Street Building	Kelowna	28,978	100
Royal Bank Building	Edmonton	132,373	70
Select Engineering	Edmonton	23,432	100
Stanley Buildings	Edmonton	34,976	94
Sterling Business Centre	Edmonton	67,909	83
The Village at Blackmud Creek	Edmonton	48,335	88
Trail Business Centre	Edmonton	77,296	78
Westcor Building	Edmonton	72,810	77
Westgate Business Centre	Edmonton	75,141	100
White Oaks Square	Edmonton	30,497	100
<b>TOTAL</b>		<b>1,604,052</b>	<b>86</b>

RETAIL BUILDINGS	LOCATION	GLA	OCC %
Chestermere	Chestermere	84,551	96%
Coast Home Centre	Edmonton	59,725	92%
Kingsview Market	Airdrie	100,027	97%
Leduc Common	Leduc	283,255	95%
Liberty Crossing	Red Deer	64,240	50%
Market Mall	Regina	42,912	87%
The District	Calgary	23,238	100%
The Village at Blackmud Creek	Edmonton	9,046	100%
Towers Mall	Regina	114,331	97%
University Park Shopping Centre	Regina	41,238	91%
West Henday Promenade	Edmonton	77,129	100%
Westgrove Common	Spruce Grove	29,242	93%
White Oaks Square	Edmonton	127,824	100%
<b>TOTAL</b>		<b>1,056,758</b>	<b>93</b>

INDUSTRIAL BUILDINGS	LOCATION	GLA	OCC %
Lethbridge Industrial Building	Lethbridge	49,005	100
Telford Industrial	Leduc	143,118	100
TKE Building	Edmonton	15,968	100
<b>TOTAL</b>		<b>208,091</b>	<b>100</b>

LAND LEASE COMMUNITY	LOCATION	GLA	OCC %
Watergrove	Calgary	308	100



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Ralph Young

## MESSAGE FROM THE CHAIRMAN

I am pleased to report on an important and successful year for Melcor REIT in 2018. The REIT celebrated its fifth year of business on May 1, 2018 in the midst of another year of economic challenge for Alberta and western Canada.

2018 was a year focused on achieving business and financial success in these challenging times while responding to opportunities and maintaining strong tenant relations. The REIT completed an important transaction with Melcor Developments to strengthen our retail and industrial asset base and financial performance.

The oversupply of office space in Edmonton and Calgary has contributed to challenges to maintain effective rental revenues and occupancy levels. Our management has performed well to retain tenants and maintain a reasonable level of Adjusted Funds from Operations to ensure our ability to maintain unitholder distributions. While our payout ratio has grown during the year, we remain confident that our distributions will be maintained at acceptable levels for unitholders.

I thank our Trustees for their diligent and effective governance. Our Trustees have provided a high level of skill and judgment in the creation and growth of the REIT over the past five and a half years. In particular, I wish to acknowledge the contributions of our two retiring Trustees, Brian Hunt and Patrick Kirby. Brian has served as our Audit Committee Chair since inception and has provided very wise counsel to the Board and has represented unitholders interests with a high level of integrity. Patrick Kirby has also brought exceptional skill and judgment to the REIT, particularly in areas of tax and financial accountability and reporting. Both these Trustees have served with distinction and we will miss their counsel to the REIT.

Our management leadership, Trustees and principal shareholder have experienced various economic cycles over many years of industry involvement. They have the skill and judgment to successfully operate in real estate markets through these cycles. The REIT has demonstrated focus and patience over its short history and has maintained its financial strength to position itself for future opportunities and growth.

Finally, we thank our unitholders for your continued support of our strategy to be one of Canada's premier real estate investment trusts. We continue to be confident in our ability to manage through current market challenges and to provide strong returns for our unitholders.







**Andrew Melton**

## MESSAGE FROM THE PRESIDENT & CEO

It is my privilege to report to you on our 2018 financial results. It was another year where the Alberta economy and a pipeline, or lack thereof, were big stories.

Since our inception in 2013, we've experienced a variety of challenging market conditions. Our most recent challenge has been the decline in oil and the continuing negative impact to Alberta's economy as a result. This combined with an influx of office product in downtown Edmonton, where 12% of our portfolio is located, and policies implemented by new governments both provincially and nationally have contributed to the challenge.

In spite of this, throughout 2018, we continued to execute on our strategy, leading to stable results. We've paid out total distributions of \$3.94 per unit to our unitholders since inception. We've maintained occupancy of approximately 90% through challenging markets. We've achieved our target of 95%+ on-time response on service calls for the past five years, which is a critical component of maintaining strong relationships with tenants for continued retention.

We've also grown our portfolio gross leasable area by 83% and re-balanced our asset class mix. We completed four vend-ins from Melcor – a key component of our growth strategy and our competitive advantage. In addition, we acquired assets from third parties and divested three assets to monetize the value we had created while at the same time diversifying our portfolio. Through these transactions, we've acquired 1,418,148 square feet and sold 118,125 square feet.

We continue to monitor and respond to market demand and trends in commercial real estate and to focus on exceptional customer care as a differentiating factor in a market where tenants have many options to choose from.

## LANDLORD OF CHOICE

The strength of our portfolio is in our people. Our goal of being the landlord of choice requires the dedicated effort of the teams that take care of all aspects of our business – from building operations and maintenance, to leasing, to property management and all the back office roles that support these functions – to ensure that our customer's experience with the REIT is positive. Our ability to

maintain occupancy through challenging markets is a testament to the way our people take care of our tenants and our buildings. We remain committed to exceptional property management and customer care to ensure we remain the landlord of choice.

I'm not surprised that we had a pretty good year; our team continues to work diligently and enthusiastically to lease space, look after our tenants and make continual improvements to our business.

## OUTLOOK

We believe that we still have some challenges ahead, but we expect next year to remain stable and hope to even improve on this year's results. We will continue to emphasize our pillars of customer care and sustainability while we focus on protecting and strengthening our portfolio of income-generating assets.

Retail continues to be resilient to offset softness in office space. We are renewing leases and remain pleased with the volume of new leasing prospects. While competitive pressure is resulting in increased costs associated with renewals and securing new leases, we are encouraged by the interest and activity that we continue to see across our portfolio.

We were able to retain a healthy 77% of GLA that expired in 2018, a great result in a year when over 16% of GLA expired. For 2019, just under 10% of total GLA expires. We continue to work on securing early renewals. There can be no assurance that this strategy will be successful or that we will meet our retention rate target going forward.

Properties acquired in 2018 are 100% occupied and, as newer construction, have longer lease terms remaining, helping to offset the potential loss of tenants as leases expire over the year. With a strong, diversified portfolio, focus on property management and client relationships, and a solid pipeline of over 6.5 million sf of high quality assets being developed over the next 5-10 years, we remain well positioned for the future.

## IN APPRECIATION

In closing, I would like to express my deep appreciation to our Trustees. Thank you for your ongoing support and guidance. In particular, I acknowledge Brian Hunt and Patrick Kirby for their 5 years of service to the REIT and wish them well.

I am also incredibly grateful to the Melcor team for the exceptional work they do every day to take care of our tenants and manage our properties.

Finally, I thank our unitholders for your ongoing support and trust in the REIT and our business.







## BOARD OF TRUSTEES

*1 Melcor employees do not receive trustee compensation.*



**Andrew Melton** | Calgary, AB

RELATED

**Principal Occupation:**  
President & CEO, Melcor REIT

**Trustee Since:** 2013  
**Attendance:** 100%  
**Compensation<sup>1</sup>:** \$nil  
**Unitholdings:** 133,025  
No committees



**Brian Hunt** | Calgary, AB

INDEPENDENT

**Principal Occupation:**  
President & Director, Taviston Inc.

**Trustee Since:** 2013  
**Attendance:** 82%  
**Compensation:** \$43,750  
**Unitholdings:** 40,000  
Audit, Investment



**Larry Pollock** | Edmonton, AB

INDEPENDENT

**Principal Occupation:**  
Corporate Director

**Trustee Since:** 2013  
**Attendance:** 100%  
**Compensation:** \$39,750  
**Unitholdings:** 80,000  
Audit, Governance, Investment



**Darin Rayburn** | Edmonton, AB

RELATED

**Principal Occupation:**  
President & CEO, Melcor

**Trustee Since:** 2017  
**Attendance:** 100%  
**Compensation<sup>1</sup>:** \$nil  
**Unitholdings:** 161,283  
Investment



**Donald Lowry ICD.D** | Edmonton, AB

INDEPENDENT – LEAD TRUSTEE

**Principal Occupation:**  
Corporate Director

**Trustee Since:** 2013  
**Attendance:** 100%  
**Compensation:** \$50,250  
**Unitholdings:** 59,600  
Audit, Governance



**Patrick Kirby** | Edmonton, AB

INDEPENDENT

**Principal Occupation:**  
Corporate Director

**Trustee Since:** 2013  
**Attendance:** 100%  
**Compensation:** \$31,500  
**Unitholdings:** 43,260  
Governance



**Ralph Young** | Edmonton, AB

RELATED (CHAIR)

**Principal Occupation:**  
Corporate Director

**Trustee Since:** 2013  
**Attendance:** 100%  
**Compensation:** \$38,500  
**Unitholdings:** 23,800  
No committees

# CORPORATE GOVERNANCE

We are committed to effective corporate governance practices as a core component of our operating philosophy. Strong governance practices lay the foundation for a sustainable company and long-term value creation for our unitholders.

As governance practices evolve, we periodically review, evaluate and enhance our governance program. Here are a few highlights of our program:

## INDEPENDENCE

The majority of our trustees are independent. Committees are comprised of a majority of independent trustees. The audit committee is 100% independent. The independent trustees meet in camera (without management and related directors) for a portion of each in person meeting held. As our chairman is related, we have appointed a lead trustee, Don Lowry, who is independent. Mr. Lowry chairs the in camera sessions and ensures that the board conducts itself in accordance with good governance practices. Each of the arrangements with Melcor (Asset Management, Property Management and Development and Opportunities Agreements) require the agreement of the majority of independent trustees, providing independent oversight on all transactions to represent the interests of minority unitholders. As two of our trustees – all of whom have been with the REIT since its inception – are not seeking re-election this year, we are pleased to welcome two new independent trustees to the board.

## INTEGRITY: THE HEART OF OUR BUSINESS

The highest standard of ethical conduct has always been at the heart of our operating philosophy. All employees, trustees and officers follow our Code of Business Conduct & Ethics, which governs the work environment, regulatory compliance and the protection of our assets and reputation. The Code can be found on our website at [www.MelcorREIT.ca](http://www.MelcorREIT.ca). Melcor employees who manage our properties follow the Melcor Code of Business Conduct & Ethics, which is essentially the same.

## STRATEGIC PLANNING PROCESS

The board ensures that we establish a solid strategy designed to optimize unitholder value. This process includes active consultation with management on the issues, business environment, assumptions, goals and financial budgets that underpin the strategy and ensures that risk levels are appropriate. To keep the board fully informed and engaged in the strategic issues and critical risks of our business, one meeting each year is dedicated to the review and approval of our strategic plan to manage risk, protect unitholder value and build a sustainable business.

## ALIGNMENT WITH UNITHOLDER INTERESTS

All trustees and officers took part in the REIT's initial public offering. In 2018, trustees increased their holdings by 12% to an average of 77,281 units, ensuring alignment with unitholder interests and a focus on long-term value creation. Additional information on our governance practices can be found in our 2019 Information Circular.



# MANAGEMENT'S DISCUSSION & ANALYSIS

March 7, 2019

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The following Management's Discussion and Analysis (MD&A) of Melcor Real Estate Investment Trust's (the REIT) results should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2018. The discussion outlines strategies and provides analysis of our financial performance for the fourth quarter and the full year.

The underlying financial statements in this MD&A, including 2017 comparative information, have been prepared in accordance with International Financial Reporting Standards (IFRS) unless otherwise noted. All dollar amounts included in this MD&A are Canadian dollars unless otherwise specified.

The REIT's Board of Trustees, on the recommendation of the Audit Committee, approved the content of this MD&A on March 7, 2019. Disclosure contained in this MD&A is current to March 7, 2019, unless otherwise indicated.

## REGULATORY FILINGS

Additional information about the REIT, including our annual information form, information circular and quarterly reports, is available on our website at MelcorREIT.ca and on SEDAR at [www.sedar.com](http://www.sedar.com).

## NON-STANDARD MEASURES

We refer to terms and measures which are not specifically defined in the CPA Canada Handbook and do not have any standardized meaning prescribed by IFRS. These measures include funds from operations (FFO), adjusted funds from operations (AFFO), adjusted cash flows from operations (ACFO) and net operating income (NOI), which are key measures of performance used by real estate businesses. We believe that these measures are important in evaluating the REIT's operating performance, financial risk, economic performance, and cash flows. These non-standard measures may not be comparable to similar measures presented by other companies and real estate investment trusts and should not be used as a substitute for performance measures prepared in accordance with IFRS.

Non-standard measures included in this MD&A are defined in the Non-standard Measures section.

## CAUTION REGARDING FORWARD-LOOKING STATEMENTS

In order to provide our investors with an understanding of our current results and future prospects, our public communications often include written or verbal forward-looking statements.

Forward-looking statements are disclosures regarding possible events, conditions, or results of operations that are based on assumptions about future economic conditions or courses of action and include future-oriented financial information.

This MD&A and other materials filed with the Canadian securities regulators contain statements that are forward-looking. These statements represent the REIT's intentions, plans, expectations, and beliefs and are based on our experience and our assessment of historical and future trends, and the application of key assumptions relating to future events and circumstances. Forward-looking statements may involve, but are not limited to, comments with respect to our strategic initiatives for 2019 and beyond, future leasing, acquisition and financing plans and objectives, targets, expectations of the real estate, financing and economic environments, our financial condition or the results of or outlook for our operations.

By their nature, forward-looking statements require assumptions and involve risks and uncertainties related to the business and general economic environment, many beyond our control. There is significant risk that the predictions, forecasts, valuations, conclusions or projections we make will not prove to be accurate and that our actual results will be materially different from targets, expectations, estimates or intentions expressed in forward-looking statements. We caution readers of this document not to place undue reliance on forward-looking statements. Assumptions about the performance of the western Canadian economy and how this performance will affect the REIT's business are material factors we consider in determining our forward-looking statements. For additional information regarding material risks and assumptions, please see the discussion under Business Environment and Risks.

Readers should carefully consider these factors, as well as other uncertainties and potential events, and the inherent uncertainty of forward-looking statements. Except as may be required by law, we do not undertake to update any forward-looking statement, whether written or oral, made by the REIT or on its behalf.

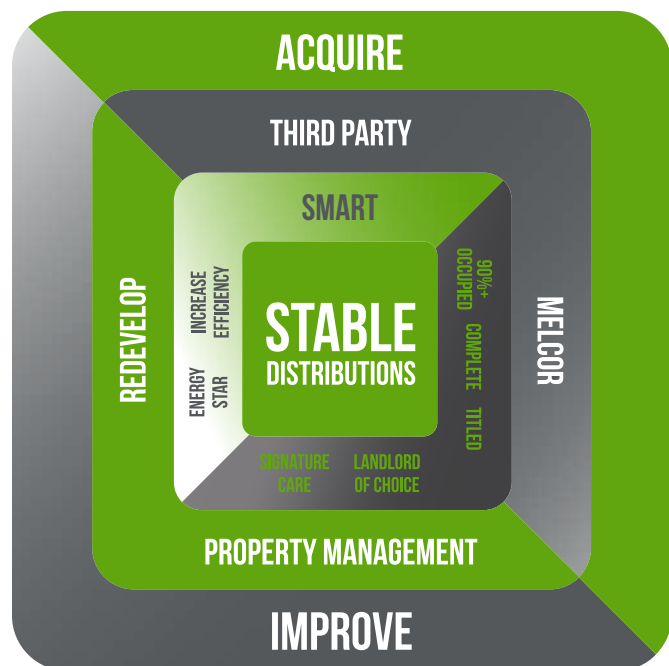


## OUR BUSINESS: VISION, GOALS & STRATEGY

The REIT has an established and diversified portfolio focused on western Canada. On May 1, 2018 the REIT marked its 5th year of operations. We currently own 37 income-producing office, retail and industrial properties representing 2.87 million sf (square feet) in gross leasable area (GLA). These high-quality properties feature stable occupancy and a diversified mix of tenants, some of whom have been in place for over 20 years. The REIT is externally managed, administered and operated by Melcor Developments Ltd. (Melcor) pursuant to the asset management and property management agreements entered into in conjunction with the IPO.

Melcor holds an approximate 53.0% effective interest in the REIT through ownership of all Class B LP units of Melcor REIT Limited Partnership (the partnership) through an affiliate and a corresponding number of special voting units of the REIT. The Class B LP units are economically equivalent to, and are exchangeable for, trust units. Melcor is the ultimate controlling party.

Melcor, a real estate company founded in 1923, has a rich history of growth and performance. Our objective is to continue that tradition by providing stable monthly cash distributions to unitholders. Our growth strategy is simple: acquire and improve. Together with Melcor, we have a proven track record of doing both.



### ACQUIRE

Our acquisition growth strategy is focused on:

- Diversifying our property portfolio,
- Increasing penetration in existing geographic markets to exploit competitive advantage, and
- Expanding to adjacent geographic markets.

We focus on two channels to support our acquisition growth strategy.

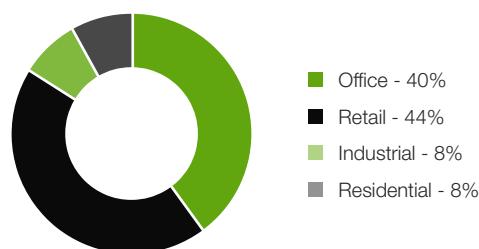
### Acquiring properties via our proprietary pipeline:

As Melcor completes development and leasing of commercial properties, the REIT has a first right to purchase each asset for its portfolio. This organic asset pipeline is unique to the REIT. Based on projects currently being developed or planned to begin in the near-term, we expect this current acquisition pipeline to yield 6.50 million sf of GLA over the next 5-10 years. The REIT also has the opportunity to participate in investment opportunities, joint ventures and mezzanine financing on Melcor projects under the Development and Opportunities Agreement.

On January 12, 2018 the REIT acquired 172,629 sf of GLA from Melcor (the Melcor Acquisition). These recently constructed, high-quality properties were acquired for a purchase price of \$80.88 million, adding 128,301 sf to our retail and 44,328 sf to our industrial portfolios, both of which are targeted for growth in our overall portfolio mix. These properties include additional phases at four existing properties and one new property. Since our IPO in 2013, we have acquired over 1.00 million sf of GLA via our proprietary pipeline.

Melcor currently has an additional 121,800 sf of GLA under development.

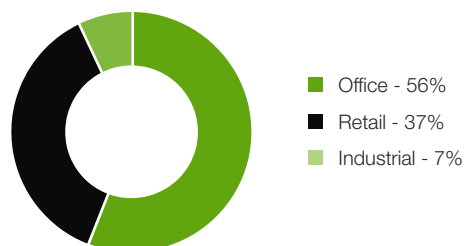
### GLA FOR FUTURE DEVELOPMENT



**Acquiring accretive income-producing properties:** We actively seek strategic third party property acquisitions that fit our SMART investment criteria: properties that have a good Story, are in the right Market, Accretive to AFFO per unit, at the Right price and in our Targeted areas. Target acquisitions include properties with potential to increase value through expansion, redevelopment or improved property management.

On December 3, 2018 we acquired a 33,196 sf single tenant office building in Lethbridge, Alberta for \$6.25 million. This acquisition represents partial redeployment of proceeds from property sales completed in 2018 and 2017. Continued competition for assets which meet our investment criteria highlights the strategic importance of the Melcor pipeline and our first right to these properties.

### GLA BY PROPERTY TYPE



## SMART ACQUISITION STRATEGY

### SMART

#### Acquisition Targets

- Stable, accretive properties
- Penetrate existing geographic markets
- Expand into adjacent markets
- Properties with redevelopment & repositioning potential

### MARKET

### ACCRETIVE

#### Acquisition & Integration Strength

- Proven due diligence process
- Agility to quickly execute on decisions
- Ability to close within 30 days for preferred access to unmarketed opportunities
- Clustering of properties for efficient management & strong market knowledge

### RIGHT PRICE

### TARGETED

## IMPROVE

There are two key components to improving our existing assets – property management and asset enhancement. The goals of our property management and asset enhancement programs are to:

- Maximize occupancy
- Maximize tenant retention
- Increase rental income

As a component of our improvement strategy, we also regularly review our portfolio to identify opportunities to recycle capital and pare our portfolio of non-core assets. Value monetized through recycled assets allows the REIT to reduce debt and provides additional capacity to acquire and improve core assets.

## PROPERTY MANAGEMENT

We are committed to being the Landlord of Choice by providing consistent, high quality service to our clients, thus ensuring that our occupancy rates remain high and that our space is leased at attractive rates.

Efficient property management optimizes operating costs, occupancy and rental rates. Our hands-on, on-site building management identify issues early on for prompt resolution, and with continuous logging and monitoring of all maintenance activity, we can make capital investment decisions at the right time to sustain long-term operating margins.

Our property management practices are designed to improve operating efficiency and reduce cost while at the same time increasing client satisfaction and thus retention rates. We enjoy strong, long-term relationships with our clients, some of whom have been with Melcor for over 20 years.

Our Signature Customer Care program is the solution centre for client service requests via telephone, email or website. We continue to provide responsive service and are proud of our track record of responding to over 99% of service requests within 30 minutes during business hours.

This high level of satisfaction contributes to other metrics, such as our retention rate which was a healthy 77.4% in 2018.

We continue to be proactive with leasing strategies designed to maintain occupancy at or above our target.

## ASSET ENHANCEMENT

We continually improve our assets with value-adding investments that enhance property quality, which leads to higher occupancy and rental rates. These upgrades typically focus on increasing operating efficiency, property attractiveness, functionality and desirability. We use our intimate knowledge of the buildings we operate to support capital investment decisions, optimize operating efficiency and continuously improve our buildings for enhanced client satisfaction.

## CAPITAL EXPENDITURE STRATEGY

### PRESERVE

- Inner works (boilers, roofs, maintenance)
- Maintain asset value through routine care
- Improve efficiencies through upgrades for lower building operating costs
- Driven by annual building & equipment condition assessments

### ENHANCE

- Visible improvements such as common area upgrades, landscaping, and aesthetics
- Enhancements that improve tenant comfort
- Upgrades to help lease space and retain tenants
- Driven by lease expiries, vacancy and need

Our buildings undergo annual assessments to identify preventative maintenance and capital investment requirements, and we continuously monitor and log all equipment and maintenance activity. Many of our continuous improvement initiatives focus on sustainability and energy reduction strategies to ensure our buildings are green. As we upgrade and replace equipment, we do so with technology that promotes energy efficiency. We also engage specialists to monitor and analyze our energy usage to identify ways it can be improved.

On October 1, 2018 Melcor announced the unveiling of the re-branded Melcor Centre, formally known as Lethbridge Centre. The name change reflects the significant upgrades and redevelopment that Melcor and the REIT have completed on the property over the past 11 years as it transitioned from a mall to a major health and professional service centre in the heart of downtown Lethbridge.

## CAPITAL RECYCLING

We continually review our asset portfolio to identify opportunities to recycle capital. Our capital recycling strategy focuses on pruning non-core assets with a view to mitigate against market and tenancy exposures and maximizing return on investment.

On January 31, 2018 we sold a 23,179 sf retail property in Leduc, Alberta for gross proceeds of \$6.85 million. The property was acquired by the REIT as part of its purchase of the initial properties from Melcor in 2013 and had previously been developed and owned by Melcor since 1974. Proceeds from the sale were used to repay amounts drawn under the revolving credit facility.

On April 16, 2018 we sold a 27,336 sf retail property in Edmonton, Alberta for gross proceeds of \$13.80 million. The property was acquired by the REIT as part of its purchase of the initial properties from Melcor in 2013 and was developed by Melcor in 2009.

Proceeds from these sales were used to repay amounts drawn under the revolving credit facility, providing the REIT with additional capacity for future asset acquisitions.



## KEY METRICS & 2018 RESULTS

METRIC	TARGET	2018
Debt/gross book value excluding debentures	50-55%	48%
Debt/gross book value including debentures	55-60%	56%
Tenant retention	75%	77.4%
Occupancy	90%+	89.9%
Portfolio diversification		
Retail	40%	36.8%
Office	40%	55.9%
Industrial	20%	7.3%
Weighted average base rent (by sf)		
Retail	\$18.50+	\$20.28
Office	\$14.00+	\$14.02
Industrial	\$8.00+	\$14.32
Customer Care On-time Response	95%+	99%

## 2018 HIGHLIGHTS & KEY PERFORMANCE INDICATORS

### FINANCIAL HIGHLIGHTS

(\$000s)	Year ended December 31		Δ%
Non-Standard KPIs	2018	2017	
Net operating income (NOI)	43,983	42,101	4
Same-asset NOI	38,962	40,803	(5)
Funds from Operations (FFO)	26,084	26,670	(2)
Adjusted Funds from Operations (AFFO)	19,152	20,194	(5)
Adjusted Cash Flows from Operations (ACFO)	18,943	19,969	(5)
Rental revenue	70,173	66,613	5
Income before fair value adjustment and taxes	12,930	13,742	(6)
Fair value adjustment on investment properties <sup>1</sup>	(11,385)	(12,800)	nm
Cash flows from operations	11,870	13,605	(13)
Distributions to unitholders	8,901	7,527	18
Distributions <sup>2</sup>	\$0.68	\$0.68	-

1. The abbreviation nm is shorthand for not meaningful and is used through this MD&A where appropriate.
2. Distributions for the current and comparative periods have been paid out at a rate of \$0.05625 per unit per month.

### PER UNIT METRICS

	Year ended December 31		Δ%
Per Unit Metrics	2018	2017	
Net income/(loss)			
Basic	\$1.34	\$0.07	
Diluted	\$0.43	\$0.07	
Weighted average number of units for net income/(loss) (000s): <sup>1</sup>			
Basic	13,120	11,151	18
Diluted	28,010	11,151	151
FFO			
Basic	\$0.93	\$1.04	
Diluted	\$0.92	\$1.02	
Payout ratio	73%	65%	
AFFO			
Basic	\$0.68	\$0.78	
Payout ratio	99%	86%	
Weighted average number of units for FFO & AFFO (000s): <sup>2</sup>			
Basic	28,010	25,767	9
Diluted	32,737	28,555	15

1. For the purposes of calculating per unit net income/(loss) the basic weighted average number of units includes Trust Units and the diluted weighted average number of units includes Class B LP Units and convertible debentures, to the extent that their impact is dilutive.
2. For the purposes of calculating per unit FFO and AFFO the basic weighted average number of units includes Trust Units and Class B LP Units. The diluted weighted average number of units includes convertible debentures.

	Year ended December 31		Δ%
	2018	2017	
Total assets (\$000s)	709,603	676,237	5
Equity (\$000s) <sup>1</sup>	280,401	260,600	8
Debt (\$000s) <sup>2</sup>	390,918	353,340	11
Weighted average interest rate on debt	3.77%	3.75%	1
Debt to GBV, excluding convertible debentures (maximum threshold - 60%)	48%	47%	1
Debt to GBV (maximum threshold - 65%)	56%	56%	—
Finance costs coverage ratio <sup>3</sup>	2.60	2.93	(11)
Debt service coverage ratio <sup>4</sup>	2.30	2.60	(12)

1. Calculated as the sum of trust units and Class B LP Units at their book value. In accordance with IFRS the Class B LP Units are presented as a financial liability in the consolidated financial statements.
2. Calculated as the sum of total drawn on revolving credit facility, mortgages payable, Class C LP Units, excluding unamortized fair value adjustment on Class C LP Units, liability held for sale (as applicable) and convertible debentures, excluding unamortized discount and transaction costs.
3. Calculated as the sum of FFO and finance costs; divided by finance costs, excluding distributions on Class B LP Units and fair value adjustment on derivative instruments.
4. Calculated as FFO; divided by sum of contractual principal repayments on mortgages payable and distributions of Class C LP Units, excluding amortization of fair value adjustment on Class C LP Units.

## OPERATING HIGHLIGHTS

	31-Dec-18	31-Dec-17	Δ%
Number of properties	37	37	-
Gross leasable area (GLA) (sf)	2,868,901	2,710,862	6
Occupancy (weighted by GLA)	89.9%	91.8%	(2)
Retention (weighted by GLA)	77.4%	80.6%	(4)
Weighted average remaining lease term (years)	4.67	4.66	-
Weighted average base rent (per sf)	\$16.51	\$15.88	4

## 2018 HIGHLIGHTS

In 2018, we executed on our growth strategy by adding 205,825 sf of GLA through our fourth Melcor Acquisition under our right of first offer and through a third party acquisition. We were pleased to grow our portfolio through these acquisitions following two years spent focusing on improving and maintaining our existing assets. We also continued to look for capital recycling opportunities and divested two retail assets in 2018. May 1, 2018 marked the REIT's fifth year of operations. Over the past five years the REIT's portfolio has grown 83% or 1.30 million sf.

The following table outlines asset transactions completed in 2018 for net GLA growth of 6% over 2017.

## PROPERTY ACQUIRED

### Melcor Acquisition: January 2018 | \$80,875,000

	Type	GLA	Occ. %
Kingsview Market Phase 2	Retail	32,008	100
Kingsview Market Phase 4	Retail	20,461	100
Telford Industrial Phase 4	Industrial	44,328	100
District at North Deerfoot Phase 1	Retail	23,159	100
West Henday Promenade Phase 2	Retail	42,142	100
Chestermere Station Phase 7 <sup>1</sup>	Retail	10,531	100

### 3rd Party Acquisition: December 2018 | \$6,250,000

LFS Building	Office	33,196	100
<b>Total Property Acquired</b>		205,825	100

## PROPERTY SOLD

### 3rd Party Disposition: January 2018 | \$6,850,000

	Type	GLA	Occ. %
Corinthia Plaza	Retail	23,179	87

### 3rd Party Disposition: April 2018 | \$13,800,000

Miller Crossing	Retail	27,336	97
<b>Total Property Sold</b>		50,515	92

1. Chestermere Station Phase 7 is held within a Joint Venture where the REIT has a 50% interest.

Growth across key indicators was tempered by a decline in same-asset performance, particularly in our Edmonton office assets where market fundamentals remain challenging. We are proactively engaged in renewing existing tenants and pursuing new tenants and achieved a healthy retention rate of 77.4% at year end and overall occupancy of 89.9%. The stability and diversity of our portfolio with respect to both tenant profile and asset class enable the REIT to continue navigating through economic cycles.

Highlights of our performance in the year include:

- Revenue and NOI growth of 5% over 2017 as a result of portfolio growth.
- We continued to execute on our proactive leasing strategy to both retain existing and attract new tenants. We completed lease renewals representing 305,344 sf (including holdovers) for a retention rate of 77.4% at December 31, 2018. New leasing has been steady across the portfolio with 72,967 sf in new deals commencing in 2018 and an additional 32,000 sf in committed leasing in office buildings for future occupancy.
- Same-asset NOI was down 1% in the fourth quarter and 5% over 2017, trending with a decline in same-asset occupancy. The decline in our Northern Alberta office assets was partially offset by stability in our retail and office assets in Southern Alberta and British Columbia.
- Net income in the current and comparative periods is significantly impacted by non-cash fair value adjustments on investment properties and Class B LP Units. Management believes funds from operations (FFO) is a better reflection of our true operating performance. FFO was \$26.08 million or \$0.93 per unit (basic), down 2% from 2017. Lower FFO was primarily due to property dispositions completed earlier in the year, declining same-asset performance and proceeds from the over-allotment on the convertible debenture and trust units which have only been partially re-deployed to date.
- Adjusted funds from operations (AFFO) was \$19.15 million or \$0.68 per unit (basic), down 5% from 2017. The decrease in AFFO was due to lower same-asset NOI and an increase in normalized capital, tenant incentive and leasing commissions.
- We issued 2,035,500 trust units on January 12, 2018 to complete the Melcor Acquisition, increasing our public float by 18%.
- We paid monthly distributions of \$0.05625 per trust unit during 2018 FFO payout ratio of 73% and an AFFO payout ratio of 99%. Our payout ratios are impacted by undeployed capital following the sale of the two assets earlier this year. Near term liquidity provides the REIT with the flexibility to allocate available resources towards operational, investing and financing initiatives. We continue to pursue various opportunities to maximize value for our unitholders.
- We took advantage of favourable lending conditions and early re-financed our largest mortgage securing \$39.00 million in financing at an interest rate of 3.84% in 2018. Early re-financing was a strategy employed to mitigate and re-balance our risk in 2019, reducing our percentage of mortgage maturing from 32% to 16%.
- As at December 31, 2018 we have \$1.58 million in cash and \$29.92 million in additional capacity under our revolving credit facility. We conservatively manage our debt, with a debt to GBV within our target range.

## CONSOLIDATED REVENUE & NET OPERATING INCOME

(\$000s)	Year ended December 31		Δ%
	2018	2017	
Base rent	43,835	41,019	7
Recoveries	25,897	25,209	3
Other	2,348	2,373	(1)
Amortization of tenant incentives	(3,097)	(3,062)	1
Straight-line rent adjustments	1,190	1,074	11
<b>Rental revenue</b>	<b>70,173</b>	<b>66,613</b>	<b>5</b>
Operating expenses	13,118	12,802	2
Utilities and property taxes	14,979	13,698	9
<b>Direct operating expenses</b>	<b>28,097</b>	<b>26,500</b>	<b>6</b>
<b>Net rental income</b>	<b>42,076</b>	<b>40,113</b>	<b>5</b>
<b>NOI</b>	<b>43,983</b>	<b>42,101</b>	<b>4</b>
<b>Same-asset NOI</b>	<b>38,962</b>	<b>40,803</b>	<b>(5)</b>
<b>Operating margin</b>	<b>60%</b>	<b>60%</b>	<b>—</b>

### REVENUE

Rental revenue increased \$3.56 million or 5% over 2017. The increase in revenue was a result of the Melcor Acquisition (Jan-2018) and LFS Building (Dec-2018) purchases, partially offset by property sales and lower same-asset revenue. Rental revenue from the acquired properties was \$7.00 million in 2018. During 2018 we also recognized \$0.38 million of rental revenue from properties sold within the last two years (2017 - \$1.74 million). Same-asset revenues were down over 2017 due to lower same-asset occupancy, impacting base rents as well as our recovery ratio.

We continue to be proactive and strategic in our leasing programs to meet the demands of an evolving market while retaining and attracting new tenants. In 2018 we completed 305,344 sf of lease renewals (including holdovers) and had 72,967 sf in new leases commence for occupancy of 89.9%. We exceeded our retention rate target, with the renewal of 77.4% of expiring leases (representing 57 leases) in spite of challenging market conditions in many of our operating regions.

The table below summarizes leasing activity for 2018:

	Square feet	Weighted average base rent (per sf)	Occ. %
<b>Opening occupancy</b>	2,487,574	\$15.88	91.8%
Expiring leases	(394,727)	\$14.02	
Renewals/holdovers	305,344	\$12.82	
Other terminations	(45,874)	\$13.75	
New leasing	72,967	\$14.82	
Lease amendments	(5,115)	\$—	
Investment properties acquired	205,825	\$25.68	
Investment properties sold	(46,524)	\$22.28	
<b>Closing occupancy</b>	<b>2,579,470</b>	<b>\$16.51</b>	<b>89.9%</b>

Weighted average base rent was \$16.51, up \$0.63 compared to December 31, 2017 due to the Melcor Acquisition, which had a

weighted average base rate of \$28.08. The increase was partially offset by lower rates on new and renewed leasing completed during the year and third party sales completed in 2018.

The table below summarizes the REIT's average base rent, GLA, occupancy and retention:

(\$000s)	December 31		Δ%
	2018	2017	
Weighted average base rent (per sf)	\$16.51	\$15.88	4
Weighted average remaining lease term	4.67	4.66	—
GLA	2,868,901	2,710,862	6
Occupancy	89.9%	91.8%	(2)
Retention	77.4%	80.6%	(4)

Recoveries are amounts recovered from tenants for direct operating expenses incurred and include a nominal administrative charge. We typically expect recovery revenue to correlate with changes in recoverable operating expenses. Recovery revenue was up 3% in 2018 while direct operating expenses increased 6% over 2017. Our recovery ratio was down over 2017 as a result of lower occupancy and higher non-recoverable costs. Comparative period recoveries were also elevated as a result of truing up 2016 year-end estimates.

Other revenue is comprised of parking revenue and other miscellaneous revenue which fluctuates from period to period.

Amortization of tenant incentives can fluctuate based on the timing of lease rollovers and leasing incentives. Straight-line rent adjustments relate to new leases which have escalating rent rates and/or rent-free periods. Straight-line rent adjustments were up due to leases assumed as part of the Melcor Acquisition, which had primarily long-term leases with multiple rent escalations. Straight-line rent adjustments fluctuate due to the timing of signed leases.

### DIRECT OPERATING EXPENSES

Direct operating expenses were up 6% over 2017. Excluding the impact of properties acquired and disposed of over the past twelve months, direct operating expenses were flat. On a same-asset basis, property taxes and utilities increased by 3% due to higher mill rates and increased utility consumption on account of colder weather and increases to levies and taxes in Alberta. The timing of maintenance projects led to a 2% decrease in same-asset operating expenses to date in 2018. As a cornerstone of our property management strategy, we are committed to efficient and cost effective maintenance of our buildings to ensure maximum value to our tenants and unitholders.

### NOI AND SAME-ASSET NOI

Net operating income (NOI) and same-asset NOI are non-standard metrics used in the real estate industry to measure the performance of investment properties. The IFRS measure most directly comparable to NOI and same-asset NOI is net income.

Portfolio growth over the past year contributed to a 4% increase in NOI. On a same-asset basis, NOI was down 5% over 2017 as a result of lower occupancy and weighted average base rates.

The calculation of same-asset NOI is as follows (refer to Non-standard Measures for calculation of NOI and reconciliation to net income):

(\$000s)	Year ended December 31		Δ%
	2018	2017	
Same-asset NOI	38,962	40,803	(5)
Acquisitions	4,740	—	
Disposals	281	1,298	
NOI	43,983	42,101	4
Amortization of tenant incentives	(3,097)	(3,062)	
Straight-line rent adjustments	1,190	1,074	
Net rental income per financial statements	42,076	40,113	5

## PROPERTY PROFILE

At December 31, 2018 our portfolio includes interests in 37 retail, office and industrial income-producing properties located in Western Canada for a total of 2,868,901 sf of GLA, and a land lease community.

The following table summarizes the composition of our properties by property type:

	Number of Properties	GLA (sf)/ Lots	% of Portfolio (GLA)	Fair Value of Investment Properties (\$000s)	Net Rental Income 2018 (\$000s)
Retail	12	1,056,758	36.8	356,243	20,792
Office	21	1,604,052	55.9	288,696	17,463
Industrial	3	208,091	7.3	43,200	2,885
Land Lease Community	1	308 lots	n/a	16,200	936
	37	2,868,901	100.0	704,339	42,076

The following table details key financial and operational metrics for each property type:

(\$000s)	Retail		Office		Industrial		Land Lease Community	
	2018	2017	2018	2017	2018	2017	2018	2017
Year ended December 31 (\$000s)								
Rental revenue	30,676	26,337	34,494	36,500	3,669	2,471	1,334	1,305
Net rental income	20,792	17,809	17,463	19,481	2,885	1,895	936	928
Same-asset NOI	16,798	17,042	19,375	21,074	1,853	1,759	936	928
As at December 31								
Average base rent (per sf)	\$20.28	\$18.90	\$14.02	\$14.32	\$14.32	\$10.83	n/a	n/a
Occupancy	93.2%	96.0%	86.5%	88.3%	100.0%	100.0%	100.0%	100.0%

**Retail** - our 12 retail properties include 5 multi-building retail power centres and 7 neighborhood shopping centres. The Melcor Acquisition increased our owned retail GLA by 128,301 sf. Rental revenue from acquired assets was \$5.69 million in 2018. During the first half of 2018, we sold two retail assets (50,515 sf). Rental revenue recognized from these assets was \$0.38 million (2017 - \$1.58 million). Occupancy was down 2.8% from 2017 while

weighted average base rent was up \$1.38 in 2018. Newly acquired GLA contributed to higher rent and occupancy and offset the decline in same-asset performance due to lease rollover at our Red Deer, AB property (representing approximately 31,358 sf in increased vacancy).

**Office** - our 21 office properties include low and medium-rise buildings located in strategic urban and suburban centres. Our office portfolio is our most geographically diverse asset class, with properties across Alberta, in Regina, SK and Kelowna, BC. On December 3, 2018 we acquired the 33,196 sf LFS Building in Lethbridge, AB. Rental revenue for the 28 days owned in 2018 was \$0.03 million. Increased competition in downtown Edmonton led to a decrease in average base rent. Across the portfolio we completed 197,590 sf in new and renewed leasing, maintaining occupancy at 86.5%. We have signed lease commitments on 32,000 sf of office.

**Industrial** - our 3 industrial properties include single and multi-tenant buildings. We acquired a 44,328 sf building in our Telford Industrial Park in Q1-2018 as part of the Melcor Acquisition adding \$1.28 million to 2018 rental revenues. In 2017 we recognized \$0.16 million in rental revenues from LC Industrial, a 67,610 sf property we sold in Q2-2017. Our assets remained fully occupied through 2018. Weighted average base rents were up \$3.49 over 2017 as a result of the changes in the portfolio over the past two years. On a same-asset basis rental revenue and NOI were up over 2017 as a result of rent escalations on leases with stepped rent rates.

**Land Lease Community** - we have one land lease community in Calgary, AB consisting of 308 pad lots. It was 100% occupied at December 31, 2018 (2017 - 100%). Revenue and NOI on our land lease community were up 2% and 1% respectively over 2017 as a result of higher pad rates, partially offset by higher property taxes and utilities.

## REGIONAL ANALYSIS

The following table summarizes the composition of our properties at December 31, 2018 by geographic region:

	Number of Properties	GLA (sf)	% of Portfolio (GLA)	Fair Value of Investment Properties (\$000s)	Net Rental Income 2018 (\$000s)
Northern Alberta	21	1,670,896	58.2	405,141	23,543
Southern Alberta	9	831,216	29.0	229,824	14,669
Saskatchewan & BC	7	366,789	12.8	69,374	3,864
	37	2,868,901	100.0	704,339	42,076

The following table details key financial and operational metrics for each of our geographic regions for the year ended December 31, 2018:

(\$000s)	Northern AB		Southern AB		SK & BC	
	2018	2017	2018	2017	2018	2017
Year ended December 31 (\$000s)						
Rental revenue	40,715	40,321	22,376	18,866	7,082	7,426
Net rental income	23,543	23,574	14,669	12,371	3,864	4,168
Same-asset NOI	22,012	23,990	12,521	12,349	4,429	4,464
As at December 31						
Average base rent/sf	\$16.85	\$16.61	\$17.08	\$15.38	\$13.63	\$13.68
Occupancy	87.5%	90.5%	94.8%	94.4%	90.0%	92.1%

**Northern Alberta** - our Northern Alberta assets are located throughout the greater Edmonton area, including Leduc, Spruce Grove and Red Deer. Rental revenue and net rental income were up due to the addition of 86,470 sf through the Melcor Acquisition. Same-asset NOI was down 8% over 2017 due to continued pressure on our Edmonton office properties rent and occupancy.

**Southern Alberta** - our Southern Alberta assets are located throughout the greater Calgary area, including Chestermere, Airdrie and Lethbridge. The addition of 86,159 sf of retail GLA through the Melcor Acquisition and 33,196 sf of office GLA (LFS Building) contributed to the increase in rental revenue and net rental income. Same-asset NOI was up 1% due to step ups on leases with escalating rents.

**Saskatchewan and British Columbia** - our Saskatchewan and British Columbia assets are located in Regina, Saskatchewan and Kelowna, British Columbia. Rental revenue was down due to higher vacancy and fluctuations in straight-line rent adjustments. NOI was down 1% over 2017.

## GENERAL & ADMINISTRATIVE EXPENSE

(\$000s)	Year ended December 31		Δ%
	2018	2017	
Asset management fee	1,739	1,583	10
Professional fees	428	413	4
Public company costs	336	293	15
Other	381	429	(11)
	2,884	2,718	6

General & administrative (G&A) expense was \$2.88 million (4% of rental revenue) in 2018. Public company costs were up over 2017 due to changes to trustee compensation and extra meetings. Asset management fees were up 10% over 2017 due to the net increase in the portfolio following acquisitions and dispositions completed over the past two years. The asset management fee is charged at an annual rate of 0.25% of gross book value. Higher professional fees and other expenses are due to timing of expenses incurred and increased market activity. We are committed to prudent financial stewardship, including careful monitoring of discretionary G&A expenses to ensure maximum value to our unitholders. We expect G&A to be approximately 5% of rental revenue.

## FINANCE COSTS

(\$000s)	Year ended December 31		Δ%
	2018	2017	
Interest on mortgages payable and revolving credit facility	8,961	8,160	10
Interest on Class C LP Units	2,893	2,858	1
Amortization of fair value adjustment on Class C LP Units	(209)	(225)	(7)
Interest on convertible debentures	3,100	1,931	61
Interest on subscription receipts	—	114	(100)
Fair value adjustment on derivative instruments	(421)	(521)	nm
Amortization of deferred financing fees	1,597	1,011	58
Finance costs before distributions	15,921	13,328	19
Distributions on Class B LP Units	10,057	9,866	2
Finance costs	25,978	23,194	12

Finance costs were up \$2.78 million or 12% over 2017 due to the Melcor Acquisition, which closed on January 12, 2018. As part of the transaction we assumed \$31.04 million in mortgages payable, issued 1,331,202 Class C LP Units representing \$13.31 million, and issued 283,447 Class B LP Units representing \$2.50 million. Cash to close the transaction was partially funded through the December 21, 2017 public offering of \$23.00 million in convertible debentures (2017 Debentures) and \$17.30 million in subscription receipts.

Higher interest on mortgages payable and Class C LP units were partially offset by lower amounts drawn on our revolving credit facility during the current period and settlement of the indebtedness on two investment properties disposed of in 2018.

We recognized \$0.11 million in interest on subscription receipts in the comparative period, holders of which were entitled to receive cash payments equivalent to distributions declared by the REIT in the period they were outstanding. The subscription receipts were converted to trust units on the closing of the Melcor Acquisition on January 12, 2018.

Distributions on Class B LP Units increased 2% over 2017 as a result of new units issued during the period. Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units (\$0.675 per unit during the year).

Amortization of discount and transaction costs on the 2017 Debentures led to an increase in amortization of deferred financing fees over 2017.

The 2017 Debentures, issued on December 21, 2017, pay a coupon of 5.25% annually. The \$34.50 million 2014 Debentures pay a coupon of 5.50% annually.

We recognized a fair value gain of \$0.42 million in 2018 on our derivative instruments. Interest rate volatility, combined with decreased remaining term resulted in a depreciation in the value of our floating for fixed interest rate swap on one of our mortgages; while softening credit spread and increased volatility led to a decline in the value of the conversion features on our convertible debentures.

As at December 31, 2018, the weighted average interest rate on our revolving credit facility, mortgages payable, Class C LP Units and convertible debenture was 3.77% based on period end balances (December 31, 2017 – 3.75%).

## INCOME TAXES

As at December 31, 2018, the REIT qualifies as a mutual fund trust within the meaning of the Income Tax Act (Canada) and as a real estate investment trust eligible for the 'REIT Exception' under the Specified Investment Flow-Through (SIFT) rules; accordingly, no current or deferred income tax expense has been recognized on income earned or capital gains recognized subsequent to the formation of the REIT.

## FFO, AFFO & ACFO

Funds From Operations (FFO), Adjusted Funds From Operations (AFFO) and Adjusted Cash Flow From Operations (ACFO) are non-standard measures used in the real estate industry to measure the operating and cash flow performance of investment properties.

## FFO & AFFO

REALpac defines FFO as net income (calculated in accordance with IFRS), adjusted for, among other things, fair value adjustments, amortization of tenant incentives and effects of puttable instruments



classified as financial liabilities (distributions on Class B LP Units). The REIT calculates FFO in accordance with REALpac.

We believe that FFO is an important measure of operating performance and the performance of real estate properties, while AFFO is an important cash flow measure. AFFO is not a substitute for cash flow from operations as it does not include changes in operating assets and liabilities.

FFO and AFFO are not a substitute for net income established in accordance with IFRS when measuring the REIT's performance. While our methods of calculating FFO and AFFO comply with REALpac recommendations, they may differ from and not be comparable to those used by other entities.

(\$000s, except per unit amounts)	Year ended December 31		Δ%
	2018	2017	
Net income for the year	17,610	732	
Add / (deduct)			
Fair value adjustment on investment properties	11,385	12,800	
Fair value adjustment on Class B LP Units	(15,644)	731	
Amortization of tenant incentives	3,097	3,062	
Distributions on Class B LP Units	10,057	9,866	
Fair value adjustment on derivative instruments	(421)	(521)	
<b>Funds From Operations (FFO)</b>	<b>26,084</b>	<b>26,670</b>	<b>(2)</b>
Deduct			
Straight-line rent adjustments	(1,190)	(1,074)	
Normalized capital expenditures	(2,424)	(2,312)	
Normalized tenant incentives and leasing commissions	(3,318)	(3,090)	
<b>Adjusted Funds from Operations (AFFO)</b>	<b>19,152</b>	<b>20,194</b>	<b>(5)</b>
<b>FFO/Unit</b>	<b>\$0.93</b>	<b>\$1.04</b>	
<b>AFFO/Unit</b>	<b>\$0.68</b>	<b>\$0.78</b>	
<b>Weighted average number of units (000s)<sup>1</sup></b>	<b>28,010</b>	<b>25,767</b>	<b>9</b>

1. For the purposes of calculating per unit FFO and AFFO, the basic weighted average number of units includes Trust and Class B LP Units.

Our convertible debentures can be converted into trust units at the holder's option and are considered dilutive instruments. The following table calculates diluted FFO and diluted FFO/Unit:

(\$000s, except per unit amounts)	Year ended December 31		Δ%
	2018	2017	
<b>Funds From Operations (FFO)</b>	<b>26,084</b>	<b>26,670</b>	<b>(2)</b>
Convertible debentures interest and amortization of deferred financing fees	4,071	2,480	
<b>Funds From Operations - Diluted (FFO - Diluted)</b>	<b>30,155</b>	<b>29,150</b>	<b>3</b>
<b>FFO - Diluted/Unit</b>	<b>\$0.92</b>	<b>\$1.02</b>	
<b>Diluted weighted average number of units (000s)<sup>1</sup></b>	<b>32,737</b>	<b>28,555</b>	<b>15</b>

1. The diluted weighted average number of units includes Trust Units, Class B LP Units and convertible debentures.

## CAPITAL EXPENDITURES

We continually invest in our assets to enhance property quality, which contributes to higher occupancy and rental rates. These upgrades typically focus on increasing operating efficiency, property attractiveness, functionality and desirability. Asset enhancement and preservation investments fluctuate based on the nature and timing of projects undertaken, and are impacted by many factors including, but not limited to, the age and location of the property, and the leasing profile and strategy. The majority of building improvement expenditures are recoverable from tenants over 5-25 years. As actual expenditures can vary from one period to another, the REIT uses a normalized capital expenditure in determining AFFO and sustainable, economic cash flow of investment properties.

Normalized expenditures exclude new property development initiatives such as densification and non-recoverable capital as these are discretionary in nature. Normalized capital expenditures are calculated based on a trailing 5 year historical actual spend plus 5 year projected spend (historical results are limited to May 1, 2013 onward).

The following summarizes our actual expenditures compared to normalized amounts.

(\$000s)	Year ended December 31	
	2018	2017
Investment in property improvements and development	2,592	2,315
Less non-recoverable	(318)	—
Actual capital expenditures	2,274	2,315
Normalized capital expenditures	2,424	2,312
Variance	(150)	3

## TENANT INCENTIVES & DIRECT LEASING EXPENDITURES

We continually invest in tenant incentives and direct leasing costs as part of our leasing strategy. Tenant incentives directly correlate to our ability to achieve higher base rents on lease deals. Expenditures on any particular building are impacted by many factors including, but not limited to, the lease maturity profile and strategy, market conditions and the property's location and asset class. As actual expenditures can vary from one period to another, the REIT uses a normalized capital expenditure in determining AFFO and sustainable, economic cash flow of investment properties. Normalized tenant incentives are calculated based on a trailing 5 year historical actual spend plus 5 year projected spend (historical results are limited to May 1, 2013 onward).

The following summarizes our actual expenditures compared to normalized amounts.

(\$000s)	Year ended December 31	
	2018	2017
Actual tenant incentives and direct leasing expenditures	4,981	3,385
Normalized tenant incentives and direct leasing expenditures	3,318	3,090
Variance	1,663	295

Actual expenditures were elevated in 2018 due to the composition of deals completed in 2018 (weighted more heavily to Edmonton office) in conjunction with higher than average lease rollover at 16.1%.

## ADJUSTED CASH FLOWS FROM OPERATIONS

REALpac defines Adjusted Cash Flow from Operations (ACFO) as cash flow from operations adjusted for, among other things, changes in operating assets and liabilities, payments of tenant incentives and direct leasing costs, non-cash finance costs, normalized capital expenditures and normalized tenant incentives and direct leasing costs. We calculate ACFO in accordance with the guidelines set out by REALpac.

(\$000s)	Year ended December 31		Δ%
	2018	2017	
<b>Cash flows from operations</b>	<b>11,870</b>	13,605	(13)
Distributions on Class B LP Units	10,057	9,866	
Actual payment of tenant incentives & direct leasing costs	4,730	3,192	
Changes in operating assets & liabilities	(375)	(281)	
Amortization of deferred financing fees	(1,597)	(1,011)	
Normalized capital expenditures	(2,424)	(2,312)	
Normalized tenant incentives & leasing commissions	(3,318)	(3,090)	
<b>Adjusted Cash Flows from Operations (ACFO)</b>	<b>18,943</b>	19,969	(5)

In order to continue to qualify for the 'REIT Exception', as provided under the SIFT rules, we must allocate substantially all taxable income. As such, we allocate monthly distributions to unitholders as determined and approved by the Board of Trustees. We made monthly distributions to unitholders at a rate of \$0.05625 per unit, representing \$0.675 per unit on an annualized basis. Distributions to unitholders during the year were \$8.90 million (2017 - \$7.53 million).

Distributions made during the year ended December 31, 2018 represent a payout ratio of approximately 99% of AFFO (2017 - 86%). On an FFO basis, distributions represent a payout ratio 73% (2017 - 65%). FFO and AFFO have been negatively impacted throughout the year due to a number of factors:

- Lower same-asset performance, particularly in our downtown Edmonton office portfolio.
- Capital recycling activities, with sales in 2017 and 2018 resulting in fewer properties contributing to FFO & AFFO, proceeds of which have only been partially redeployed to date.
- The exercise of the over-allotment option on the Melcor Acquisition, and recent re-financings which have resulted in undepleted capital.

We continue to actively seek investment opportunities to deploy the cash on hand. We also generate sufficient cash flows from operations to sustain our current distribution rate for the foreseeable future.

We use ACFO in evaluating our ability to continue to fund distributions. The most similar IFRS measure is cash flows from operations. Cash flows from operations, which includes Class B LP Unit distributions as a financing charge, exceeded distributions by \$2.97 million in 2018 (2017 - \$6.08 million) as illustrated in the table that follows.

(\$000s)	Year ended December 31		Δ%
	2018	2017	
Cash flows from operations	11,870	13,605	(13)
Distributions on Class B LP Units	10,057	9,866	2
<b>Cash flows from operations before Class B LP Unit distributions</b>	<b>21,927</b>	23,471	(7)
Distributions to unitholders	(8,901)	(7,527)	18
Distributions on Class B LP Units	(10,057)	(9,866)	2
<b>Total distributions</b>	<b>(18,958)</b>	(17,393)	9
Cash flows from operations before Class B LP Unit distributions less total distributions	2,969	6,078	(51)
<b>Total distributions as a % of cash flows from operations before Class B LP Unit distributions</b>	<b>86%</b>	74%	16

## INVESTMENT PROPERTIES

As at December 31, 2018 we owned 37 income-producing office, retail and industrial properties representing 2.87 million sf in GLA and a fair value of \$704.34 million. The change in the fair value of our portfolio is summarized as follows:

	Investment Properties	Investment Properties Held For Sale	Fair Value of Portfolio
<b>Balance, December 31, 2017</b>	636,031	6,732	642,763
<b>Additions:</b>			
Acquisitions	87,346	—	87,346
Property improvements	2,592	—	2,592
Direct leasing costs	742	—	742
Tenant inducements additions	4,239	—	4,239
Dispositions	(13,319)	(6,732)	(20,051)
Straight-line rent adjustments	1,190	—	1,190
Amortization of tenant incentives	(3,097)	—	(3,097)
Fair value adjustment on investment properties	(11,385)	—	(11,385)
<b>Balance, December 31, 2018</b>	<b>704,339</b>	—	<b>704,339</b>

### Acquisitions:

- On December 3, 2018 the REIT acquired a 33,196 sf single tenant office building in Lethbridge, Alberta for \$6.25 million.
- On January 12, 2018 the REIT acquired 172,629 sf of GLA via the Melcor Acquisition for \$80.88 million. These properties include additional phases at four existing properties and one new property in Alberta.

### Dispositions:

- On April 16, 2018 we sold a 27,336 sf retail property in Edmonton, Alberta for gross proceeds of \$13.80 million.
- On January 31, 2018 we sold million we sold a 23,179 sf retail property in Leduc, Alberta for gross proceeds of \$6.85 million.

**Additions** – during 2018 we invested \$2.59 million in asset enhancement and preservation projects. We remain committed to strategic value-adding asset enhancement and preservation projects as an integral component of our strategy to improve our assets and retain and attract tenants. The majority of building improvement expenditures are recoverable from the tenants over 5-25 years. We also spent \$4.98 million on tenant inducements and direct leasing

costs in connection with 378,311 sf of leasing completed during the year.

**Fair value adjustment** – we carry our investment properties at fair value in accordance with IFRS 13, Fair value measurement. The following table summarizes key metrics of our investment properties and components of the fair value calculation:

(\$000s)	Year ended December 31	
	2018	2017
Number of properties	37	37
Total GLA (sf)	2,998,938	2,830,368
GLA (REIT owned %) (sf)	2,868,901	2,710,862
Fair value of portfolio (\$000s)	704,339	642,763
Value per square foot	\$246	\$237
NOI (\$000s)	43,983	42,101
Weighted average capitalization rate	6.69%	6.68%
Weighted average terminal cap rate	6.75%	6.79%
Weighted average discount rate	7.70%	7.75%

For the year ended December 31, 2018, Melcor's internal valuation team performed the valuation assessment. In 2018, 24 phases of 50 legal phases with a fair value of \$367.55 million were valued by qualified independent external valuation professionals. Valuations performed during the year resulted in fair value losses of \$11.39 million. In 2017, 27 phases of 46 legal phases with a fair value of \$392.70 million were valued by qualified independent external valuation professionals, resulting in a fair value loss of \$12.80 million. Refer to note 26 to the consolidated financial statements for additional information on the calculation of fair value adjustments.

Phases are a result of the property development process when a larger project is developed over an extended period of time and subdivided into legal phases for increased flexibility.

A breakdown of our fair value adjustment on investment properties by geographic region is as follows:

(\$000s)	Year ended December 31		\$ Δ
	2018	2017	
Northern Alberta	(12,816)	(16,959)	4,143
Southern Alberta	33	4,710	(4,677)
Saskatchewan & British Columbia	1,398	(551)	1,949
	(11,385)	(12,800)	1,415

Fair value losses in Northern Alberta were due to increased vacancy on certain Edmonton office properties and our Red Deer retail property in conjunction with spending on tenant incentives and capital projects. Fair value gains in Southern Alberta were realized on Calgary area retail properties and our office property in Lethbridge where market fundamentals remain strong. Our retail portfolio in Saskatchewan & office assets in British Columbia drove fair value gains in the region with higher NOI and a 25 to 50 basis point decrease in capitalization rates. The remainder of fair value losses across the portfolio were due to capital and tenant incentive spending that did not result in a significant change in the fair value of the related property. Fair value adjustments represent a change of approximately 2% in the fair value of our portfolio.

Fair values are most sensitive to changes in capitalization rates.

December 31, 2018			
	Min	Max	Weighted Average
Capitalization rate	5.50%	10.50%	6.69%
Terminal capitalization rate	5.75%	9.00%	6.75%
Discount rate	6.50%	9.75%	7.70%

December 31, 2017			
	Min	Max	Weighted Average
Capitalization rate	5.50%	8.75%	6.68%
Terminal capitalization rate	5.75%	9.00%	6.79%
Discount rate	6.50%	9.75%	7.75%

A capitalization rate increase of 50 basis points (+0.5%) would decrease the fair value of investment properties by \$48.65 million (2017 - \$44.31 million) while a 50 basis points decrease (-0.5%) would increase it by \$56.50 million (2017 - \$51.48 million).

## LIQUIDITY & CAPITAL RESOURCES

We employ a range of strategies to fund operations and facilitate growth. Our principal liquidity needs are to:

- Fund recurring expenses;
- Meet debt service requirements;
- Make distribution payments;
- Fund capital projects; and
- Purchase investment properties.

## CASH FLOWS

The following table summarizes cash flows from operating, investing and financing activities:

(\$000s)	Year ended December 31		\$ Δ
	2018	2017	
Cash from operating activities	11,870	13,605	(1,735)
Cash (used in) from investing activities	(26,700)	1,905	(28,605)
Cash from (used in) financing activities	4,222	(4,951)	9,173
(Decrease) increase in cash and cash equivalents	(10,608)	10,559	(21,167)
Cash and cash equivalents, beginning of year	12,189	1,630	10,559
Cash and cash equivalents, end of year	1,581	12,189	(10,608)

## OPERATING ACTIVITIES

Cash from operating activities decreased compared to the prior period as a result of fluctuations in adjustments for working capital and expenditures on tenant incentives and direct leasing costs. Our tenant incentives and direct leasing cost investments were \$4.73 million in the year (2017 - \$3.19 million) as we completed 378,311 sf of new and renewed leasing, resulting in year-end occupancy of 89.9%. The timing of lease expiries impacts the level of spending on tenant incentives and direct leasing costs and will fluctuate from period to period. Cash flows before adjustments for working capital and payment of tenant incentives and direct leasing costs was down

\$0.29 million over 2017. The decrease is due to asset dispositions, lower same-asset NOI and higher finance costs, which offset the operating cash flows from the Melcor Acquisition.

## INVESTING ACTIVITIES

On January 12, 2018 we completed the Melcor Acquisition for a purchase price of \$81.02 million (including transaction costs). The purchase price was partially settled through \$34.18 million in cash, with the balance being satisfied through mortgage assumption and the issuance of Class C and B LP Units. On December 3, 2018 we acquired LFS Building in Lethbridge, AB for a purchase price of \$6.32 million (including transaction costs), settled in cash.

On January 31, 2018, we sold Corinthia Plaza in Leduc, AB for \$6.73 million (net of transaction costs). The sale was settled through mortgage assumption of \$3.66 million and cash of \$3.07 million. Proceeds were used to repay amounts drawn under our revolving credit facility.

On April 16, 2018, we sold Miller Crossing in Edmonton, AB for \$13.32 million (net of transaction costs). Proceeds were used to retire the \$6.95 million outstanding Class C LP unit liability, with remaining proceeds used to repay amounts drawn under our revolving credit facility.

In the comparative period, we sold LC Industrial in Lethbridge, AB for \$7.76 million (net of transaction costs). The sale was settled through mortgage assumption of \$2.64 million, issuance of a vendor-take-back mortgage of \$0.90 million, and cash of \$4.22 million. Proceeds were used to repay amounts drawn under our revolving credit facility.

We have invested \$2.59 million in our 2018 capital program (2017 - \$2.32 million). We remain committed to strategic value-adding asset enhancement and preservation projects as a integral component of our strategy to improve our assets and retain and attract tenants. Asset enhancement investments fluctuate based on the nature and timing of projects undertaken.

## FINANCING ACTIVITIES

On January 12, 2018 we received \$16.11 million from the issuance of 2,035,500 trust units, net of transaction costs. Proceeds were used to fund the Melcor Acquisition. This follows the issuance of the 2017 Debentures for net proceeds of \$21.54 million received in December 2017.

During 2018, we re-financed the mortgages on three properties for gross proceeds of \$60.24 million (net \$21.81 million). In October 2018, we also repaid \$4.15 million in Class C LP Units and \$2.46 million of mortgage indebtedness on maturity. In 2017, we re-financed the mortgages on three properties and obtained new mortgage financing on two additional properties for gross proceeds of \$34.41 million (net \$11.33 million). In August 2017, we also repaid \$2.58 million in Class C LP Units on maturity.

We continued our monthly distribution of \$0.05625 per unit for total annual distributions of \$8.79 million to unitholders (2017 - \$7.53 million).

We are able to meet our capital needs through a number of sources, including cash generated from operations, short-term borrowings under our revolving credit facility, mortgage financings, and the issuance of trust units and Class B LP units in connection with investment property purchases.

We believe that internally generated cash flows, supplemented by borrowings through our revolving credit facility and mortgage financings, where required, will be sufficient to cover our normal operating, debt service, distribution and capital expenditure requirements. We regularly review our credit facility limits and manage our capital requirements accordingly.

As at December 31, 2018, we had \$1.58 million in cash and cash equivalents and \$29.92 million in funds available under our revolving credit facility.

## CAPITAL STRUCTURE

We define capital as the total of trust units, Class B LP Units, Class C LP Units, mortgages payable, convertible debentures and amounts drawn under our revolving credit facility.

Pursuant to the Declaration of Trust (DOT) Degree of Leverage Ratio, we may not incur or assume any indebtedness if, after incurring or assuming such indebtedness, the total indebtedness of the REIT would be more than 60% (65% including any convertible debentures) of Gross Book Value (GBV). Throughout the year, we were in compliance with the Degree of Leverage Ratio and had a ratio of 48% as at December 31, 2018 (56% including the convertible debenture).

As at December 31, 2018, the REIT's total capitalization was \$671.32 million, comprised as follows:

(\$000s)	31-Dec-18
Revolving credit facility	—
Mortgages payable <sup>1</sup>	261,067
Class C LP Units <sup>2</sup>	72,351
<b>Indebtedness, excluding convertible debentures</b>	<b>333,418</b>
Convertible debentures <sup>3</sup>	57,500
<b>Indebtedness</b>	<b>390,918</b>
Class B LP Units <sup>4</sup>	150,207
Trust units	130,194
<b>Equity</b>	<b>280,401</b>
<b>Total capitalization</b>	<b>671,319</b>
<b>Gross Book Value ("GBV")<sup>5</sup></b>	<b>699,207</b>
Debt to GBV, excluding convertible debentures (maximum threshold - 60%)	48%
Debt to GBV (maximum threshold - 65%)	56%

1. Debts are presented excluding unamortized transaction costs.
2. Class C LP Units excluding unamortized fair value adjustment on Class C LP Units.
3. Convertible debentures are presented at face value, excluding unamortized transaction costs and amounts allocated to conversion feature.
4. Class B LP Units are classified as equity for purposes of this calculation and are included at their book value.
5. GBV is calculated as the cost of the total assets acquired in the Initial Properties, subsequent asset purchases and development costs less dispositions.

We are also subject to financial covenants on our \$35.00 million revolving credit facility. The covenants include a maximum debt to gross book value ratio of 60% (excluding convertible debentures), a minimum debt service coverage ratio of 1.50, and a minimum adjusted unitholders' equity of \$140.00 million. We also have financial covenants on certain mortgages for investment properties. As at December 31, 2018 we were not in default or arrears on any of our obligations or any debt covenants. We prepare financial

forecasts to monitor changes to our debt and capital levels and manage our ability to meet our financial covenants.

## INDEBTEDNESS

**Debt Repayment Schedule** – the following table summarizes our contractual obligations and illustrates certain liquidity and capital resource requirements:

(\$000s)	Revolving credit facility <sup>1</sup>	Mortgages payable	Class C LP units	Convertible debentures	Total	% of portfolio
2019	—	44,177	3,628	34,500	82,305	21
2020	—	21,453	27,092	—	48,545	12
2021	—	37,006	14,675	—	51,681	13
2022	—	31,566	1,095	23,000	55,661	14
2023	—	40,117	14,932	—	55,049	14
Thereafter	—	86,748	10,929	—	97,677	26
<b>Total</b>	<b>—</b>	<b>261,067</b>	<b>72,351</b>	<b>57,500</b>	<b>390,918</b>	<b>100</b>

1. There was \$nil drawn on the line of credit at December 31, 2018.

We ladder the renewal and maturity dates on our borrowings as part of our capital management strategy. This mitigates the concentration of interest rate and financing risk associated with refinancing in any particular period. In addition, we try to match the maturity of our debt portfolio with the weighted average remaining lease term on our properties.

On June 1, 2018 we entered into the first amendment to our revolving credit facility agreement with two western Canadian financial institutions. Under the terms of the amending agreement the REIT maintains an available credit limit based upon the carrying value of specific investment properties to a maximum of \$35.00 million for general corporate purposes and acquisitions, including a \$5.00 million swingline sub-facility. An additional \$10.00 million is available by way of an accordion feature, subject to lender approval. Depending on the form under which the credit facility is accessed, rates of interest will vary between prime plus 1.25% or bankers acceptance plus 2.25% stamping fee. The facility matures June 1, 2021.

During 2018, six mortgages (including two secured by Class C LP Unit retained debt) were up for renewal. We re-financed three retail property mortgages for \$23.68 million in gross proceeds (net \$8.43 million) at a weighted average interest rate of 4.12% (previously 3.48%). In April we extended the maturity of a \$7.21 million mortgage that secures retained debt to April 1, 2021, at an interest rate of 3.58% (previously 3.33%). A fourth mortgage and Class C LP Unit encumbrance, secured against an Edmonton, AB office property, was repaid on maturity. This property was added as security to our revolving credit facility subsequent to year-end.

In July 2018 we re-financed the mortgage on a Lethbridge, AB mixed use property, scheduled to mature in 2019, securing \$39.00 million in gross proceeds (net \$13.38 million) at an interest rate of 3.84% (previously 3.38%). We re-financed this mortgage early to reduce our risk of financing at less favourable rates and terms.

Over the next 12 months, six mortgages are up for renewal. These mortgages had an outstanding principal balance of \$37.59 million and a weighted average interest rate of 3.23% at December 31, 2018. Subsequent to year-end we repaid the \$6.81 million

outstanding mortgage which was secured against our Red Deer, AB retail property. We expect to be able to re-finance remaining debts at market competitive terms.

In addition, our \$34.50 million 2014 Debentures mature December 31, 2019. We are actively reviewing re-financing options and expect to be able to re-secure financing at market competitive terms.

We continually monitor our upcoming mortgage renewals to identify opportunities and risks.

**Debt Analysis** – our mortgages payable, Class C LP Units and convertible debentures bear interest at fixed rates; our revolving credit facility bears interest at variable rates. The following table summarizes the interest rates and terms to maturity:

(\$000s)	Revolving credit facility <sup>1</sup>	Mortgages payable	Class C LP units	Convertible debentures	Total
Total	—	261,067	72,351	57,500	390,918
Fixed	—	244,007	72,351	57,500	373,858
Variable	—	17,060	—	—	17,060
Weighted average interest rate	—%	3.51%	3.4%	5.4%	3.77%
Weighted average term to maturity	2.42	4.42	3.54	2.2	3.93

The weighted average interest rate on our debts was 3.77% (December 31, 2017 - 3.75%).

The financing environment remains competitive and we expect to be able to secure new financing on upcoming mortgage and Class C LP Unit renewals at market competitive rates.

Debt Service Coverage Ratio and Finance Costs Coverage Ratio – we calculate debt service coverage ratio as FFO for the period divided by principal repayments on mortgages payable and Class C LP Units made during the period. We calculate interest coverage as FFO plus finance costs for the period divided by finance costs expensed during the period, less distributions on Class B LP Units. We consider these measures to be useful in evaluating our ability to service our debt. These metrics are not calculated for purposes of covenant compliance on any of our debt facilities. Our coverage ratios were down in 2018 due to an increase in leverage, higher amortization of deferred financing fees and decline in same-asset performance.

(\$000s)	Year ended December 31	
	2018	2017
FFO	26,084	26,670
Principal repayments on Mortgages payable	7,654	6,751
Principal repayments on Class C LP Units	3,705	3,489
Debt service coverage ratio	2.30	2.60
FFO plus finance costs	42,426	40,519
Finance costs <sup>1</sup>	16,342	13,849
Finance costs coverage ratio	2.60	2.93

1. Finance costs excluding finance expense recognized on Class B LP Unit distributions and fair value adjustment on derivative instruments.



## EQUITY

The REIT is authorized to issue an unlimited number of trust units and an unlimited number of special voting units. Each trust unit represents a holder's proportionate undivided beneficial ownership interest in the REIT and will confer the right to one vote at any meeting of unitholders and to receive any distributions by the REIT. Special voting units have no economic entitlement in the REIT but entitle the holder to one vote per special voting unit. Special voting units may only be issued in connection with securities exchangeable into trust units (including Class B LP Units).

Class B LP Units of the Partnership are economically equivalent to, and exchangeable into, trust units at the option of the holder, and therefore, are considered a dilutive instrument. The Class B LP Units are classified as financial liabilities in accordance with IAS 32, Financial Instruments – presentation, due to their puttable feature.

On January 12, 2018 the REIT issued 2,035,500 trust units in exchange for subscription receipts previously issued at a price of \$8.50 per unit for gross proceeds of \$17.30 million. The issuance was qualified under a short form prospectus dated December 14, 2017.

On January 12, 2018 the REIT issued 283,447 Class B LP Units at a price of \$8.82, or \$2.50 million, to Melcor as partial consideration for the Melcor Acquisition.

The following table summarizes the change in units during the year and the fully diluted number of units outstanding:

Issued and fully paid units (000s/\$000s)	December 31, 2018		December 31, 2017	
	Units	Amount	Units	Amount
Balance, beginning of year	11,151	112,892	11,151	112,892
Issuance of trust units	2,036	17,302	—	—
<b>Balance, end of year</b>	<b>13,187</b>	<b>130,194</b>	11,151	112,892
<i>Dilutive securities</i>				
Class B LP Units <sup>1</sup>	14,899	150,207	14,616	147,708
Convertible debentures	4,727	57,500	4,727	57,500
<b>Diluted balance, end of year</b>	<b>32,813</b>	<b>337,901</b>	30,494	318,100

1. A corresponding number of special voting units are held by Melcor through an affiliate.

## OFF BALANCE SHEET ARRANGEMENTS

As at December 31, 2018, we had no off-balance-sheet arrangements outside of the following commitments and contingencies.

In the normal course of operations we enter into lease agreements with tenants which specify tenant incentive payments upon completion of the related tenant improvements. The REIT has entered into lease agreements that may require tenant incentive payments of approximately \$1.60 million (2017 - \$0.44 million).

The REIT also retains a loan guarantee related to the mortgage transferred as part of the January 31, 2018 property sale. As at December 31, 2018 the loan balance was \$3.58 million (2017 - \$nil).

## QUARTERLY RESULTS

2018				
	Q4	Q3	Q2	Q1
Revenue (\$000s)	17,336	17,283	17,537	18,017
Net income (loss) (\$000s) <sup>1</sup>	6,737	3,097	(1,768)	9,544
Funds from operations (FFO) (\$000s)	6,382	6,277	6,723	6,702
Adjusted funds from operations (AFFO) (\$000s) <sup>2</sup>	4,792	4,494	4,973	4,893
<i>Per unit metrics</i>				
Earnings (loss) per unit (basic) <sup>1</sup>	\$0.51	\$0.23	\$(0.13)	\$0.74
FFO (basic)	\$0.23	\$0.22	\$0.24	\$0.24
AFFO (basic) <sup>2</sup>	\$0.17	\$0.16	\$0.18	\$0.18
Annualized distribution rate	\$0.675	\$0.675	\$0.675	\$0.675
Payout ratio	99%	105%	95%	96%
Period-end closing unit price	\$7.46	\$8.10	\$8.22	\$8.10
Annualized distribution yield on closing unit price (%) <sup>3</sup>	9.05%	8.33%	8.21%	8.33%

2017				
	Q4	Q3	Q2	Q1
Revenue (\$000s)	16,263	16,791	16,559	17,000
Net income (loss) (\$000s) <sup>1</sup>	11,723	4,291	(1,792)	(13,490)
Funds from operations (FFO) (\$000s)	5,991	7,029	6,835	6,815
Adjusted funds from operations (AFFO) (\$000s) <sup>2</sup>	4,567	5,158	5,219	5,250
<i>Per unit metrics</i>				
Earnings (loss) per unit (basic) <sup>1</sup>	\$0.35	\$0.25	\$(0.16)	\$(1.21)
FFO (basic)	\$0.23	\$0.27	\$0.27	\$0.26
AFFO (basic) <sup>2</sup>	\$0.18	\$0.20	\$0.20	\$0.20
Annualized distribution rate	\$0.675	\$0.675	\$0.675	\$0.675
Payout ratio	95%	84%	83%	83%
Period-end closing unit price	\$8.51	\$8.85	\$8.86	\$8.50
Annualized distribution yield on closing unit price (%) <sup>3</sup>	7.93%	7.63%	7.62%	7.94%

1. Management believes that FFO is a better measure of operating performance and that AFFO is a better measure of cash flows.
2. We adopted REALpac's new guidance on AFFO in Q2-2017 retroactively.
3. Annualized distribution yield is calculated as the annualized distribution rate divided by the period-end closing unit price.

## FOURTH QUARTER RESULTS

### CONSOLIDATED REVENUE & NET OPERATING INCOME

(\$000s)	3 months ended December 31		Δ%
	2018	2017	
Base rent	10,920	10,178	7
Recoveries	6,490	6,232	4
Other	576	560	3
Amortization of tenant incentives	(809)	(781)	4
Straight-line rent adjustments	159	74	115
<b>Rental revenue</b>	<b>17,336</b>	<b>16,263</b>	<b>7</b>
Operating expenses	3,320	3,334	—
Utilities and property taxes	3,660	3,399	8
<b>Direct operating expenses</b>	<b>6,980</b>	<b>6,733</b>	<b>4</b>
<b>Net rental income</b>	<b>10,356</b>	<b>9,530</b>	<b>9</b>
<b>NOI</b>	<b>11,006</b>	<b>10,237</b>	<b>8</b>
<b>Same asset NOI</b>	<b>9,810</b>	<b>9,939</b>	<b>(1)</b>
<b>Operating margin</b>	<b>60%</b>	<b>59%</b>	<b>2</b>

Fourth quarter rental revenue increased \$1.07 million or 7% over Q4-2017 due to portfolio growth over the past twelve months. Excluding the impact of acquired and sold assets rental revenue was down 2% due to lower occupancy and declining lease rates. Direct operating expenses were up 4% over Q4-2017. Excluding the impact of properties acquired and disposed of over the past twelve months, direct operating expenses were down 1%. Same-asset NOI was up 3% over Q3-2018 and down 1% over Q4-2017.

### GENERAL & ADMINISTRATIVE EXPENSE

(\$000s)	3 months ended December 31		Δ%
	2018	2017	
Asset management fee	435	394	10
Professional fees	129	137	(6)
Public company costs	67	69	(3)
Other	97	180	(46)
	<b>728</b>	<b>780</b>	<b>(7)</b>

Asset management fees were up 10% over Q4-2017 due to the net increase in the portfolio following acquisitions and dispositions completed over the past twelve months. Other expenses can fluctuate from period to period due to the timing of costs incurred.

## FINANCE COSTS

(\$000s)	3 months ended December 31		Δ%
	2018	2017	
Interest on mortgages payable and revolving credit facility	2,300	2,051	12
Interest on Class C LP Units	659	711	(7)
Amortization of fair value adjustment on Class C LP Units	(41)	(56)	(27)
Interest on convertible debentures	776	508	53
Interest on subscription receipts	—	114	(100)
Fair value adjustment on derivative instruments	(366)	(182)	101
Amortization of deferred financing fees	393	234	68
<b>Finance costs before distributions</b>	<b>3,721</b>	<b>3,380</b>	<b>10</b>
Distributions on Class B LP Units	2,514	2,467	2
<b>Finance costs</b>	<b>6,235</b>	<b>5,847</b>	<b>7</b>

Finance costs for the fourth quarter were up \$0.39 million or 7% over Q4-2017. Interest on mortgages payable and revolving credit facility and Class C LP Units were up 8% due to the Melcor Acquisition and an up-tick in rates on re-financings completed in 2018. Securities issued in connection with the Melcor Acquisition resulted in an increase in interest on convertible debentures and distributions on Class B LP Units. In the comparative period we recognized \$0.11 million in interest on subscription receipts, holders of which were entitled to receive cash payments equivalent to distributions declared by the REIT in the period they were outstanding. The subscription receipts were converted to trust units on the closing of the Melcor Acquisition on January 12, 2018. Amortization of discount and transaction costs on the 2017 Debentures led to an increase in amortization of deferred financing fees over Q4-2017.

## FUNDS FROM OPERATIONS & ADJUSTED FUNDS FROM OPERATIONS

(\$000s)	3 months ended December 31		Δ %
	2018	2017	
Net income for the period	6,737	11,723	
Add / (deduct)			
Fair value adjustment on investment properties	6,224	(3,829)	
Fair value adjustment on Class B LP Units	(9,536)	(4,969)	
Amortization of tenant incentives	809	781	
Distributions on Class B LP Units	2,514	2,467	
Fair value adjustment on derivative instruments	(366)	(182)	
<b>Funds From Operations (FFO)</b>	<b>6,382</b>	<b>5,991</b>	<b>7</b>
Deduct			
Straight-line rent adjustments	(159)	(74)	
Normalized capital expenditures	(606)	(578)	
Normalized tenant incentives and leasing commissions	(825)	(772)	
<b>Adjusted Funds from Operations (AFFO)</b>	<b>4,792</b>	<b>4,567</b>	<b>5</b>
<b>FFO/Unit</b>	<b>\$0.23</b>	<b>\$0.23</b>	
<b>AFFO/Unit</b>	<b>\$0.17</b>	<b>\$0.18</b>	
<b>Weighted average number of units (000s)<sup>1</sup></b>	<b>28,086</b>	<b>25,767</b>	<b>9</b>

1. For the purposes of calculating per unit FFO and AFFO the basic weighted average number of units includes Trust Units and Class B LP Units.

FFO and AFFO were up 7% and 5% over Q4-2017 due to the Melcor Acquisition and lower G&A costs.

Fourth quarter distributions to unitholders were \$2.23 million (2017 - \$1.88 million).

A reconciliation of cash flows from operations to ACFO is as follows:

(\$000s)	3 months ended December 31		Δ %
	2018	2017	
<b>Cash flows from operations</b>	<b>3,583</b>	<b>3,326</b>	<b>8</b>
Distributions on Class B LP Units	2,514	2,467	
Actual payment of tenant incentives and direct leasing costs	1,171	990	
Changes in operating assets and liabilities	(693)	(688)	
Amortization of deferred financing fees	(393)	(234)	
Normalized capital expenditures	(606)	(578)	
Normalized tenant incentives and leasing commissions	(825)	(772)	
<b>Adjusted Cash Flows from Operations (ACFO)</b>	<b>4,751</b>	<b>4,511</b>	<b>5</b>

## OUTLOOK

We own a high quality portfolio of income-producing assets. Alberta, our main market, has undergone dramatic changes throughout the past few years, primarily related to lower oil prices and a decline in economic activity. In addition, our portfolio continues to face competitive pressure due to the significant new supply of property in the downtown Edmonton office market. This competitive pressure is resulting in increased costs associated with renewals and securing new leases. While leasing in this environment remains challenging, we continue to execute our strategic leasing program and have seen interest across our portfolio.

Occupancy at year end was 89.9% compared to 91.8% at the end of the 2017. Our tenants include a diversified mix of national, regional and local businesses operating in a variety of industries. This diversified tenant base helps mitigate our exposure to negative trends occurring in any one sector.

With 9.7% of total GLA expiring in 2019, we continue to work towards securing early renewals, particularly on larger tenants. There can be no assurance that this strategy will be successful or that we will continue to meet our retention rate target. Recently acquired properties are 100% occupied and, as newer construction, have longer lease terms remaining, helping to offset the potential loss of tenants as leases expire over the year.

The following table summarizes maturing mortgage balances, Class C LP Units, and the revolving credit facility and their respective weighted average interest rates relative to the fair value of encumbered assets:

(\$000s)	Revolving credit facility <sup>1</sup>	Mortgages payable	Class C LP units	Total
2019	—	36,252	—	36,252
2020	—	14,613	24,027	38,640
2021	—	30,513	13,257	43,770
2022	—	26,096	—	26,096
2023	—	35,394	14,265	49,659
Thereafter	—	78,079	9,529	87,608
<b>Total</b>	<b>—</b>	<b>220,947</b>	<b>61,078</b>	<b>282,025</b>

(\$000s, except as indicated)	FV of Collateral	Leverage (%)	Weighted Average Interest Rate
2019	131,280	28%	3.23%
2020	84,530	46%	3.17%
2021	105,205	42%	3.05%
2022	43,011	61%	3.43%
2023	95,536	52%	3.90%
Thereafter	210,091	42%	3.67%
<b>Total</b>	<b>669,653</b>		

Over the next 12 months, six mortgages are up for renewal. These mortgages had an outstanding principal balance of \$37.59 million and a weighted average interest rate of 3.23% at December 31, 2018. Subsequent to year-end we repaid the outstanding balance on \$6.81 million of mortgage debt which was secured against our retail property in Red Deer, AB. We expect to be able to re-finance remaining debts at market competitive terms.

In addition, our \$34.50 million 2014 Debentures mature December 31, 2019. We are actively reviewing re-financing options and expect to be able to re-secure financing at market competitive terms.

We continually monitor our upcoming mortgage renewals to identify opportunities and risks.

We continue to seek out and complete suitable acquisitions to expand our asset base as conditions allow. We also continue to improve existing assets through asset enhancement programs and efficient and effective property management. Our disciplined approach helps to ensure that our assets remain profitable over the long-term while at the same time achieving our objective of providing stable monthly cash distributions to unitholders. We also remain committed to our signature care program to ensure we are the landlord of choice for our tenants.

With a strong, diversified portfolio, focus on property management and client relationships, and a solid pipeline of over 6.50 million sf of high quality assets being developed over the next 5-10 years, we remain well positioned for the future.

## BUSINESS ENVIRONMENT & RISKS

We are exposed to various risks and uncertainties, many of which are beyond our control. The following risk factors could materially impact our financial condition, results of operations, cash flows and the value of our trust units. We take steps to mitigate these risks; however, there is no assurance that the steps taken will avoid future loss.

### GENERAL RISKS

We are subject to market conditions in the geographic areas where we own and manage properties. Where strong market conditions prevail, we are able to achieve higher occupancy rates. Market conditions are influenced by outside factors such as general inflation and interest rate fluctuations; population growth and migration; financing and economic environments; job creation and employment patterns; consumer confidence; government policies, regulations and taxation; and availability of credit and financing.

### REAL ESTATE RISK

Real estate investments are subject to varying levels of risk. These risks include changes to general economic conditions, government and environmental regulations, local supply/demand, and competition from other real estate companies. Real estate assets are relatively illiquid in down markets. As a result, the REIT may not be able to rebalance its portfolio in response to changing economic or investment conditions.

Other real property risks include:

- The value of the property and any improvements made to it;
- Rollover of leases and the ability to rent unleased suites;
- Financial stability of tenants and their ability to pay rent and fulfill their lease obligations; and
- Geographic concentration.

Cash available for distribution will be adversely affected if a significant number of tenants are unable to meet their obligations under their leases or if a significant amount of space in our properties becomes vacant and cannot be leased on economically favourable lease terms.

## CONCENTRATION OF PROPERTIES AND TENANTS

Of our total GLA, 87.18% is located in Alberta at December 31, 2018. Consequently, the market value of the REIT's properties, the income generated by the REIT and the REIT's performance are particularly sensitive to changes in Alberta's real estate markets and general economic conditions. The factors impacting the real estate markets in Alberta and the Alberta economy in general may differ from those affecting other regions of Canada.

Adverse changes in economic conditions in Alberta may have a material adverse effect on the REIT's business, cash flows, financial condition and results of operations and on our ability to make distributions to unitholders. The Alberta economy is sensitive to the price of oil and gas. To mitigate against this risk, the REIT endeavors to achieve a diverse mix of tenants representing a variety of industries, as well as a mix of regional, local and national tenants.

## COMPETITIVE CONDITIONS

The real estate market is highly competitive, with a large number of well-financed companies operating in the same markets as the REIT. We may compete for real property acquisitions with individuals, corporations, institutions and other entities, which may increase the purchase price and reduce the yield of an acquired property. The REIT's rights under the Development and Opportunities Agreement entered into with Melcor helps to mitigate competitive risk.

We also compete with other developers, managers and property owners in attracting tenants. Some of our competitors are better capitalized or financially stronger, and would be in a better position to withstand an economic downturn. The existence of competition for tenants could have an adverse effect on our ability to lease space in our properties and on the rents charged or concessions granted, and could materially and adversely affect our cash flows, operating results and financial condition. New office towers in downtown Edmonton are adding 1.8 million sf of competing space from 2016-2019.

The REIT focuses on providing exceptional customer care and building solid relationships with our clients to increase the likelihood that they will renew leases.

## FIXED COSTS

The failure to lease vacant space on a timely basis or at all would likely have an adverse effect on the REIT's financial condition and results of operation and decrease the amount of cash available for distributions. Certain significant expenditures, including property taxes, ground rent, maintenance costs, mortgage payments (including those associated with the Retained Debt), insurance costs and related charges must be made throughout the period of ownership of real property regardless of whether a property is producing any income. If the REIT is unable to meet mortgage payments on any property (including those associated with the Retained Debt), losses could be sustained as a result of the mortgagee's exercise of its rights of foreclosure or sale or the landlord's exercise of remedies. Costs may also be incurred in making improvements or repairs to properties required by a new tenant.

The timing and amount of capital expenditures by the REIT will indirectly affect the amount of cash available for distribution to unitholders. Distributions may be reduced, or even eliminated, at times when the REIT deems it necessary to make significant capital or other expenditures.

## FINANCING

We require access to capital to maintain our properties and fund our growth strategy. There is no assurance that capital will be available when needed or on favourable terms. Our access to third-party financing is subject to a number of factors, including general market conditions; the market's perception of our growth potential; our current and expected future earnings; our cash flows and cash distributions, and cash interest payments; and the market price of our units.

We use debt and other forms of leverage in the ordinary course of business to execute on our strategy.

We are subject to general risks associated with debt financing. The following risks may adversely affect our financial condition and results of operations:

- Cash flows may be insufficient to meet required payments of principal and interest;
- Payments of principal and interest on borrowings may leave us with insufficient cash resources to pay operating expenses;
- We may not be able to refinance indebtedness on our assets at maturity due to company and market factors;
- The fair market value of our assets;
- Liquidity in the debt markets;
- A high level of debt will reduce the amount of funds available for the payment of distributions to unitholders and interest payments on our debentures
- Financial, competitive, business and other factors, including factors beyond our control;
- Refinancing terms that are not as favourable as the original terms of the related financing.

We attempt to mitigate these risks through the use of long-term debt and diversifying terms and maturity dates.

The terms of various credit agreements and other financing documents require that we comply with a number of financial and other covenants, such as maintaining debt service coverage and leverage ratios, and minimum insurance coverage. These covenants may limit our flexibility in our operations, and breaches of these covenants could result in defaults under the instruments governing the indebtedness, even if we had satisfied our payment obligations.

If we are unable to refinance assets/indebtedness on acceptable terms, or at all, we may need to use available liquidity, which would reduce our ability to pursue new investment opportunities. Alternately we may be required to dispose of one or more of our assets on disadvantageous terms. In addition, unfavourable interest rates or other factors at the time of refinancing could increase interest expense.

A large proportion of our capital is invested in physical, long-lived assets, which can be difficult to liquidate, especially if local market conditions are poor. This circumstance could limit our ability to diversify our portfolio of assets promptly in response to changing economic or investment conditions.

The liabilities of the REIT have fixed and floating interest rate components resulting in exposure to interest rate fluctuations. These fluctuations in interest rates may impact the earnings of the REIT. The REIT's financial and operating results could be materially adversely affected by higher interest rates.

The REIT may implement hedging programs in order to offset the risk of revenue losses and to provide more certainty regarding the payment of distributions to unitholders should current variable interest rates increase. However, to the extent that the REIT fails to adequately manage these risks, its financial results, and its ability to pay distributions to unitholders and interest payments on debt and future financings may be adversely affected. Increases in interest rates generally cause a decrease in demand for properties. Higher interest rates and more stringent borrowing requirements, whether mandated by law or required by banks, could have a material adverse effect on the REIT's ability to sell any of its properties.

We may enter into financing commitments in the normal course of business and, as a result, may be required to fund these, particularly through joint arrangements. If we are unable to fulfill any of these commitments, damages could be pursued against the REIT.

## LEASE MATURITY RISK

We are subject to lease maturity risk as there is no assurance that we will be able to renew or replace expiring leases at similar terms. We manage our lease maturity risk by pro-actively engaging tenants whose leases are expiring for early identification of potential vacancy risk. In addition, where possible we ladder maturity dates to minimize exposure in any particular period and to maintain a diversified portfolio.

The following table illustrates the number of leases maturing over the next five years and beyond.

Year of maturity	Number of Leases	Renewal GLA (sf)	% of GLA	Average Base Rent Expiring Per Annum
2019	85	279,560	9.7%	\$15.78
2020	75	262,276	9.1%	\$17.11
2021	100	235,507	8.2%	\$17.83
2022	68	288,111	10.0%	\$14.32
2023	77	537,595	18.7%	\$12.31
Thereafter	177	976,421	34.0%	\$19.28
Vacant space	—	289,431	10.1%	—
<b>Total</b>	<b>582</b>	<b>2,868,901</b>		

The following table illustrates the 2019 maturities by portfolio type and geographic area:

Property Type	Northern AB	Southern AB	BC & SK	Total
Retail	29,176	—	26,028	55,204
Office	151,145	47,767	25,444	224,356
Industrial	—	—	—	—
	<b>180,321</b>	<b>47,767</b>	<b>51,472</b>	<b>279,560</b>

## CREDIT RISK

We are subject to credit risk as our tenants may not be able to fulfill their financial obligations on current balances and contracted future rents. We manage our credit risk through careful selection of tenants and look to obtain national tenants or tenants in businesses with a long standing history, or perform financial background checks including business plan review for smaller tenants. We manage our concentration risk by renting to an expansive tenant base, with no dependency on rents from any one specific tenant.



The following table illustrates the ten largest tenants for the portfolio, as measured by their percentage contribution to the total contracted future minimum lease payment for 2019 and corresponding areas leased by each tenant.

Rank	Tenant (Operating Name)	% of Total Minimum Rent	Lease GLA (sf)	% of Total Owned GLA	Remaining Term (yrs)	No. of Locations in Properties	Credit Rating (S&P/Moody's/ DBRS)
1	Alberta Health Services	3.7%	88,997	3.1%	7	2	---
2	Government of Alberta	3.5%	97,632	3.4%	5	4	A+ /Aa1/AA
3	Royal Bank of Canada	3.5%	65,155	2.3%	1	6	AA-/A1/AA
4	Shoppers Drug Mart	3.0%	44,228	1.5%	8	3	BBB-/BBB
5	NDT Global	2.7%	44,328	1.5%	7	1	---
6	BasinTek LLC	2.5%	88,699	3.1%	5	1	---
7	Fountain Tire Ltd.	2.1%	30,514	1.1%	10	1	---
8	TD Bank	1.5%	25,675	0.9%	4	4	AA-/Aa1/AA
9	The Brick Warehouse LP	1.5%	39,481	1.4%	4	3	---
10	Canadian Brewhouse	1.4%	16,141	0.6%	10	3	---

## SIGNIFICANT OWNERSHIP BY MELCOR

Melcor holds a 53.0% effective interest in the REIT, where each Class B LP Unit is attached to a Special Voting Unit of the REIT. Melcor also holds all of the Class C LP Units of the Partnership.

The Class C LP Units entitle Melcor to priority distributions over holders of Class A LP and Class B LP Units in an amount that is expected to be sufficient (without any additional amounts) to permit Melcor to satisfy amounts payable under the Retained Debt.

In addition, the DOT grants Melcor the right to nominate Trustees to the REIT board. For so long as Melcor maintains a significant effective interest in the REIT, Melcor will have the ability to exercise certain influence with respect to the affairs of the REIT and may significantly affect the outcome of unitholder votes, and may have the ability to prevent certain fundamental transactions. As a result, Melcor has the ability to influence many matters affecting the REIT.

Accordingly, the units may be less liquid and trade at a relative discount compared to such units in circumstances where Melcor did not have the ability to influence or determine matters affecting the REIT. Additionally, Melcor's significant effective interest in the REIT may discourage transactions involving a change of control of the REIT, including transactions in which an investor, as a holder of the units, might otherwise receive a premium for its units over the then-current market price.

Pursuant to the Exchange Agreement, each Class B LP Unit is exchangeable at the option of the holder for one unit of the REIT (subject to customary anti-dilution adjustments). If Melcor exchanges some or all of its Class B LP Units for units and subsequently sells such units in the public market, the market price of the units may decrease. Moreover, the perception in the public market that these sales will occur could also produce such an effect.

## DEPENDENCE ON MELCOR

The REIT is dependent on Melcor for management, administrative and operating services relating to the REIT's business. The Asset Management Agreement has a term of 5 years, with automatic 5 year renewals, and may at times in the future not reflect current market terms for duties and responsibilities of Melcor. There is a risk that, because of the term and termination provisions of the Asset Management Agreement, termination of the Asset Management Agreement may be uneconomical for the REIT and accordingly not in the best interest of the REIT.

Should Melcor terminate the Asset Management Agreement or the Property Management Agreement, the REIT may be required to engage the services of an external asset manager and/or property manager. The REIT may be unable to engage an asset manager and/or property manager on acceptable terms, in which case the REIT's operations and cash available for distribution may be materially adversely affected. Alternatively, it may be able to engage an asset manager and/or property manager on acceptable terms or it may elect to internalize its external management structure, but the process undertaken to engage such managers or to internalize management could be costly and time-consuming and may divert the attention of management and key personnel away from the REIT's business operations, which could materially adversely affect its financial condition.

Additionally, the Development and Opportunities Agreement provides that, subject to certain exceptions, the REIT will not engage a party other than Melcor or its affiliates to perform any of the services to be performed by Melcor pursuant to the Asset Management Agreement.

While the Trustees have oversight responsibility with respect to the services provided by Melcor pursuant to the Asset Management Agreement and the Property Management Agreement, the services provided by Melcor under such agreements will not be performed by employees of the REIT or the Partnership, but by Melcor directly, and through entities to which it may subcontract its duties. Further, the foregoing arrangements are subject to limited termination rights in favour of the REIT. As a result, Melcor directly, and indirectly through entities to which it may subcontract, has the ability to influence many matters affecting the REIT and the performance of its properties now and in the foreseeable future.

While the Melcor name and trade-mark and related marks and designs will be licensed to the REIT by Melcor under a non-exclusive, royalty-free trademark license agreement, such license will not be on a perpetual basis and may be terminated by Melcor at any time on 30 days' notice following the date of termination of the Asset Management Agreement. Termination of the license would require the REIT to rebrand its business, which could be costly and time-consuming and may divert attention of management and key personnel from the REIT's business operations, which could materially adversely affect its financial condition.

## POTENTIAL CONFLICTS OF INTEREST WITH MELCOR

Melcor's continuing businesses may lead to conflicts of interest between Melcor and the REIT. The REIT may not be able to resolve any such conflicts, and, even if it does, the resolution may be less favourable to the REIT than if it were dealing with a party that was not a holder of a significant interest in the REIT. The agreements that the REIT entered into with Melcor on Closing may be amended upon agreement between the parties, subject to applicable law and approval of the independent Trustees. As a result of Melcor's significant holdings in the REIT, the REIT may not have the leverage

to negotiate any required amendments to these agreements on terms as favourable to the REIT as those the REIT could secure with a party that was not a significant unitholder.

## **TAXATION MATTERS**

Although we currently meet the requirements of the REIT Exception, there can be no assurance that the REIT will continue to qualify for the REIT Exception to remain tax exempt by the SIFT Rules in future years.

The SIFT Rules may have an adverse impact on the REIT and the unitholders, on the value of the units and on the ability of the REIT to undertake financings and acquisitions and if the SIFT Rules were to apply, the distributable cash of the REIT may be materially reduced. The effect of the SIFT Rules on the market for the units is uncertain.

If certain tax proposals released on September 16, 2004 are enacted as proposed (the "September 16th Tax Proposals"), the REIT would cease to qualify as a "mutual fund trust" for purposes of the Tax Act if, at any time after 2004, the fair market value of all units held by non-residents, partnerships that are not Canadian partnerships or any combination of the foregoing is more than 50% of the fair market value of all issued and outstanding units unless not more than 10% (based on fair market value) of the REIT's property is at any time "taxable Canadian property" within the meaning of the Tax Act and certain other types of specified property. Restrictions on the ownership of units are intended to limit the number of units held by non-residents, such that non-residents, partnerships that are not Canadian partnerships or any combination of the foregoing may not own units representing more than 50% of the fair market value of all units. The September 16th Tax Proposals were not included in budget implementation and technical amendment bills including Bill C-52 of the First Session of the Thirty-Ninth Parliament, which received Royal Assent on June 22, 2007, Bill C-45 and Bill C-48 of the First Session of the Forty-first Parliament, 60-61 Elizabeth II, 2011-2012.

## **ENVIRONMENTAL RISK**

The REIT is subject to various requirements (including federal, provincial and municipal laws) relating to the protection of the environment.

Under these requirements, the REIT could be, or become, liable for environmental or other harm, damage or costs, including with respect to the release of hazardous, toxic or other regulated substances into the environment and/or affecting persons, and the removal or other remediation of hazardous, toxic or other regulated substances that may be present at or under its properties.

Such requirements often impose liability without regard to whether the owner or operator knew of, or was responsible for, the release or presence of such substances. Additional liability may be incurred by the REIT with respect to the release of such substances from the REIT's properties to properties owned by third parties, including properties adjacent to the REIT's properties or with respect to the exposure of persons to such substances. The failure to remove or otherwise address such substances may materially adversely affect the REIT's ability to sell such property, maximize the value of such property or borrow using such property as collateral security, and could potentially result in claims or other proceedings against the REIT.

It is the REIT's operating policy to obtain, or be entitled to rely on, a Phase I environmental site assessment prior to acquiring a property. Where a Phase I environmental site assessment warrants further investigation, it is the REIT's operating policy to conduct further environmental investigations. Although such environmental assessments provide the REIT with some level of assurance about

the condition of the properties, the REIT may become subject to liability for undetected contamination or other environmental conditions of its properties against which it cannot insure, or against which the REIT may elect not to insure where insurance premium costs are considered to be disproportionate to the assessed risk, which could have a material adverse effect on the REIT's business, cash flows, financial condition and results of operations and ability to make distributions to unitholders.

Environmental laws and other requirements can change and the REIT may become subject to more stringent environmental laws or other requirements in the future. Compliance with more stringent environmental laws or requirements, the identification of currently unknown environmental issues or an increase in the costs required to address a currently known condition may have a material adverse effect on the REIT's business, cash flows, financial condition and results of operations and ability to make distributions to unitholders.

Subject to the obligations of Melcor described above, the REIT will bear the risk of assessment, remediation or removal of such contamination, hazardous substances or other residual pollution. The discovery of any such residual pollution on the sites and/or in the buildings, particularly in connection with the lease or sale of properties or borrowing using the real estate as security, could trigger claims for rent reductions or termination of leases for cause, for damages and other breach of warranty claims against the REIT. The remediation of any contamination and the related additional measures the REIT would have to undertake could have a materially adverse effect and could involve considerable additional costs that the REIT may have to bear. The REIT will also be exposed to the risk that recourse against the polluter or the previous owners or occupants of the properties might not be possible, for example, because they cannot be identified, no longer exist or have become insolvent. Moreover, the existence or even the mere suspicion of the existence of contamination, hazardous materials or other residual pollution can materially adversely affect the value of a property and our ability to lease or sell such a property.

The REIT employs a rigorous due diligence process, including obtaining a Phase I environmental site assessment, prior to acquiring property to mitigate its exposure to these potential issues.

## **CYBER SECURITY RISK**

Cyber security has become an increasingly problematic issue for issuers and businesses in Canada and around the world, including for the REIT and the real estate industry in general. Cyber attacks may focus on financial fraud, obtaining sensitive data for inappropriate use or to disrupt business operations. A cyber incident is any adverse event that threatens the confidentiality, integrity or availability of the organization's information resources, including intentional or unintentional events to gain unauthorized access to information systems to disrupt operations, corrupt data or steal confidential information.

As our reliance on technology has increased, so have our risk of a cyber security breach. The REIT's primary risks that could directly result from the occurrence of a cyber incident include operational interruption, damage to our reputation, damage to our business relationships with tenants, disclosure of confidential information regarding our tenants, employees and third parties with whom we do business, and may result in negative consequences, including remediation costs, loss of revenue, additional regulatory scrutiny and litigation.

The Board and management are responsible for overseeing the REIT's cyber security risks. To remain resilient to these risks, the REIT has implemented processes, procedures and controls to

help mitigate these risks, including installing firewalls and anti-virus programs on its networks, servers and computers, and staff training. However, these measures, as well as its increased awareness of a risk of a cyber incident, do not provide assurance that its efforts will be effective or that attempted security breaches or disruptions will not be successful or damaging.

## JOINT ARRANGEMENTS

Some of our properties are jointly owned. These joint arrangements may involve risks that would not otherwise be present if the third parties were not involved, including the possibility that the partners have different economic or business interests or goals. Also, within these arrangements, the REIT may not have sole control of major decisions relating to these assets, such as: decisions relating to the sale of the assets and businesses; timing and amount of distributions of cash from such entities to the REIT and its joint arrangement partners; and capital expenditures.

## OTHER FINANCIAL INFORMATION

### JOINT ARRANGEMENTS

We record only our share of the assets, liabilities, revenue and expenses of our joint arrangements. In 2018, we had three joint arrangements (2017 - three). Refer to note 21 to the consolidated financial statements for additional information. The following table illustrates selected financial data related to joint arrangements at 100% as well as the net portion relevant to the REIT:

	Joint arrangement activity at 100%		Joint arrangement activity at JV%	
(\$'000s)	Year ended December 31		Year ended December 31	
	2018	2017	2018	2017
Revenue	11,362	10,238	5,681	5,119
Earnings	4,462	5,192	2,231	2,596
Assets	133,782	124,002	66,891	62,001
Liabilities	68,492	64,384	34,246	32,192

## RELATED PARTY TRANSACTIONS

Please refer to note 20 to the consolidated financial statements for information pertaining to transactions with related parties.

## SUBSEQUENT EVENTS

Please refer to note 27 to the consolidated financial statements for information pertaining to subsequent events.

## CRITICAL ACCOUNTING ESTIMATES

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with IFRS. In applying IFRS, we make estimates and assumptions that affect the carrying amounts of assets and liabilities, disclosure of contingent liabilities and the reported amount of income for the period. Actual results could differ from estimates previously reported. We have discussed the development, selection and application of our key accounting policies, and the critical accounting estimates and assumptions they involve, with the Audit Committee and the Board of Trustees.

Our significant accounting policies and accounting estimates are contained in the consolidated financial statements. Please refer to note 3 to the consolidated financial statements for a description of our accounting policies and note 4 for a discussion of accounting estimates and judgments.

## CHANGES IN ACCOUNTING POLICIES

We adopted IFRS 15, Revenue with Contracts with Customers and IFRS 9, Financial Instruments effective January 1, 2018. Refer to note 5 to the consolidated financial statements for further discussion on the impact of adoption and overview of our policy.

## INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLOSURE CONTROLS

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant and material information is gathered and reported to senior management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), in a timely manner. Under the supervision of the CEO and CFO, we carried out an evaluation of the effectiveness of our disclosure controls and procedures as defined in Canada by National Instrument 52-109 as of December 31, 2018. Based on this evaluation, our CEO and CFO concluded that the design and operation of our disclosure controls and procedures related to the REIT and its subsidiaries and joint arrangements were effective.

Internal control over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. Management designed these controls based on the criteria set out in Internal Control - Integrated Framework (COSO 2013 Framework) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The CEO and CFO have certified that the internal controls over financial reporting were properly designed and effective for the year ended December 31, 2018.

There has been no change in the REIT's disclosure controls and procedures of internal control over financial reporting during the year ended December 31, 2018, that materially affected, or is reasonably likely to materially affect, the REIT's internal control over financial reporting.

Notwithstanding the foregoing, no assurance can be made that the REIT's controls over disclosure and financial reporting and related procedures will detect or prevent all failures of people to disclose material information otherwise required to be set forth in the REIT's reports.

## DECLARATION OF TRUST

The investment guidelines and operating policies of the REIT are outlined in the Amended and Restated Declaration of Trust (DOT) dated May 1, 2013. A copy of the DOT is filed on SEDAR at [www.sedar.com](http://www.sedar.com) and is available on request to all unitholders. At March 7, 2019, the REIT was in compliance with all investment guidelines and operating policies stipulated in the DOT.

## NON-STANDARD MEASURES

Throughout this MD&A, we refer to terms that are not specifically defined in the CPA Canada Handbook or in IFRS. These non-standard measures may not be comparable to similar measures presented by other companies.

We believe that these non-standard measures are useful in assisting investors in understanding components of our financial results.

The non-standard terms that we refer to in this MD&A are defined below.

## CALCULATIONS

We use the following calculations in measuring our performance.

**Net effective rent:** is calculated as total base rent receivable over the term of the lease less any tenant incentives and direct leasing costs paid divided by the square footage of the space, as calculated on an annualized basis.

**Operating margin:** is calculated as net rental income divided by rental revenue.

**Net operating income (NOI):** NOI is defined as rental revenue, adjusted for amortization of tenant improvements and straight-line rent adjustments, less direct operating expenses as presented in the statement of income and comprehensive income. A reconciliation of NOI to the most comparable IFRS measure, net income, is as follows:

(\$000s)	3 months ended December 31		% Δ	Year ended December 31		% Δ
	2018	2017		2018	2017	
Net income	6,737	11,723		17,610	732	
Net finance costs	6,203	5,825		25,841	23,132	
Fair value adjustment on Class B LP Units	(9,536)	(4,969)		(15,644)	731	
Fair value adjustment on investment properties	6,224	(3,829)		11,385	12,800	
General and administrative expenses	728	780		2,884	2,718	
Amortization of tenant incentives	809	781		3,097	3,062	
Straight-line rent adjustment	(159)	(74)		(1,190)	(1,074)	
NOI	11,006	10,237	8	43,983	42,101	4

**Same-asset NOI:** this measure compares the NOI on assets that have been owned for the entire current and comparative period and are classified for continuing use.

**Funds from operations (FFO):** FFO is defined as net income in accordance with IFRS, excluding: (i) fair value adjustments on investment properties; (ii) gains (or losses) from sales of investment properties; (iii) amortization of tenant incentives; (iv) fair value adjustments, interest expense and other effects of redeemable units classified as liabilities; (v) acquisition costs expensed as a result of the purchase of a property being accounted for as a business combination; and (vi) fair value adjustment on derivative instrument, after adjustments for equity accounted entities, joint ventures and non-controlling interests calculated to reflect FFO on the same basis as consolidated properties.

**FFO per unit:** FFO per unit is defined as FFO divided by weighted average trust units and weighted average Class B LP Units outstanding. Dilutive FFO includes the effect of the convertible debentures to the extent that their impact is dilutive.

**Adjusted funds from operations (AFFO):** AFFO is defined as FFO subject to certain adjustments, including: (i) adjusting for any differences resulting from recognizing property revenues on a straight-line basis; (ii) deducting a reserve for normalized maintenance capital expenditures, tenant inducements and leasing costs, as determined by us. Other adjustments may be made to AFFO as determined by the Board in its discretion.

**AFFO per unit:** AFFO per unit is defined as AFFO divided by weighted average trust units and weighted average Class B LP Units outstanding.

**Adjusted cash flows from operations (ACFO):** ACFO is defined as cash flows from operations subject to certain adjustments, including: (i) fair value adjustments and other effects of redeemable units classified as liabilities; (ii) payments of tenant incentives and direct leasing costs; (iii) changes in operating assets and liabilities which are not indicative of sustainable cash available for distribution; (iv) amortization of deferred financing fees; and (v) deducting a reserve for normalized maintenance capital expenditures, tenant inducements and leasing costs, as determined by us. Other adjustments may be made to ACFO as determined by the Board in its discretion.

**FFO and AFFO Payout ratio:** is calculated as per unit distributions divided by basic per unit FFO and AFFO.

**Finance costs coverage ratio:** is calculated as FFO plus finance costs for the period divided by finance costs expensed during the period excluding distributions on Class B LP Units and fair value adjustment on derivative instruments.

**Debt service coverage ratio:** is calculated as FFO for the period divided by principal repayments on mortgages payable and Class C LP Units made during the period.

**Debt to Gross Book Value:** is calculated as the sum of total amount drawn on revolving credit facility, mortgages payable, Class C LP Units, excluding unamortized fair value adjustment on Class C LP Units, liability held for sale (as applicable) and convertible debenture, excluding unamortized discount and transaction costs divided by Gross Book Value (GBV). GBV is calculated as the total assets acquired in the Initial Properties, subsequent asset purchases and development costs less dispositions.

**Cash finance costs:** is calculated as finance costs less amortization of deferred financing fees, fair value adjustment on derivative instruments and amortization of fair value adjustment on Class C LP Units.



## MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements, management's discussion and analysis (MD&A) and all financial information contained in the annual report are the responsibility of management. The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards and, where appropriate, have incorporated estimates based on the best judgment of management.

To discharge its responsibility for financial reporting, management is responsible for implementing and maintaining adequate internal controls to provide reasonable assurance that the Trust's assets are safeguarded, that transactions are properly authorized and that reliable financial information is relevant, accurate and available on a timely basis.

The consolidated financial statements have been examined by PricewaterhouseCoopers LLP, the Trust's external auditors. The external auditors are responsible for examining the consolidated financial statements and expressing their opinion on the fairness of the financial statements in accordance with International Financial Reporting Standards. The auditor's report outlines the scope of their audit examination and states their opinion.

The Board of Trustees, through the Audit Committee, is responsible for ensuring management fulfils its responsibilities for financial reporting and internal controls. The Audit Committee is comprised of three financially literate and independent directors. This committee meets regularly with management and the external auditors to review significant accounting, financial reporting and internal control matters. PricewaterhouseCoopers LLP have unrestricted access to the Audit Committee with and without the presence of management. The Audit Committee reviews the financial statements, the auditor's report, and MD&A and submits its report to the board of trustees for formal approval. The Audit Committee is also responsible for reviewing and recommending the annual appointment of external auditors and approving the external audit plan. These consolidated financial statements and Management's Discussion and Analysis have been approved by the Board of Trustees for inclusion in the Annual Report based on the review and recommendation of the Audit Committee.



**Andrew Melton**  
Chief Executive Officer

**Naomi Stefura**  
Chief Financial Officer

Edmonton, Alberta  
March 7, 2019

## INDEPENDENT AUDITOR'S REPORT

To the Unitholders of Melcor Real Estate Investment Trust

### OUR OPINION

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of Melcor Real Estate Investment Trust and its subsidiaries (together, the REIT) as at December 31, 2018 and 2017, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

### What we have audited

The REIT's consolidated financial statements comprise:

- the consolidated statements of financial position as at December 31, 2018 and 2017;
- the consolidated statements of income and other comprehensive income for the years then ended;
- the consolidated statements of changes in unitholders' equity for the years then ended;
- the consolidated statements of cash flows for the years then ended; and
- the notes to the consolidated financial statements, which include a summary of significant accounting policies.

### 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 *Auditor's responsibilities for the audit of the consolidated financial statements* section of our report.

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

### Independence

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

### OTHER INFORMATION

Management is responsible for the other information. The other information comprises the Management's Discussion and Analysis and the information, other than the consolidated financial statements and our auditor's report thereon, included in the annual report.

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

In connection with our audit of the consolidated 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 consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

### **RESPONSIBILITIES OF MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE FOR THE CONSOLIDATED FINANCIAL STATEMENTS**

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

In preparing the consolidated financial statements, management is responsible for assessing the REIT'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 REIT or to cease operations, or has no realistic alternative but to do so.

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

### **AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF THE CONSOLIDATED FINANCIAL STATEMENTS**

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's 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 these consolidated 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 consolidated 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 REIT'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 REIT's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated 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 auditor's report. However, future events or conditions may cause the REIT to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the REIT to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We 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.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to 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 independent auditor's report is Carlie Persson.

*PricewaterhouseCoopers LLP*

#### **Chartered Professional Accountants**

Edmonton, Alberta

March 7, 2019

# CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As at December 31

(\$000s)	2018	2017
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	1,581	12,189
Restricted cash (note 15)	—	16,956
Accounts receivable	1,330	1,764
Other assets (note 8)	1,070	1,161
Assets held for sale (note 6)	—	6,732
	3,981	38,802
Non-Current Assets		
Investment properties (note 7 and 26)	683,768	617,278
Other assets (note 8)	20,571	18,753
Loan receivable (note 6)	900	900
Derivative financial asset (note 11 and 26)	383	504
	705,622	637,435
<b>TOTAL ASSETS</b>	<b>709,603</b>	<b>676,237</b>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	1,692	1,649
Distribution payable	1,580	1,453
Accrued liabilities and other payables (note 10 and 20)	7,873	7,195
Subscription receipts (note 15)	—	16,623
Class C LP Units (note 12)	3,628	14,637
Mortgages payable (note 11)	44,177	24,348
Convertible debentures (note 13)	33,873	—
Liability held for sale (note 6)	—	3,670
	92,823	69,575
Non-Current Liabilities		
Accrued liabilities and other payables (note 10)	1,579	1,524
Class B LP Units (note 14 and 26)	111,149	124,381
Class C LP Units (note 12)	68,952	59,639
Mortgages payable (note 11)	215,409	192,892
Convertible debentures (note 13)	21,144	54,046
Derivative financial liabilities (note 13 and 26)	187	729
<b>TOTAL LIABILITIES</b>	<b>511,243</b>	<b>502,786</b>
<b>UNITHOLDERS' EQUITY</b>	<b>198,360</b>	<b>173,451</b>
<b>TOTAL LIABILITIES AND UNITHOLDERS' EQUITY</b>	<b>709,603</b>	<b>676,237</b>

See accompanying notes to the consolidated financial statements.

By order of the REIT's Board of Trustees:



Brian Hunt  
Audit Committee Chair



Ralph Young  
Chairman

## CONSOLIDATED STATEMENTS OF INCOME & COMPREHENSIVE INCOME

For the years ended December 31

(\$000s)	2018	2017
Rental revenue (note 16 and 20)	70,173	66,613
Direct operating expenses (note 20)	(28,097)	(26,500)
Net rental income	42,076	40,113
General and administrative expenses (note 20)	(2,884)	(2,718)
Fair value adjustment on investment properties (note 7 and 26)	(11,385)	(12,800)
Fair value adjustment on Class B LP Units (note 14 and 26)	15,644	(731)
Income before finance costs	43,451	23,864
Interest income	137	62
Finance costs (note 17 and 20)	(25,978)	(23,194)
Net finance costs	(25,841)	(23,132)
Net income and comprehensive income	17,610	732
Basic earnings per trust unit (note 19)	\$1.34	\$0.07
Diluted earnings per trust unit (note 19)	\$0.43	\$0.07

See accompanying notes to the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN UNITHOLDERS' EQUITY

As at December 31

(\$000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Retained Earnings	Total Unitholders' Equity
<b>Balance at December 31, 2016</b>	11,151,297	102,707	40,448	37,091	180,246
Net income for the year	—	—	—	732	732
Distributions to unitholders	—	—	—	(7,527)	(7,527)
<b>Balance at December 31, 2017</b>	11,151,297	102,707	40,448	30,296	173,451
Issuance of trust units (note 15C)	2,035,500	16,112	—	—	16,112
Property purchase from Melcor Developments Ltd. (note 14)	—	—	88	—	88
Net income for the year	—	—	—	17,610	17,610
Distributions to unitholders	—	—	—	(8,901)	(8,901)
<b>Balance at December 31, 2018</b>	13,186,797	118,819	40,536	39,005	198,360

See accompanying notes to the consolidated financial statements.



# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31

(\$000s)	2018	2017
<b>CASH FLOWS FROM (USED IN)</b>		
<b>OPERATING ACTIVITIES</b>		
Net income for the year	17,610	732
Non cash items:		
Amortization of tenant incentives (note 8 and 16)	3,097	3,062
Straight-line rent adjustments (note 16)	(1,190)	(1,074)
Fair value adjustment on investment properties (note 7 and 26)	11,385	12,800
Fair value adjustment on Class B LP Units (note 14 and 26)	(15,644)	731
Amortization of fair value adjustment on Class C LP Units (note 17)	(209)	(225)
Fair value adjustment on derivative financial instruments (note 17)	(421)	(521)
Amortization of deferred financing fees (note 17)	1,597	1,011
	16,225	16,516
Payment of tenant incentives and direct leasing costs	(4,730)	(3,192)
Changes in operating assets and liabilities (note 3P)	375	281
	11,870	13,605
<b>INVESTING ACTIVITIES</b>		
Additions to investment properties (note 6)	(40,497)	—
Net proceeds from disposal of investment property (note 6)	16,389	4,220
Investment property improvements (note 7)	(2,592)	(2,315)
	(26,700)	1,905
<b>FINANCING ACTIVITIES</b>		
Proceeds from issuing trust units (note 15)	16,112	—
Proceeds from issuing convertible debenture, net of costs (note 13)	—	21,543
Change in revolving credit facility	—	(17,480)
Proceeds from mortgages payable (note 11)	60,240	34,407
Repayment of mortgages payable	(48,542)	(29,827)
Repayment on Class C LP Units	(14,799)	(6,067)
Distributions to unitholders	(8,789)	(7,527)
	4,222	(4,951)
<b>(DECREASE) INCREASE IN CASH &amp; CASH EQUIVALENTS DURING THE YEAR</b>	<b>(10,608)</b>	<b>10,559</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR</b>	<b>12,189</b>	<b>1,630</b>
<b>CASH AND CASH EQUIVALENTS, END OF THE YEAR</b>	<b>1,581</b>	<b>12,189</b>

See accompanying notes to the consolidated financial statements.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

## 1. DESCRIPTION OF THE TRUST

Melcor Real Estate Investment Trust (the "REIT" or "we") is an unincorporated, open-ended real estate investment trust established pursuant to a declaration of trust ("DOT") dated January 25, 2013 and subsequently amended and restated May 1, 2013. The REIT began operations on May 1, 2013.

The principal business of the REIT is to acquire, own and manage office, retail and industrial properties in select markets across Western Canada. The REIT is externally managed, administered and operated by Melcor Developments Ltd. ("Melcor") pursuant to the Property Management Agreement and Asset Management Agreement (see note 20).

As at March 7, 2019, Melcor, through an affiliate, holds an approximate 53.0% effective interest in the REIT through ownership of all Class B LP Units of Melcor REIT Limited Partnership (the "Partnership") and is the ultimate controlling party.

The REIT is governed under the laws of the Province of Alberta. The registered office of the REIT is located at Suite 900, 10310 Jasper Avenue Edmonton, Alberta, Canada. Our trust units are traded on the Toronto Stock Exchange under the symbol "MR.UN".

## 2. BASIS OF PRESENTATION

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

These consolidated financial statements are presented in Canadian dollars, which is the presentation and functional currency of the REIT; and were authorized for issue by the Board of Trustees on March 7, 2019.

## 3. SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies used in the preparation of these consolidated financial statements are described below.

### A. BASIS OF MEASUREMENT

These consolidated financial statements have been prepared under the historical cost convention, except for investment properties, Class B LP Units and derivative financial instruments which are measured at fair value.

We prepare our consolidated financial statements in conformity with IFRS which requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying our accounting policies. Changes in assumptions may have a significant impact on the consolidated financial statements in the period the assumptions change. We believe that the underlying assumptions are appropriate. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in note 4.

### B. BASIS OF CONSOLIDATION

#### SUBSIDIARIES

Subsidiaries are entities controlled by the REIT. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences

until the date that control ceases. These consolidated financial statements include the accounts of the REIT and its subsidiaries, its controlled partnership Melcor REIT Limited Partnership (the "Partnership"), and its general partner, Melcor REIT GP Inc.

### JOINT ARRANGEMENTS

These arrangements are undivided interests in the assets, liabilities, revenues and expenses under arrangement and we record our proportionate share in accordance with the agreements as joint operations. These consolidated financial statements include investments in three joint arrangements (2017 – three) with 50% interests. Refer to note 21 for additional details on our joint arrangements.

All intercompany transactions and balances are eliminated on consolidation.

### C. CASH AND CASH EQUIVALENTS

Cash and cash equivalents are comprised of cash and short-term deposits with maturity dates of less than three months from the date they were acquired.

### D. RESTRICTED CASH

Restricted cash can only be used for specified purposes. The REIT's restricted cash as at December 31, 2017 represented amounts held in escrow pending the closing of the Melcor Acquisition (note 6 and 15).

### E. INVESTMENT PROPERTIES

Investment properties include office, retail and industrial properties, and a manufactured home community held for the long term to earn rental income or for capital appreciation, or both. It also includes property under development for future use as investment properties.

Acquired investment properties are measured initially at cost, including transaction costs associated with the acquisition when the acquisition is accounted for as an asset purchase. Costs capitalized to properties under development include direct development and construction costs, borrowing costs, and property taxes.

After initial recognition, investment properties are recorded at fair value, determined based on the accepted valuation methods of direct income capitalization or discounted future cash flows.

The REIT's management company, Melcor Developments Ltd. ("Melcor") is responsible for determining the fair value of investment properties quarterly. Melcor has an internal valuation team consisting of individuals who are knowledgeable and have experience in the fair value techniques applied in valuing investment property. At least once every two years, the valuations are performed by qualified external valuers who hold recognized and relevant professional qualifications and have recent experience in the location and category of the investment properties being valued. The quarterly valuations, including key inputs, are reviewed by the REIT's Chief Executive Officer and Chief Financial Officer and are discussed with the REIT's Audit Committee prior to being finalized.

Changes in fair value are recognized in the consolidated statements of income and comprehensive income in the period in which they arise.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

Fair value measurement of an investment property under development is only applied if the fair value is considered to be reliably measurable. In rare circumstances, investment property under development is carried at cost until its fair value becomes reliably measurable. It may sometimes be difficult to determine reliably the fair value of an investment property under development. In order to evaluate whether the fair value of an investment property under development can be determined reliably, management considers the following factors, among others:

- the provisions of the construction contract;
- the stage of completion;
- whether the project or property is standard (typical for the market) or non-standard;
- the level of reliability of cash inflows after completion;
- the development risk specific to the property;
- past experience with similar construction; and
- status of construction permits.

Subsequent expenditures are capitalized to the asset's carrying amount only when it is probable that future economic benefits associated with the expenditure will flow to the REIT and the cost of the item can be measured reliably. All repairs and maintenance costs are expensed when incurred.

Initial direct leasing costs incurred in negotiating and arranging tenant leases are added to the carrying amount of investment properties. All direct leasing costs are external expenditures, including those charged under the Property Management Agreement with Melcor (note 20), and no amounts for internal allocations are capitalized with respect to the negotiation or arranging of tenant leases.

### F. OTHER ASSETS

Other assets include prepaid expenses, deposits, straight-line rent adjustments and tenant incentives incurred in respect of new or renewed leases. Tenant incentives are amortized on a straight-line basis over the lease term and are recorded as a reduction of revenue.

### G. PROVISION FOR DECOMMISSIONING OBLIGATION

Decommissioning obligations are measured at the present value of the expected cost to settle the obligation. A corresponding decommissioning cost is added to the carrying amount of the associated investment property. Subsequent to the initial measurement, the obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows as well as any changes in the discount rate. Actual costs incurred upon settlement of the decommissioning obligation are recorded against the provision.

### H. CLASS B LP UNITS

The Class B LP Units are exchangeable into trust units at the option of the holder and, therefore, are considered a puttable instrument in accordance with International Accounting Standard ("IAS") 32, Financial instruments — presentation ("IAS 32"). The Class B LP Units, as puttable instruments, are required to be accounted for as financial liabilities. The Class B LP Units are

designated as fair value through profit or loss financial liabilities and are remeasured to fair value at each period end date based on the trading price of the trust units at the period end date with any changes in fair value recognized in the consolidated statements of income and comprehensive income. Distributions declared on Class B LP Units are recorded as finance costs in the consolidated statement of income and comprehensive income.

### I. UNIT CAPITAL

The trust units are redeemable at the option of the holders and, therefore, are considered a puttable instrument in accordance with IAS 32. Puttable instruments are required to be accounted for as financial liabilities, except where certain conditions are met in accordance with IAS 32, in which case, the puttable instruments may be presented as equity. The trust units meet the conditions of IAS 32 and are, therefore, classified and accounted for as equity.

### J. DISTRIBUTIONS

Distributions to unitholders are recognized as a liability in the period in which the distributions are approved by the Board of Trustees and are recorded as a reduction of retained earnings.

### K. RECOGNITION OF REVENUE

Tenant leases are accounted for as operating leases given that we have retained substantially all of the risks and benefits of the ownership of our investment properties.

Rental revenues include both lease revenue and service revenue components. Lease revenues from investment properties include base rents, recoveries of operating expenses including property taxes, parking revenue, incidental income and sign and storage lease revenue. Revenue recognition under a lease commences when the tenant has a right to use the leased asset. The total amount of contractual rent to be received from the operating leases is recognized on a straight line basis over the term of the lease; a straight line rent receivable which is included in other assets, is recorded for the difference between the rental revenue recognized and the contractual amount received. When incentives are provided to our tenants, the cost of these incentives is recognized over the lease term, on a straight line basis as a reduction to rental revenue.

Service revenues are amounts outlined separately in the lease agreement for distinct services provided including utilities, maintenance and security recoveries from tenants which are recognized on a monthly basis in the period in which the corresponding costs are incurred and performance obligations are completed.

### L. FINANCE COSTS

Finance costs are comprised of interest expense on mortgages, interest and other finance fees on our revolving credit facility, interest on Class C LP Units, amortization of fair value adjustment on Class C LP Units, distributions on Class B LP Units, interest on convertible debentures, interest on subscription receipts, fair value adjustment on derivative financial instruments and amortization of deferred financing fees. Borrowing costs are recognized in income using the effective interest rate method.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

### M. INCOME TAXES

The REIT qualifies as a mutual fund trust within the meaning of the Income Tax Act (Canada) ("Tax Act") and as a real estate investment trust eligible for the 'REIT Exception', as defined in the rules applicable to Specified Investment Flow-Through ("SIFT") trusts and partnerships in the Tax Act. We expect to allocate all taxable income and to continue to qualify for the REIT Exception. Accordingly, no income tax expense or deferred income tax assets or liabilities have been recorded in these consolidated financial statements subsequent to the formation of the REIT.

### N. ASSETS HELD FOR SALE

Investment property held for sale are assets that the REIT intends to sell rather than hold for the long term and meet the criteria established in IFRS 5, "Non-Current Assets Held For Sale and Discontinued Operations", for separate classification. Non-current assets and groups of assets and liabilities are categorized as assets held for sale where the asset is available for immediate sale in its present condition and the sale is highly probable.

### O. FINANCIAL INSTRUMENTS

At initial recognition, we classify our financial instruments in the following categories depending on the purpose for which the instruments were acquired:

#### FINANCIAL ASSETS

Financial assets that are held for collection of contractual cash flows represent solely payments of principal and interest are measured at amortized cost. This includes cash and cash equivalents, restricted cash, accounts receivable and loan receivable. Financial assets are initially recognized at fair value plus transaction costs, adjusted for an expected credit loss. Subsequently, receivables are measured at amortized cost using the effective interest rate method adjusted for expected credit losses. For financial assets, the REIT applies the simplified expected credit loss approach, which requires expected lifetime losses to be recognized from initial recognition.

#### FINANCIAL LIABILITIES

We record our financial liabilities at fair value on initial recognition. Subsequently, financial liabilities are measured at amortized cost using the effective interest rate method and financial liabilities designated as fair value through profit or loss ("FVTPL") are remeasured at fair value with changes in their fair value recorded through income. Financial liabilities measured at amortized cost include accounts payable, distribution payable, subscription receipts, liability held for sale, mortgages payable, and Class C LP Units. Class B LP Units are classified as FVTPL.

#### COMPOUND FINANCIAL INSTRUMENT

Our compound financial instrument is comprised of convertible debentures that can be converted to trust units at the option of the holder, and the number of units to be issued does not vary with changes in their fair value. We also have the ability to redeem the debentures at a price equal to the principal amount thereof plus accrued and unpaid interest. We also have the ability to convert the debentures into trust units; however, the number of units to be issued at conversion varies with the market price of the units.

On initial recognition, convertible debentures are separated into two financial liability components: the host instrument and the

conversion feature. The conversion feature is required to be presented as a financial liability as the feature permits the holder to convert the debenture into trust units that, except for the available exemption under IAS 32, would normally be presented as a liability due to their redemption feature. Both components are measured based on their respective estimated fair values at the date of issuance. The host instrument financial liability is recognized initially at the fair value of a similar liability that does not have a conversion feature. The conversion feature is recognized at fair value. The fair value of the host instrument is recorded net of any related transaction costs.

Subsequent to initial recognition, the host instrument is measured at amortized cost using the effective interest method. The conversion feature derivative of the convertible debenture is classified as FVTPL and measured at fair value.

#### FINANCIAL DERIVATIVES

Our financial derivatives are comprised of the conversion features on our convertible debentures and interest rate swap on one of our mortgages. Derivatives are initially recognized at fair value on the date a derivative contract is entered into and subsequently remeasured at their fair value. The method of recognizing the resulting gain or loss depends on whether the derivative is designated as a hedging instrument and, if so, the nature of the item being hedged.

Derivative instruments are recorded in the consolidated statement of financial position at their fair value. Changes in fair value of derivative instruments that are not designated as hedges for accounting purposes are recognized in the consolidated statement of income and comprehensive income.

The REIT has not designated any derivatives as hedges for accounting purposes.

### P. STATEMENTS OF CASH FLOWS

Operating assets and liabilities is defined as the net change of accounts receivable, prepaid expense, and other, accounts payable, distribution payable, accrued liabilities and other payables and deferred finance fees capitalized during the year. Excluded from operating assets and liabilities are investment property additions and tenant incentive payments that are unpaid and included in accounts payable at year end.

## 4. SIGNIFICANT JUDGMENTS AND CRITICAL ACCOUNTING ESTIMATES

Estimates and judgments are continually evaluated and are based on historical experience as adjusted for current market conditions and other factors.

### SIGNIFICANT JUDGMENTS

In the process of applying our accounting policies, we make various judgments, apart from those involving estimations, that can significantly impact the amounts recognized in the consolidated financial statements. These include:

#### A. INVESTMENT PROPERTIES

Our accounting policies related to investment properties are described in note 3E. In applying this policy, judgment is required in determining whether certain costs are additions to the carrying amount of an investment property.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

In determining the fair value of our investment property, judgment is required in assessing the 'highest and best use' as required under IFRS 13, Fair value measurement. We have determined that the current use of our investment properties are its 'highest and best use'.

### B. CLASSIFICATION OF TENANT INCENTIVES

Payments are often made to, or on behalf of, tenants of our commercial properties when new leases are signed. When the payments add future value to the space independent of the lease in place, such costs are capitalized to the investment property. If the costs incurred are specific to the lessee, and do not have stand-alone value, these costs are treated as tenant incentives and amortized on a straight-line basis to revenue over the lease term in accordance with SIC 15, Operating leases – incentives.

### C. COMPLIANCE WITH REIT EXEMPTION UNDER ITA

Under current tax legislation, a real estate investment trust is not liable for Canadian income taxes provided that its taxable income is fully allocated to unitholders during the year. In order to continue to be taxed as a mutual fund trust, we need to maintain our REIT status. At inception, we qualify as a REIT under the specified investment flow-through ("SIFT") rules in the Income Tax Act (Canada). The REIT's current and continuing qualification as a REIT depends on our ability to meet the various requirements imposed under the SIFT rules, which relate to matters such as our organizational structure and the nature of our assets and revenues. We apply judgment in determining whether we continue to qualify as a REIT under the SIFT rules. Should we cease to qualify, we would be subject to income tax on our earnings and would reflect current and deferred tax balances on our consolidated financial statements.

### CRITICAL ACCOUNTING ESTIMATES

We make estimates and assumptions that affect the carrying amounts of assets and liabilities, disclosure of contingent liabilities and the reported amount of income for the period. Actual results could differ from estimates previously reported. The estimates and assumptions that are critical to the determination of the amounts reported in the consolidated financial statements relate to the following:

#### A. VALUATION OF INVESTMENT PROPERTIES

The fair value of investment properties is dependent on stabilized net operating income or forecasted future cash flows and property specific capitalization or discount rates. The stabilized net operating income or forecasted future cash flows involve assumptions of future rental income, including estimated market rental rates and vacancy rates, estimated direct operating costs and estimated capital expenditures. Capitalization and discount rates take into account the location, size and quality of the property, as well as market data at the valuation date. Refer to note 7 and 26 for further information about methods and assumptions used in determining fair value.

## 5. NEW STANDARDS

### NEW STANDARDS ADOPTED

We have adopted the following new standard interpretations effective January 1, 2018.

### IFRS 15, Revenue from Contracts with Customers

supersedes IAS 18, 'Revenue', IAS 11, 'Construction Contracts' and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single model to determine how and when an entity should recognize revenue, as well as requiring entities to provide more informative, relevant disclosures in respect of its revenue recognition criteria.

#### Impact of Adoption

The adoption of IFRS 15 did not result in any adjustments upon transition, change in recognition, or timing of recognition of revenues in the REIT. Adoption does require additional detail included within our recognition of revenue policy (note 3K), and disclosures to the year end financial statements to distinguish between those revenues related to lease components or service revenues (note 16).

**IFRS 9, Financial Instruments** replace IAS 39 and introduces a new classification and measurement model with three classification categories, 'amortized cost', 'fair value' and 'fair value through other comprehensive income', for financial assets, as well as an expected loss impairment model that requires more timely recognition of expected credit losses and a new hedge accounting model.

#### Impact of Adoption

The adoption of IFRS 9 did not result in any adjustments upon transition. Financial assets which include cash and cash equivalents, restricted cash, accounts receivable and loan receivable were previously classified as Loans and Receivables are now classified as amortized cost. This change in classification did not result in any changes in measurement of financial assets in the REIT.

The REIT was required to revise its impairment methodology under IFRS 9 for its financial assets, to account for expected credit losses. To measure the expected credit loss, financial assets have been grouped based on shared credit risk characteristics and the days past due. While our financial assets are subject to the expected credit loss requirements, the identified loss was immaterial.

There was no impact to the measurement, recognition or disclosures of financial liabilities. There has been a change to the financial asset policy to reflect the change in expected credit losses (note 3O)

### NEW AND AMENDED STANDARD NOT YET ADOPTED

**IFRS 16, Leases** was issued in January 2016 by the IASB to replace IAS 17. IFRS 16 includes several changes in the method of accounting for operating leases, including:

- i. All leases will be on the balance sheet of lessees, except those that meet the limited exception criteria;
- ii. Rent expense for leases on the balance sheet will be recorded as depreciation and finance expenses;
- iii. Timing of expenses will change as the finance lease model results in an accelerated recognition of expenses compared to a straight-line operating lease model.

IFRS 16 is required to be applied for annual periods beginning on or after January 1, 2019. We have completed our evaluation of the impact of this standard on our financial statements and concluded that there is no material impact.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

### 6. ACQUISITIONS AND DISPOSALS

#### ACQUISITIONS

On December 3, 2018 we purchased an office property for a purchase price of \$6,322 (including transaction costs). The purchase price approximates fair market value and in accordance with our policy has been accounted for as an asset purchase (note 7).

On January 12, 2018 the REIT closed on the previously announced acquisition of five commercial properties from Melcor Developments Ltd. ("Melcor Acquisition") for a total purchase price of \$80,875.

(\$000s)	
Investment properties	80,875
Assumed mortgages (note 11)	(31,037)
	49,838
Consideration to Melcor	
Class C LP units Issues (note 12)	13,312
Class B LP units issues (note 14)	2,500
Cash paid to Melcor	34,026
	49,838

An additional \$149 in transaction costs were incurred for a net cash investment of \$34,175. The purchase price approximates fair market value and in accordance with our policy, has been accounted for as an asset purchase (note 7).

#### DISPOSALS

On April 16, 2018 we sold a retail property for a sale price of \$13,319 (net of transaction costs and including tenant incentives of \$434 and straight line rent of \$80). Concurrent with the sale we repaid the associated Class C LP Unit liability which had a balance of \$6,947.

On January 31, 2018, we disposed of a retail property previously classified as held for sale for a sales price of \$6,732 (including investment property of \$6,642, tenant incentives of \$66 and straight line rent of \$24) (note 7). The sale price was settled through mortgage assumption of \$3,662, and cash of \$3,070.

On April 27, 2017, we disposed of an industrial property in Lethbridge, Alberta for a sale price of \$7,760 (net of transaction costs). The sale price was settled through mortgage assumption of \$2,640, issuance of vendor-take-back mortgage of \$900, and cash of \$4,220. The vendor take-back (VTB) mortgage bears interest at an annual rate of 6.00%, with interest only payments payable monthly over a 36 month term. The VTB can be prepaid in whole or in part without penalty.

### 7. INVESTMENT PROPERTIES

(\$000s)	2018	2017
Balance - beginning of year	617,278	641,365
Additions		
Direct acquisition	87,346	—
Property improvements	2,592	2,315
Direct leasing costs	742	800
Fair value adjustment on investment properties (note 26)	(11,385)	(12,800)
Investment property classified as held for sale during the year (note 6)	—	(6,642)
Investment property disposed of during the year	(12,805)	(7,760)
Balance - end of year	683,768	617,278

In accordance with our policy, as detailed in note 3E, we record our investment properties at fair value. Fair value adjustments on investment properties are primarily driven by changes in capitalization rates and stabilized net operating income ("NOI"). Supplemental information on fair value measurement, including valuation techniques and key inputs, is included in note 26.

Presented separately from investment properties is \$14,186 (December 31, 2017 - \$13,478) in tenant incentives and \$6,385 (December 31, 2017 - \$5,275) in straight-line rent adjustments (note 8). The fair value of investment properties has been reduced by these amounts.

Our investment properties are leased to tenants primarily under long term operating leases. Rent is receivable from tenants monthly. Minimum lease payments under non-cancellable operating leases of investment properties are receivable as follows:

(\$000s)	2018	2017
Within one year	41,858	36,682
Later than one year but not later than 5 years	128,044	112,109
Later than 5 years	62,994	55,611
	232,896	204,402

### 8. OTHER ASSETS

(\$000s)	2018	2017
Current Assets		
Prepaid expense, and other	1,070	1,161
Non-Current Assets		
Straight-line rent adjustments	6,385	5,275
Tenant incentives	14,186	13,478
	20,571	18,753

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

During the year we recorded tenant incentives of \$4,239 (December 31, 2017 - \$2,585) and \$3,097 (December 31, 2017 - \$3,062) of amortization expense respectively. During the year we also disposed of a property which included tenant incentives of \$434 and straight line rent of \$80 (note 6).

In accordance with SIC 15, Operating leases - incentives, amortization of tenant incentives is recorded on a straight-line basis over the term of the lease against rental revenue.

### 9. REVOLVING CREDIT FACILITY

On June 1, 2018 we entered into an amendment to our revolving credit facility agreement with our existing lenders. Under the terms of the amending agreement the REIT maintains an available credit limit based upon the carrying value of specific investment properties to a maximum of \$35,000 for general corporate purposes and acquisitions, including a \$5,000 swingline sub-facility. An additional \$10,000 is available by way of an accordion feature, subject to lender approval. Depending on the form under which the new facility is accessed, rates of interest will vary between prime plus 1.25% or bankers' acceptance plus 2.25% stamping fee. The agreement also provides the REIT with \$5,000 in available letters of credit which bear interest at 2.25%. Interest payments are due and payable based upon the form of the facility drawn upon, and principal is due and payable upon maturity. The agreement also bears a standby fee of 0.45% for the unused portion of the new facility. The lenders hold demand debentures, a first priority general security and a general assignment of leases and rents over specific investment properties as security for the new facility. The facility matures June 1, 2021.

As at December 31, 2018, the carrying value of pledged properties was \$54,547 (December 31, 2017 - \$56,258).

As at December 31, 2018 we had \$nil (December 31, 2017 - \$nil) drawn from the facility; and posted letters of credit of \$150 (December 31, 2017 - \$nil).

### 10. ACCRUED LIABILITIES & OTHER PAYABLES

(\$000s)	2018	2017
<b>Current Liabilities</b>		
Tenant security deposits and pre-payments	3,090	2,488
Accrued finance costs	591	533
Other accrued liabilities and payables	4,192	4,174
	7,873	7,195
<b>Non-Current Liabilities</b>		
Decommissioning obligation	1,579	1,524

The REIT's decommissioning obligation relates to one of our commercial properties. The total decommissioning obligation is estimated based on the future obligation and timing of these expenditures to be incurred. We estimate the net present value of the obligation based on an undiscounted total future provision of \$2,014 (December 31, 2017 - \$2,014). At December 31, 2018, a discount rate of 4.00% (December 31, 2017 - 4.00%) and an inflation rate of 2.00% (December 31, 2017 - 2.00%) were

used to calculate the net present value of the obligation. Due to uncertainty surrounding the nature and timing of this obligation amounts are subject to change.

### 11. MORTGAGES PAYABLE

(\$000s)	2018	2017
Mortgages amortized over 15-25 years at fixed interest rates	244,007	200,728
Mortgage amortized over 25 years at a fixed interest rate (via a floating for fixed interest rate swap)	17,060	17,604
Unamortized deferred financing fees	(1,481)	(1,092)
	259,586	217,240
 Current portion of mortgages payable	 (44,177)	 (24,348)
	215,409	192,892
 Interest rate ranges	 (2.58%- 4.91%)	 (2.48%- 4.91%)

Specific investment properties with a carrying value of \$477,997 (December 31, 2017 - \$425,173) and assignment of applicable rents and insurance proceeds have been pledged as collateral for the above mortgages. The weighted average effective interest rate for the above mortgages, based on period end balances, is 3.51% (December 31, 2017 - 3.40%).

The minimum contractual principal payments due within each of the next five years and thereafter are as follows:

(\$000s)	Principal Installment Repayments	Balance Maturing	Total
2019	7,925	36,252	44,177
2020	6,840	14,613	21,453
2021	6,493	30,513	37,006
2022	5,470	26,096	31,566
2023	4,723	35,394	40,117
Thereafter	8,669	78,079	86,748
	40,120	220,947	261,067

We have a floating for fixed interest rate swap which fixes the interest rate on our variable rate mortgage at 2.97% for the term of the mortgage. As at December 31, 2018 the fair value of the interest rate swap contract is \$383 (2017 - \$504). This financial instrument has not been designated as a hedge for accounting purposes. Supplemental information on fair value measurement, including valuation technique and key inputs, is included in note 26.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

The change in mortgages payable during the year is summarized as follows:

(\$000s)	2018	2017
Balance at January 1,	217,240	218,866
Principal repayments:		
Scheduled amortization on mortgages	(7,654)	(6,751)
Mortgage repayments	(40,888)	(23,076)
Mortgage payable disposed through sale during the year (note 6)	—	(2,640)
Mortgage payable classified as held for sale during the year (note 6)	—	(3,670)
New mortgages	60,240	34,407
Mortgages assumed (note 6)	31,037	—
Deferred financing fees capitalized	(850)	(195)
Amortization of deferred financing fees	461	299
Balance at December 31,	259,586	217,240

### 12. CLASS C LP UNITS

On closing of the IPO, Melcor retained the debt on certain Initial Properties (the "Retained Debt"), with an outstanding principal balance of \$94,544 at April 30, 2013. The Class C LP Units were initially recognized at their fair value of \$96,506. The fair value of the Class C LP Units was determined based upon future payments at market interest rates. In consideration of the Retained Debt, Melcor received 9,454,411 Class C LP Units of Melcor REIT Limited Partnership (the "Partnership"), a subsidiary of the REIT, on which priority distributions are made to permit Melcor to satisfy required principal and interest payments. The Class C LP Units are classified as debt and a portion of the distributions are recognized as finance costs.

As at December 31, 2018 the carrying value of the Class C LP Units, included in the consolidated statement of financial position, were as follows:

(\$000s)	2018	2017
Class C LP Units amortized over 15-25 years at fixed interest rates	72,351	73,838
Unamortized fair value adjustment	229	438
	72,580	74,276
Current portion of Class C LP Units	(3,628)	(14,637)
	68,952	59,639
Effective interest rate	3.40%	3.39%

The change in Class C LP units during the year is summarized as follows:

(\$000s)	2018	2017
Balance at January 1,	74,276	80,568
Principal repayments:		
Scheduled amortization on Class C LP Units	(3,705)	(3,489)
Class C LP Units repayments	(11,094)	(2,578)
Class C LP Units issued (note 6)	13,312	—
Amortization of fair value adjustment on Class C LP Units (note 17)	(209)	(225)
Balance at December 31,	72,580	74,276

On April 16, 2018 Melcor retired the mortgage that secures retained debt relating to a property sold by the REIT to a third party. Concurrent with the retirement of the mortgage we repaid the outstanding Class C LP Unit liability, representing a balance of \$6,947 or 812,477 of Class C LP Units. The units were to mature September 1, 2019. During the second quarter Melcor also extended the mortgage that secures retained debt relating to two of the initial properties from April 1, 2018 to April 1, 2021 at an interest rate of 3.58% (previously 3.33%). Concurrent with the extended mortgage we extended the maturity of 894,692 Class C Units with a balance of \$7,211 from April 1, 2018 to April 1, 2021 at an interest rate of 3.58%.

On January 12, 2018 the REIT issued 1,331,202 Class C LP Units as partial consideration for the Melcor Acquisitions (note 6). As at December 31, 2018 we had 10,785,613 Class C LP Units issued and outstanding (December 31, 2017 - 9,454,411). In addition, during the year, we repaid the maturing balance of 493,354 Class C LP units with a carrying value of \$4,147.

During the prior year we repaid the maturing balance of 295,324 Class C LP units with a carrying value of \$2,578.

Specific investment properties with a carrying value of \$137,101 (December 31, 2017 - \$140,242) and assignment of applicable rents and insurance proceeds have been pledged as collateral for the above Class C LP Units, along with a guarantee by the Partnership.

The minimum contractual principal payments due within each of the next five years and thereafter are as follows:

(\$000s)	Principal Installment Repayments	Balance Maturing	Total
2019	3,628	—	3,628
2020	3,065	24,027	27,092
2021	1,418	13,257	14,675
2022	1,095	—	1,095
2023	667	14,265	14,932
Thereafter	1,400	9,529	10,929
	11,273	61,078	72,351

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

During the year \$2,684 (2017 - \$2,633) was recognized in finance costs (note 17).

### 13. CONVERTIBLE DEBENTURES

#### A. 2014 DEBENTURES

We issued a 5.50% extendible convertible unsecured subordinated debenture (the "2014 Debentures") to the public on December 3, 2014 for gross proceeds of \$34,500, including \$4,500 issued pursuant to the exercise of an over-allotment option. The 2014 Debentures bear interest at an annual rate of 5.50% payable semi-annually in arrears on June 30 and December 31 each year, commencing June 30, 2015. Upon completion of the acquisition of certain properties from Melcor, the maturity date of the 2014 Debentures were extended to December 31, 2019. The 2014 Debentures can be converted into trust units at the holders' option at any point prior to the maturity date at a conversion rate of 79.0514 trust units per one thousand principal amount of convertible debenture (the "Conversion Price"). On and from December 31, 2017, and prior to December 31, 2018, the 2014 Debentures may be redeemed by the REIT, in whole at any time, or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest, provided that the volume weighted-average trading price of the trust units for a specified period (the "Current Market Price") preceding the date on which notice of redemption is given is not less than 125% of the Conversion Price. On and from December 31, 2018, and prior to the maturity date, the 2014 Debentures may be redeemed by the REIT, in whole at any time or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest. Subject to regulatory approval and other conditions, the REIT may, at its option, elect to satisfy its obligation to pay the principal amount of the convertible debenture on redemption or at maturity, in whole or in part, by delivering that number of freely tradeable trust units obtained by dividing the principal amount of the 2014 Debentures being repaid by 95% of the Current Market Price on the date of redemption or maturity.

#### B. 2017 DEBENTURES

On December 21, 2017, the REIT issued a 5.25% extendible convertible unsecured subordinated debentures (the "2017 Debentures") to the public for gross proceeds of \$23,000, including \$3,000 issued pursuant to the exercise of an over-allotment option. Transaction costs related to the issuance were \$1,457 for net proceeds of \$21,543. The 2017 Debentures bear interest at an annual rate of 5.25% payable semi-annually in arrears on June 30 and December 31 in each year commencing June 30, 2018. Upon completion of the Melcor Acquisition (note 6), the maturity date of the 2017 Debentures were extended to December 31, 2022. The 2017 Debentures can be converted into trust units at the holders' option at any point prior to the maturity date at a conversion rate of 86.9565 trust units per one thousand principal amount of convertible debentures (the "Conversion Price"). On and from December 31, 2020, and prior to December 31, 2021, the 2017 Debentures may be redeemed by the REIT, in whole at any time, or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest, provided that the volume weighted-average trading price of the trust units for a specified period (the "Current Market Price") preceding the date on which notice of redemption is given is not less than 125% of the Conversion Price. On and

from December 31, 2021, and prior to the maturity date, the 2017 Debentures may be redeemed by the REIT, in whole at any time or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest. Subject to regulatory approval and other conditions, the REIT may, at its option, elect to satisfy its obligation to pay the principal amount of the convertible debenture on redemption or at maturity, in whole or in part, by delivering that number of freely tradeable trust units obtained by dividing the principal amount of the 2017 Debentures being repaid by 95% of the Current Market Price on the date of redemption or maturity.

The principal amount outstanding and the carrying value for the REIT's convertible debentures are as follows:

(\$000s)				December 31, 2018	December 31, 2017	
Convertible Debentures	Date Issued	Maturity Date	Interest Rate	Outstanding Principal	Carrying Value	Carrying Value
2014 Debentures	Dec 3, 2014	Dec 31, 2019	5.50%	34,500	33,873	33,291
2017 Debentures	Dec 21, 2017	Dec 31, 2022	5.25%	23,000	21,144	20,755
				57,500	55,017	54,046

As compound financial instruments, the fair value of the host instrument components were calculated using a market interest rate for an equivalent non-convertible, non-extendible bond. The conversion feature components are recognized at its fair value and presented as a liability.

A reconciliation of the convertible debentures are as follows:

(\$000s)				Host Instruments	Conversion Features	Total
Balance at December 31, 2016				32,749	61	32,810
Convertible debenture issued				22,205	795	23,000
Transaction costs				(1,457)	—	(1,457)
Amortization of discount and transaction costs				549	—	549
Fair value adjustment on conversion features (note 26)				—	(127)	(127)
Balance at December 31, 2017				54,046	729	54,775
Amortization of discount and transaction costs				971	—	971
Fair value adjustment on conversion features (note 26)				—	(542)	(542)
Balance at December 31, 2018				55,017	187	55,204

During the year \$3,100 of interest expense was recognized in finance costs (note 17) (2017 - \$1,931).

At December 31, 2018 we remeasured the conversion feature to fair value resulting in a fair value adjustment of \$542 (2017 - \$127). Supplemental information on fair value measurement, including valuation techniques and key inputs, is included in note 26.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

### 14. CLASS B LP UNITS

Melcor, through an affiliate, holds an approximate 53.0% effective interest in the REIT through ownership of all Class B LP Units of the Partnership and is the ultimate controlling party. The Class B LP Units are exchangeable at the option of the holder for one trust unit of the REIT and accompanied by one special voting unit (note 15B). Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units.

Distributions on Class B LP Units for the year were \$10,057 (2017 - \$9,866), and are included in finance costs (note 17).

In accordance with our policy, as detailed in note 3H, we record Class B LP Units at fair value. We remeasured the Class B LP Units at December 31, 2018 and recognized a fair value gain of \$15,644 during the year (2017 - fair value loss of \$731). Supplemental information on fair value measurement, including valuation technique and the key input, is included in note 26.

On January 12, 2018 the REIT issued 283,447 Class B LP Units at \$8.82 or \$2,500 as partial consideration for the Melcor Acquisition (note 6). As at the adjustment date the fair value of the units issued was \$8.51 per unit, or \$2,412; the \$88 difference between book value and fair value was recorded to contributed surplus.

The following table summarizes the change in Class B LP Units for the year.

<i>(\$000s except unit amounts)</i>	<b>2018</b>		<b>2017</b>	
Balance - beginning of year	<b>14,615,878</b>	<b>124,381</b>	14,615,878	123,650
Issuance of Class B LP Units - Melcor Acquisition	<b>283,447</b>	<b>2,412</b>	—	—
Fair value adjustment on Class B LP Units (note 26)	—	<b>(15,644)</b>	—	731
Balance - end of year	<b>14,899,325</b>	<b>111,149</b>	14,615,878	124,381

At December 31, 2018 there were 14,899,325 Class B LP Units issued and outstanding at a fair value of \$7.46 per unit or \$111,149 (December 31, 2017 - 14,615,878 Class B LP Units issued and outstanding at a fair value of \$8.51 per unit or \$124,381).

### 15. UNITHOLDERS' EQUITY

#### A. TRUST UNITS

The REIT is authorized to issue an unlimited number of trust units and an unlimited number of special voting units. Each trust unit represents a holder's proportionate undivided beneficial ownership interest in the REIT and will confer the right to one vote at any meeting of the Unitholders and to participate pro rata in any distributions by the REIT.

Unitholders are entitled to demand, at any time, the REIT to redeem all or part of the trust units at a "Redemption Price" as defined in the REIT's DOT. Upon receipt of notice to redeem trust units, the Unitholder surrenders all rights to and under the units tendered for redemption.

#### B. SPECIAL VOTING UNITS

Pursuant to the DOT, special voting units have no economic entitlement in the REIT or in the distributions or assets of the REIT but entitle the holder to one vote per special voting unit at any meeting of the Unitholders. Special voting units may only be issued in connection with or in relation to securities exchangeable into Units, including Class B LP Units, for the purpose of providing voting rights with respect to the REIT to the holders of such securities. Special voting units will not be transferable separately from the exchangeable securities to which they are attached and will be automatically transferred upon the transfer of such exchangeable securities.

#### C. UNITS OUTSTANDING

On January 12, 2018 the REIT issued 2,035,500 trust units in exchange for subscription receipts previously issued and outstanding as of December 31, 2017 at a price of \$8.50 per subscription receipt for gross proceeds of \$17,302 (transaction costs of \$1,190 were incurred for net proceeds of \$16,112). Issued and outstanding trust units at December 31, 2018 are 13,186,797 (December 31, 2017 - 11,151,297).

On December 21, 2017, the REIT issued 2,035,500 subscription receipts to the public at a price of \$8.50 per subscription receipt for gross proceeds of \$17,302, including \$2,257 issued pursuant to the exercise of an over allotment option. Subscription receipts entitled the holder to receive one trust unit of the REIT upon closing of the Melcor Acquisition from Melcor Developments Ltd. (note 6). The gross proceeds, less 50% of the underwriter's fees, representing \$16,956 were held in escrow pending the closing of the Melcor Acquisition and were recorded as Restricted Cash.

A reconciliation of the subscription receipts are as follows:

<i>(\$000s)</i>	<b>Amount</b>
Gross proceeds	<b>17,302</b>
Accrued interest payable for distribution declared (note 17)	<b>114</b>
Transaction costs	<b>(793)</b>
	<b>16,623</b>

### 16. RENTAL REVENUE

The components of rental revenue are as follows:

<i>For the year ended December 31 (\$000s)</i>	<b>2018</b>	<b>2017</b>
Lease revenue	<b>59,288</b>	55,530
Service revenue	<b>12,792</b>	13,071
Amortization of tenant incentives (note 8)	<b>(3,097)</b>	(3,062)
Straight-line adjustments	<b>1,190</b>	1,074
	<b>70,173</b>	66,613



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

### 17. FINANCE COSTS

The components of finance costs are as follows:

For the year ended December 31 (\$000s)	2018	2017
Interest on mortgages payable and revolving credit facility	8,961	8,160
Interest on Class C LP Units	2,893	2,858
Amortization of fair value adjustments on Class C LP Units	(209)	(225)
Distributions on Class B LP Units	10,057	9,866
Interest on convertible debentures	3,100	1,931
Interest on subscription receipts	—	114
Fair value adjustment on derivative financial instruments	(421)	(521)
Amortization of deferred financing fees	1,597	1,011
	25,978	23,194

Total finance costs paid during the year were \$24,883 (2017 - \$22,512).

### 18. INCOME TAXES

As at December 31, 2018 the REIT qualifies as a mutual fund trust within the meaning of the Tax Act and as a real estate investment trust eligible for the 'REIT Exception' under the Specified Investment Flow-Through ("SIFT"); accordingly, no current or deferred income tax expense has been recognized on income earned or capital gains recognized subsequent to the formation of the REIT.

Reconciliation of income tax expense based on the statutory rate to the recovery recorded using the effective tax rate is as follows:

For the year ended December 31 (\$000s)	2018	2017
Net income	17,610	732
Statutory rate	27%	27%
	4,755	198
Non-deductible expenses	—	1
Non-taxable portion of capital gains and fair value adjustments	2,716	1,959
Allocation of taxable loss to unitholders (note 3M)	(7,471)	(2,158)
	—	—

### 19. INCOME PER UNIT

Basic and diluted earnings per trust unit for the year are calculated as follows:

(\$000s except unit amounts)	2018	2017
Net income - basic	17,610	732
Impact of Class B LP unit fair value adjustment and distributions	(5,587)	—
Impact of convertible debentures interest, fair value adjustment and amortization	—	—
Net income - diluted	12,023	732
Basic weighted average trust units outstanding	13,119,876	11,151,297
Impact of conversion of Class B LP Units	14,890,006	—
Impact of conversion of convertible debentures	—	—
Diluted weighted average trust units outstanding	28,009,882	11,151,297
Basic earnings per trust unit	\$1.34	\$0.07
Diluted earnings per trust unit*	\$0.43	\$0.07

\*Diluted earnings per trust unit do not include the impact of Class B LP Units and convertible debentures when they are anti-dilutive.

### 20. RELATED PARTY TRANSACTIONS

The consolidated financial statements of the REIT include the following related party transactions with Melcor, and its affiliates, as the ultimate controlling party of the REIT:

#### A. PROPERTY AND ASSET MANAGEMENT AGREEMENTS

The REIT is externally managed, administered and operated by Melcor pursuant to the terms and conditions as set forth under the Property Management Agreement and Asset Management Agreement.

**Asset Management Agreement** – we pay a quarterly management fee which is comprised of the following:

- (a) a base annual management fee calculated and payable on a quarterly basis, equal to 0.25% of the REIT's gross book value;
- (b) a capital expenditures fee equal to 5% of all hard construction costs incurred on capital projects in excess of \$0.10 million;
- (c) an acquisition fee equal to 0.50% - 1.00% of the purchase price;
- (d) a financing fee equal to 0.25% of the debt and equity of all financing transactions completed for the REIT to a maximum of actual expenses incurred by Melcor.

**Property Management Agreement** – we pay a monthly fee which is comprised of the following:

- (a) a base fee of 1/12 of 3% of gross property revenue;
- (b) a leasing fee equal to 5% of aggregate base rent for new leases for the first 5 years and 2.5% thereafter, and 2.5% of aggregate base rent for lease renewals and expansions for the first 5 years.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

Pursuant to the terms of the agreements the REIT incurred the following fees during the year:

For the year ended December 31 (\$000s)	2018	2017
<b>Asset Management Agreement</b>		
Base Annual Management Fee	1,739	1,583
Acquisition Fee	63	—
<b>Property Management Agreement</b>		
Monthly Fee	1,998	1,897
Lease Fee	728	743
	4,528	4,223

The Base Annual Management Fee is included in general and administrative expenses. Monthly Fees are included in direct operating expenses. In accordance with our policy (3E), Acquisition Fees and Lease Fees are capitalized to investment properties. As at December 31, 2018 there was \$583 payable to Melcor related to these fees (December 31, 2017 - \$579) which is included in accrued liabilities and other payables.

### B. DISTRIBUTIONS ON CLASS B LP UNITS AND REDEMPTIONS OF CLASS C LP UNITS

During the year \$10,057 in distributions were recorded on Class B LP Units held by Melcor (2017 - \$9,866). These distributions were recorded as finance costs (note 17). As at December 31, 2018 there was \$838 payable to Melcor for the December distribution (December 31, 2017 - \$822) which is included in distribution payable.

Also during the year, Melcor, as holder of all Class C LP Units, was paid \$6,606 to fund principal and interest payments on the Retained Debt (2017 - \$6,347). These redemptions were recorded as a reduction of the Class C LP Unit liability and as finance costs (note 17). In addition, during the year we repaid the outstanding balance on 812,477 Class C LP Units with a carrying value of \$6,947 and we repaid the maturing balance on 493,354 Class C LP units with a carrying values of \$4,147.

### C. RENTAL REVENUE

During the year the REIT collected \$984 in rental revenue from Melcor and an affiliate for use of office space (2017 - \$963). In addition, pursuant to the Head and Bridge Lease Agreements, the REIT collected \$138 in rental revenue from Melcor as compensation for certain vacant spaces at the properties acquired (2017 - \$344).

### D. KEY MANAGEMENT REMUNERATION

The REIT does not directly or indirectly pay any compensation to named executive officers of the REIT. The REIT has no employees and is externally managed, administered and operated by Melcor pursuant to the Asset Management Agreement and Property Management Agreement.

### E. PURCHASE OF INVESTMENT PROPERTIES

On January 12, 2018 the REIT purchased five commercial properties from Melcor (note 6). The total purchase price of \$80,875, and transaction costs of \$149, were settled through

issuance of 283,447 Class B LP Units at price of \$8.82 representing \$2,500; assumption of \$31,037 in mortgages payable; issuance of 1,331,167 Class C LP Units, representing \$13,312 in Retained Debt by Melcor; and cash of \$34,175.

## 21. JOINT ARRANGEMENTS

The table below discloses our rights to and share of the assets, liabilities, revenues, and earnings of three joint arrangements (2017 – three) that are recorded in these consolidated financial statements:

	Interest
Capilano Investments Joint Venture	50%
Westmere Properties Joint Venture	50%
Watergrove Developments Joint Venture	50%

	Assets	Liabilities	Revenue	Earnings
For the year ended and as at December 31 (\$000s)				
2018	66,891	34,246	5,681	2,231
2017	62,001	32,192	5,119	2,596

## 22. SEGMENTED INFORMATION

All the properties included in these consolidated financial statements are located in Western Canada, and are viewed by the Chief Operating Decision Maker (determined to be the Chief Executive Officer) as one operating segment in the context of these consolidated financial statements.

## 23. COMMITMENTS AND CONTINGENCIES

The REIT is contingently liable under guarantees that are issued in the normal course of business and with respect to litigation and claims that arise from time to time. In the opinion of management, any liability that may arise from such contingencies would not have a material adverse effect on the consolidated financial statements of the REIT.

In the normal course of operations we enter into lease agreements with tenants which specify tenant incentive payments upon completion of the related tenant improvements. The REIT has entered into lease agreements that may require tenant incentive payments of approximately \$1,599 (2017 - \$440).

The REIT retains a loan guarantee related to the mortgage transferred as part of the January 31, 2018 property sale. As at December 31, 2018 the loan balance was \$3,578 (2017 - \$nil).

## 24. MANAGEMENT OF CAPITAL RESOURCES

We define capital as unitholders' equity, Class B LP Units, Class C LP Units, mortgages payables and convertible debentures. Our objective when managing capital is to ensure sufficient funds are available to make unitholder distributions, support the growth of our assets, and finance capital requirements. Specifically, we plan to utilize a combination of short, medium and long-term debt financing that aligns with the characteristics of each property.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

Pursuant to the DOT, the REIT may not incur or assume any indebtedness if, after incurring or assuming such indebtedness, the total indebtedness of the REIT would be more than 60% of Gross Book Value ("GBV") ("Degree of Leverage Ratio") (65% including any convertible debenture). At December 31, 2018, and throughout the period, we were in compliance with the Degree of Leverage Ratio.

We are also subject to financial covenants on our \$35,000 revolving credit facility. The covenants include a maximum debt to gross book value ratio of 60% (excluding convertible debentures), a minimum debt service coverage ratio of 1.50, and a minimum adjusted unitholders' equity of \$140,000. As at December 31, 2018, and throughout the period, we were in compliance with our financial covenants. We also have financial covenants on certain mortgages for investment properties. At December 31, 2018, and throughout the period, we were in compliance with our financial covenants on our mortgages. We prepare financial forecasts to monitor the changes in our debt and capital levels and our ability to meet our financial covenants.

### 25. FINANCIAL RISK MANAGEMENT

We are exposed to the following risks as a result of holding financial instruments:

#### A. CREDIT RISK

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Our financial assets that are exposed to credit risk consist of cash and cash equivalents, accounts receivable and a loan receivable measured at amortized cost. Our maximum exposure to credit risk is the carrying amount of these instruments.

We invest our cash and cash equivalents and restricted cash in bank accounts with major Canadian chartered banks. Accounts receivable balances include amounts due from tenants and various smaller amounts due from vendors. We manage our credit risk through careful selection of tenants and look to obtain national tenants or tenants in businesses with a long standing history, or perform financial background checks including business plan review for smaller tenants. We manage our concentration risk by renting to an expansive tenant base, with no dependency on rents from any one specific tenant.

For our accounts receivable and loan receivable, we apply the simplified credit loss approach, which requires us to recognize lifetime expected credit losses for all accounts receivables and loan receivable balances by applying an expected loss rate based on historical credit losses adjusted for current and forward looking information which may affect the ability of the customers to settle receivables. Accounts receivables and loan receivable have been grouped based on shared credit risk characteristics. In previous years the impairment of accounts receivable and loan receivable were assessed based on the incurred loss model whereby individual receivables which were known to be uncollectible were written off by reducing the carrying amount directly. Where management assessed a potential impairment, the estimated impairment losses were recognized in a separate provision. Receivables for which an impairment provision was recognized were written off against the provision when there was no expectation of recovering additional cash.

Amounts receivable and related allowance for doubtful accounts are summarized as follows:

(\$000s)	2018	2017
Accounts receivable	1,413	1,897
Loss allowance	(83)	(133)
Accounts receivable, net	1,330	1,764
Loan receivable	900	900
Total amounts receivable, net	2,230	2,664

Accounts receivables and loan receivables are written off when there is no reasonable expectation of recovery. Indicators that there are no reasonable expectation of recovery include, amongst others, the failure of a debtor to engage in a repayment plan, and failure to make contractual payments for a period of greater than 120 days past due.

#### B. LIQUIDITY RISK

Liquidity risk is the risk that we will not be able to meet our financial obligations as they fall due. We manage liquidity risk to ensure that we have sufficient liquid financial resources to finance operations, meet long-term mortgage repayments, Class C LP Unit redemptions, convertible debenture payments and make monthly distributions on Class B LP Units and trust units. We monitor rolling forecasts of our liquidity, which includes cash, on the basis of expected cash flows. In addition, we monitor balance sheet liquidity ratios against capital requirements and maintain on-going debt financing plans. We believe that we have access to sufficient capital through internally generated cash flows, external sources and undrawn committed borrowing facilities to meet current spending forecasts.

To mitigate the risk associated with the refinancing of maturing debt, we stagger the maturity dates of our mortgage portfolio over a number of years.

Refer to notes 11, 12 and 13 for the maturity analysis of mortgages payable, Class C LP Units and convertible debentures. Amounts drawn under the revolving credit facility are due upon the maturity of the facility, on or before June 1, 2021. We expect to be able to renew our facility on maturity, no amounts were drawn at year end. Accounts payable are expected to be repaid in the next twelve months. Distributions declared on trust units and Class B LP Units are paid one month following the date of declaration.

#### C. MARKET RISK

We are subject to interest rate cash flow risk as our revolving credit facility bears interest at rates that vary in accordance with borrowing rates in Canada. For each 1% change in the rate of interest on our revolving credit facility, the change in annual finance costs is approximately \$nil (December 31, 2017 - \$nil) based upon applicable period end debt balances. We are also subject to interest rate risk on refinancing of our fixed rate debts in the year of maturity. We are not subject to other significant market risks pertaining to our financial instruments.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

### 26. FAIR VALUE MEASUREMENT

Fair value is the price that market participants would be willing to pay for an asset or liability in an orderly transaction under current market conditions at the measurement date.

The fair value of the REIT's financial instruments were determined as follows:

- the carrying amounts of cash and cash equivalents, restricted cash, accounts receivables, loan receivable, accounts payable, distribution payable and subscription receipts approximate their fair values based on the short term maturities of these financial instruments.
- fair values of mortgages payable, liability held for sale, Class C LP Units and derivative financial asset - interest rate swap are estimated by discounting the future cash flows associated with the debt at market interest rates (Level 3).
- fair value of derivative financial liabilities, the conversion features on our convertible debenture, is estimated based upon unobservable inputs, including volatility and credit spread (Level 3).
- fair value of Class B LP Units are estimated based on the closing trading price of the REIT's trust units and the fair value of convertible debenture are estimated based on the closing trading price of the REIT's debentures (Level 2).

In addition, the REIT carries its investment properties and assets held for sale at fair value which is determined based on the accepted valuation methods of direct income capitalization or discounted future cash flows (Level 3).

The fair value hierarchy categorizes fair value measurement into three levels based upon the inputs to valuation technique, which are defined as follows:

- Level 1: quote prices (unadjusted) in active markets for identical assets or liabilities that are accessible at the measurement date.
- Level 2: inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3: unobservable inputs for the asset or liability.

There were no transfers between the levels of the fair value hierarchy during the period.

The following table summarizes the REIT's assets and liabilities carried at fair value and its financial assets and liabilities where carrying value may not approximate fair value.

December 31, 2018					
((\$000s))	Level	Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value
<b>Non-financial assets</b>					
Investment properties	3	683,768	—	683,768	683,768
Assets held for sale	3	—	—	—	—
<b>Financial liabilities</b>					
Mortgages payable	3	—	259,586	259,586	258,858
Class B LP Units	2	111,149	—	111,149	111,149
Class C LP Units	3	—	72,580	72,580	72,580
Convertible debentures	2	—	55,017	55,017	56,738
Liability held for sale	3	—	—	—	—
<b>Derivative financial instruments</b>					
Interest rate swap	3	383	—	383	383
Conversion features on convertible debentures	3	187	—	187	187
December 31, 2017					
((\$000s))	Level	Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value
<b>Non-financial assets</b>					
Investment properties	3	617,278	—	617,278	617,278
Assets held for sale	3	6,732	—	6,732	6,732
<b>Financial liabilities</b>					
Mortgages payable	3	—	217,240	217,240	219,700
Class B LP Units	2	124,381	—	124,381	124,381
Class C LP Units	3	—	74,276	74,276	74,276
Convertible debentures	2	—	54,046	54,046	57,289
Liability held for sale	3	—	3,670	3,670	3,670
<b>Derivative financial instruments</b>					
Interest rate swap	3	504	—	504	504
Conversion features on convertible debentures	3	729	—	729	729

### INVESTMENT PROPERTIES

Investment properties are remeasured to fair value on a recurring basis, determined based on the accepted valuation methods of direct income capitalization or discounted future cash flows. The application of these valuation methods results in these measurements being classified as Level 3 in the fair value hierarchy.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

Under the discounted future cash flows method, fair values are determined by discounting the forecasted future cash flows over ten years plus a terminal value determined by applying a terminal capitalization rate to forecasted year eleven cash flows.

Under the direct income capitalization method, fair values are determined by dividing the stabilized net operating income of the property by a property specific capitalization rate.

The significant unobservable inputs in the Level 3 valuations are as follows:

- Capitalization rate - based on actual location, size and quality of the property and taking into consideration available market data as at the valuation date;
- Stabilized net operating income - revenue less direct operating expenses adjusted for items such as average lease up costs, vacancies, non-recoverable capital expenditures, management fees, straight-line rents and other non-recurring items;
- Discount rate - reflecting current market assessments of the uncertainty in the amount and timing of cash flows;
- Terminal capitalization rate - taking into account assumptions regarding vacancy rates and market rents; and
- Cash flows - based on the physical location, type and quality of the property and supported by the terms of existing leases, other contracts or external evidence such as current market rents for similar properties.

An increase in the cash flows or stabilized net operating income results in an increase in fair value of investment property whereas an increase in the capitalization rate, discount rate or terminal capitalization rate decreases the fair value of the investment property.

In determining the fair value of our investment properties judgment is required in assessing the 'highest and best use' as required under IFRS 13, Fair value measurement. We have determined that the current uses of our investment properties are their 'highest and best use'.

The REIT's management company, Melcor, lead by Melcor's executive management team, is responsible for determining fair value measurements on a quarterly basis, including verifying all major inputs included in the valuation and reviewing the results. Melcor's management, along with Melcor REIT Limited Partnership's Audit Committee, discuss the valuation process and key inputs on a quarterly basis. At least once every two years, the valuations are performed by qualified external valuers who hold recognized and relevant professional qualifications and have recent experience in the location and category of the investment property being valued.

Investment properties were valued by Melcor's internal valuation team as at December 31, 2018 of which 24 investment properties (of 50 legal phases valued) with a fair value of \$367,550 were valued by qualified independent external valuation professionals during the year. Valuations performed during the year resulted in fair value losses of \$11,385. During the year ended December 31, 2017 Melcor's internal valuation team valued investment properties of which 27 invest properties (of 46 legal phases valued) with a fair value of \$392,700 were valued by qualified independent external valuation professionals during the year.

Valuations performed during the year ended December 31, 2017 resulted in fair value losses of \$12,800.

Weighted average stabilized net operating income for investment properties is \$1,500 (2017 - \$1,534) per property. Other significant valuation metrics and unobservable inputs are set out in the following table. Fair values are most sensitive to changes in capitalization rates.

December 31, 2018			
	Min	Max	Weighted Average
Capitalization rate	5.50%	10.50%	6.69%
Terminal capitalization rate	5.75%	9.00%	6.75%
Discount rate	6.50%	9.75%	7.70%

December 31, 2017			
	Min	Max	Weighted Average
Capitalization rate	5.50%	8.75%	6.68%
Terminal capitalization rate	5.75%	9.00%	6.79%
Discount rate	6.50%	9.75%	7.75%

An increase in the capitalization rates by 50 basis points would decrease the carrying amount of investment properties by \$48,645 (2017 - \$44,312). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by \$56,502 (2017 - \$51,480).

### NON-DERIVATIVE FINANCIAL LIABILITIES

The fair value of mortgages payable, liability held for sale and Class C LP Units have been calculated by discounting the expected cash flows of each loan using a discount rate specific to each individual loan. The discount rate is determined using the bond yield for similar instruments of similar maturity adjusted for each individual project's specific credit risk. In determining the adjustment for credit risk, we consider current market conditions and other indicators of credit worthiness.

### DERIVATIVE FINANCIAL INSTRUMENTS

Our derivative financial instruments are comprised of a floating for fixed interest rate swap on one of our mortgages (level 3) and the conversion features on our convertible debentures (level 3).

The fair value of the interest rate swap is calculated as the net present value of the future cash flows expected to arise on the variable and fixed portion, determined using applicable yield curves at the measurement date. As at December 31, 2018 the fair value of the interest rate swap contract is \$383 (2017 - \$504).

The significant unobservable inputs used in the fair value measurement of the conversion feature on the convertible debentures are as follows:

- Volatility - expected volatility as at December 31, 2018 was derived from the historical prices of the REIT's trust units. As the REIT was formed on May 1, 2013, price history is limited and we have used the entire historical data up until December 31, 2018. Volatility was 17.80% (2017 - 21.70%).



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(in \$000s except unit and per unit amounts)

- Credit spread - the credit spread of the convertible debenture was imputed from the traded price of the convertible debenture as at December 31, 2018. The credit spread used was 3.92% (2017 - 2.81%).

As at December 31, 2018 the fair value of the conversion features on our convertible debentures was \$187 (2017 - \$729).

Valuations performed during the year resulted in fair value gains of \$421 (2017 - gains of \$521).

### CLASS B LP UNITS

Class B LP Units are remeasured to fair value on a recurring basis and categorized as Level 2 in the fair value hierarchy. The units are fair valued based on the trading price of the trust units at the period end date. At December 31, 2018 the fair value of the Class B LP Units was \$111,149, resulting in a fair value gain of \$15,644 in income for the year (2017 - fair value loss of \$731).

## 27. SUBSEQUENT EVENTS

### DISTRIBUTION DECLARED

On January 15, 2019 we declared a distribution of \$0.05625 per unit for the months of January, February and March 2019. The distributions will be payable as follows:

Month	Record Date	Distribution Date	Distribution Amount
January 2019	January 31, 2019	February 15, 2019	\$0.05625 per unit
February 2019	February 28, 2019	March 15, 2019	\$0.05625 per unit
March 2019	March 29, 2019	April 15, 2019	\$0.05625 per unit

# CORPORATE & UNITHOLDER INFORMATION

**MELCOR** | REIT



# ANNUAL GENERAL MEETING

Please join us at our annual general meeting:

**Tuesday, April 30, 2019  
9:30 AM**

**Fairmont Hotel Macdonald  
10095 100 Street NW**

**We look forward to seeing you there!**

**MelcorREIT.ca/2019AGM**

## UPCOMING EARNINGS DATES

**Q1 – May 2, 2019  
Q2 – July 30, 2019  
Q3 – October 31, 2019  
Q4 – March 5, 2020**



## CUSTOMER SERVICE

For tenant services, please contact:  
**P. 1.866.MELCOR1  
W. Care.Melcor.ca  
E. service@care.melcor.ca**

## INVESTOR RELATIONS

**Nicole Forsythe  
P. 1.855.673.6937  
E. IR@MelcorREIT.ca**

## EXCHANGE LISTING

Toronto Stock Exchange

**REIT Units: MR.UN**

**5.5% Convertible Debenture: MR.DB  
5.25% Convertible Debenture: MR.DB.A**

## UNITHOLDER SERVICES

For unitholder services including distribution information, contact:

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E. inquiries@astfinancial.com  
W. www.astfinancial.com/ca**

## AUDITORS

PricewaterhouseCoopers LLP

## LEGAL COUNSEL

Bryan & Company LLP

## TAX INFORMATION

**Regular Income – 37%  
Capital Gains – 46%  
Return of Capital – 17%**

**MELCOR** | REIT

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