
annual report

# 2017

MELCOR | REIT

# MELCOR | REIT 2017

**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 2.86 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 94 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. Melcor has over 6.7 million sf in current and future projects to be built over the next 5 to 15 years.

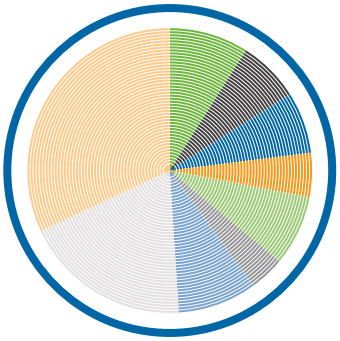
## FACTS & DATA

**$676.2M** ASSET FAIR VALUE

**$66.6M** REVENUE

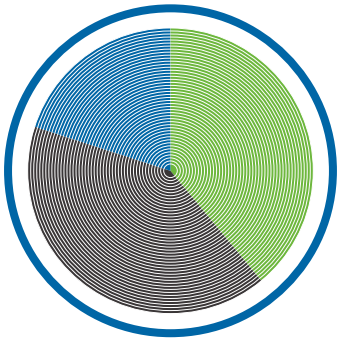
**37** ASSETS

### GLA By Tenant Industry*



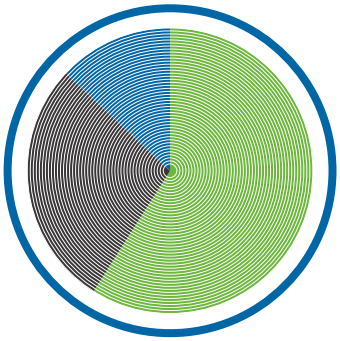
- Finance - 9%
- Oil & Gas - 4%
- Government - 7%
- Other - 9%
- Hospitality - 7%
- Professional - 19%
- Industrial - 5%
- Retail - 32%
- Medical - 8%

### GLA By Tenant Profile*



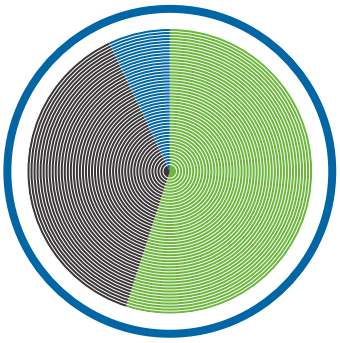
- Local - 39%
- Regional - 41%
- National - 20%

### GLA By Region*



- Northern Alberta - 59%
- Southern Alberta - 28%
- BC & SK - 13%

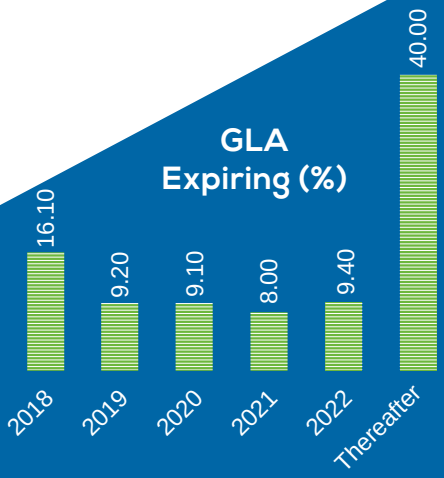
### GLA By Property Type*



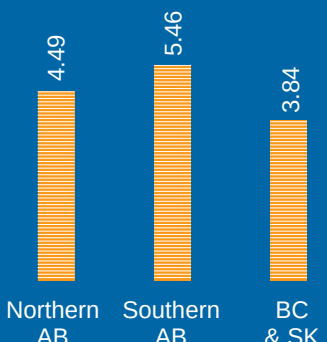
- Office - 55%
- Retail - 38%
- Industrial - 7%

*At March 1, 2018

### GLA Expiring (%)



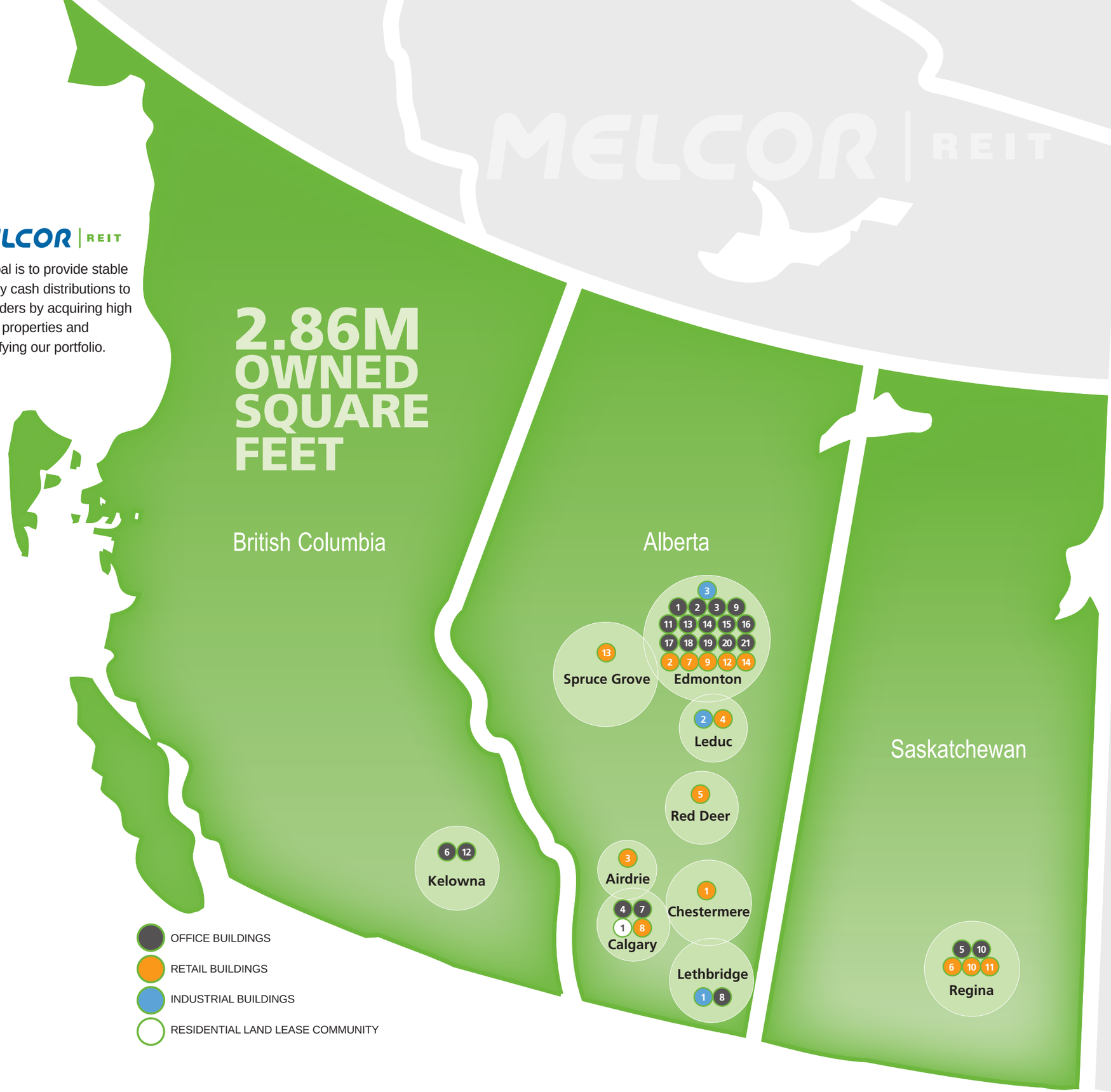

### Weighted Average Lease Term (years)



MELCOR | REIT

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

# 2.86M OWNED SQUARE FEET




**At March 1, 2018**

| | OFFICE BUILDINGS | LOCATION | GLA | OCC % |
|---|---|---|---|---|
| 1 | 100 Street Place | Edmonton | 44,295 | 87 |
| 2 | Birks Building | Edmonton | 33,987 | 98 |
| 3 | Capilano Centre | Edmonton | 45,487 | 89 |
| 4 | Crowfoot Business Centre | Calgary | 67,293 | 91 |
| 5 | Executive Terrace | Regina | 42,843 | 78 |
| 6 | Kelowna Business Centre | Kelowna | 72,076 | 98 |
| 7 | Kensington Road Building | Calgary | 24,044 | 90 |
| 8 | Lethbridge Centre | Lethbridge | 449,862 | 94 |
| 9 | Melton Building | Edmonton | 114,612 | 75 |
| 10 | Parliament Place | Regina | 24,411 | 90 |
| 11 | Princeton Place | Edmonton | 59,081 | 68 |
| 12 | Richter Street Building | Kelowna | 28,978 | 85 |
| 13 | Royal Bank Building | Edmonton | 132,373 | 72 |
| 14 | Select Engineering | Edmonton | 23,432 | 100 |
| 15 | Stanley Buildings | Edmonton | 34,976 | 93 |
| 16 | Sterling Business Centre | Edmonton | 67,909 | 82 |
| 17 | The Village at Blackmud Creek | Edmonton | 47,751 | 94 |
| 18 | Trail Business Centre | Edmonton | 77,296 | 90 |
| 19 | Westcor Building | Edmonton | 72,810 | 93 |
| 20 | Westgate Business Centre | Edmonton | 75,141 | 94 |
| 21 | White Oaks Square | Edmonton | 30,497 | 100 |
| | **TOTAL** | | **1,569,154** | **88** |

| | RETAIL BUILDINGS | LOCATION | GLA | OCC % |
|---|---|---|---|---|
| 1 | Chestermere | Chestermere | 84,551 | 97% |
| 2 | Coast Home Centre | Edmonton | 59,725 | 88% |
| 3 | Kingsview Market | Airdrie | 100,027 | 100% |
| 4 | Leduc Common | Leduc | 283,230 | 96% |
| 5 | Liberty Crossing | Red Deer | 63,317 | 100% |
| 6 | Market Mall | Regina | 42,912 | 96% |
| 7 | Miller Crossing | Edmonton | 27,336 | 97% |
| 8 | The District | Calgary | 23,159 | 100% |
| 9 | The Village at Blackmud Creek | Edmonton | 9,046 | 100% |
| 10 | Towers Mall | Regina | 114,331 | 93% |
| 11 | University Park Shopping Centre | Regina | 41,238 | 96% |
| 12 | West Henday Promenade | Edmonton | 77,129 | 100% |
| 13 | Westgrove Common | Spruce Grove | 29,242 | 93% |
| 14 | White Oaks Square | Edmonton | 127,824 | 100% |
| | **TOTAL** | | **1,083,067** | **97** |

| | INDUSTRIAL BUILDINGS | LOCATION | GLA | OCC % |
|---|---|---|---|---|
| 1 | Lethbridge Industrial Building | Lethbridge | 49,005 | 100 |
| 2 | Telford Industrial | Leduc | 143,118 | 100 |
| 3 | TKE Building | Edmonton | 15,968 | 100 |
| | **TOTAL** | | **208,091** | **100** |

| | LAND LEASE COMMUNITY | LOCATION | GLA | OCC % |
|---|---|---|---|---|
| 1 | Watergrove | Calgary | 308 | 100 |

MELCOR | REIT

# 2017




5 YEARS OF STRONG RETURNS

Ralph Young

# Message from the Chairman

I am pleased to report to you for the first time as Chairman of the Board of Trustees. May 2018 marks the fifth anniversary of the Melcor REIT. Our anniversary is a time to reflect on our results and our progress toward our goal of providing a solid platform for unitholders to invest in real estate assets. While we have faced headwinds with our focus on western Canadian assets, we have performed well in comparison with our peers in unit valuation and unitholder distributions.

During the year we have made significant transitions in the leadership of the REIT. We welcomed Andrew Melton as our President and Chief Executive Officer. As the founding Chair of the Board, he has overseen the creation and the strategic direction of the REIT and is well positioned to take on this leadership role. Darin Rayburn, our founding Chief Executive Officer was instrumental in guiding the REIT through its formation and growth. As the President and CEO of Melcor Developments Ltd., he remains actively involved in the success of Melcor REIT through his responsibilities to oversee the operating relationships and also as a member of our Board of Trustees.

We express our deep appreciation to Andrew and Darin for their continued successful leadership, which has enabled a seamless transition.

The relationship that we have with Melcor Developments Ltd. and the Melcor team is unique and beneficial. Melcor's 50 years as a public company provides a depth of experience through many market cycles. In addition to professionally managing, leasing and maintaining our properties, they also develop new commercial properties that fuel our future growth. With our fourth vend-in from Melcor completed in 2018, we've demonstrated again that this is a model that works to build the REIT to a more balanced and sustainable entity.

2017 was a year focused on sustainability, stability of distributions and modest growth, while managing the challenges of economic disruptions of office oversupply and retail realignments in our markets.

I would like to thank our Trustees for their governance, wisdom and oversight which has ensured that our unitholders and other stakeholders have been well served.

Finally, thank you to 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 continue to provide strong returns for our unitholders.

Andrew Melton

# Letter from the President & CEO

It is my privilege to report to you for the first time as your president and CEO and it is a special honor to hold this office as the REIT celebrates its fifth birthday and resumes its growth story.

Since our inception, we've witnessed all sorts of market conditions - the decline of oil and its impact on Alberta where the majority of our assets are, an influx of new office product in downtown Edmonton, where 12% of our portfolio is located, and new governments both provincially and nationally.

Against this backdrop we have consistently executed on our strategy, leading to stable results. We've paid out total distributions of $3.21 per unit to our unitholders. We've maintained occupancy of over 90% through some challenging markets. We've achieved our target of 95%+ on-time response on service calls for the past five years.

We've also grown our portfolio gross leasable area by 82% 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. We also acquired three assets from third parties and sold two assets, monetizing the value we created while at the same time diversifying our portfolio. Through these transactions, we've acquired 1.38 million square feet and sold 90,000.

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.

The vend-in completed in January 2018 further strengthens and diversifies our portfolio to position us well for 2018 and beyond. Through this vend-in, we added 128,301 square feet of retail and 44,328 square feet of industrial to our portfolio, both of which we have targeted for growth in our overall portfolio mix.

## 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.The strength of our portfolio is in our people, the relationships they build with our clients and their commitment to providing unrivalled customer care. We remain committed to being the landlord of choice for our tenants.

**$3.21**
**TOTAL DISTRIBUTIONS PAID PER UNIT**


95%+
ON-TIME RESPONSE RATE

82%
GLA GROWTH

## Growth

Over the past 5 years, we've grown our REIT significantly – by 70% in asset value, 69% in revenue and 82% in gross leasable area, including the recently completed vend-in. In 2017 and early 2018, we also recycled capital with the sale of 2 buildings. We continue to look at opportunities to grow our portfolio via acquisition and densification and to recycle capital to strengthen our portfolio.

## Strategic Leasing

Our strategic leasing program resulted in 248,600 square feet in renewals and 91,900 square feet in new leasing in 2017. We continue to focus on leasing activity throughout our portfolio.

4
VEND-INS

## Outlook

We are seeing signs of an economic recovery. Retail continues to show strength and resilience. We are renewing leases and are 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 have seen so far this year across our portfolio.

With 16.1% of total GLA expiring in 2018, we are working towards securing early renewals, particularly on larger tenants. There can be no assurance that this strategy will be successful or that we will 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.

With a strong, diversified portfolio, focus on property management and client relationships, and a solid pipeline of over 6.68 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 Darin Rayburn for his years of services as CEO of the REIT, for launching it and guiding its growth and development for four years. I also thank Ralph Young for agreeing to be appointed as the Chair of the Board of Trustees. To our Trustees, thank you for your support and guidance to ensure a smooth transition of leadership.

Thank you also to the Melcor team for the exceptional roles you play in providing asset and property management to the REIT, building strong relationships with our clients and taking care of our properties with pride.

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

1.38M
SQUARE FEET
ACQUIRED


# Corporate Governance

## 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 directors. The audit committee is 100% independent. The independent directors 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 director, 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.

## 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 and 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. 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 2017, trustees increased their holdings by 6% to an average of 68,757 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 2017 Information Circular.

# Board of Trustees

## Andrew Melton
**Calgary, Alberta**

**RELATED**

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

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation[1]:** $nil
**Unitholdings:** 120,400
**Committees:** Investment

## Brian Hunt
**Calgary, Alberta**

**INDEPENDENT**

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

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $49,000
**Unitholdings:** 40,000
**Committees:** Audit (Chair), Investment, Special

## Larry Pollock
**Edmonton, Alberta**

**INDEPENDENT**

**Principal Occupation:**
Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $44,000
**Unitholdings:** 75,800
**Committees:** Audit, Governance, Investment, Special (Chair)



## Ralph Young
**Edmonton, Alberta**

**RELATED**

**Principal Occupation:**
Chairman, Melcor REIT

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $32,621
**Unitholdings:** 23,800
**Committees:**
None

## Darin Rayburn
**Edmonton, Alberta**

**RELATED**

**Principal Occupation:**
President & CEO, Melcor Developments Ltd.

**Trustee Since:** 2017
**Attendance:** 100%
**Compensation[1]:** $nil
**Unitholdings:** 133,702
**Committees:** Investment

## Donald Lowry ICD.D
**Edmonton, Alberta**

**INDEPENDENT - LEAD TRUSTEE**

**Principal Occupation:**
Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $48,385
**Unitholdings:** 59,600
**Committees:** Audit, Governance (Chair), Special

## Patrick Kirby
**Edmonton, Alberta**

**INDEPENDENT**

**Principal Occupation:**
Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $34,500
**Unitholdings:** 28,000
**Committees:** Governance, Special

*1 Melcor employees do not receive trustee compensation.*

## Table of Contents



# Management's Discussion & Analysis

March 1, 2018

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, 2017. 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 2016 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 1, 2018. Disclosure contained in this MD&A is current to March 1, 2018, unless otherwise indicated.

## 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 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 2018 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.

**Regulatory Filings**

***Additional information about the REIT, including our annual information form, management information circular and quarterly reports, is available on our website at melcorREIT.ca and on SEDAR at sedar.com.***

MELCOR | REIT

# CORPORATE & UNITHOLDER INFORMATION

## Annual General Meeting

Please join us at our annual general meeting:
**Thursday, May 10, 2018 | 10 AM MT**

**The Westin Edmonton**
Devonian Room
10135 100 Street NW
**We look forward to seeing you there!**

## Customer Service

For tenant services, please contact:
**P. 1-866-MELCOR1**
**W.Care.Melcor.ca**
**E. service@care.melcor.ca**

## Unitholder Services

For unitholder services including distribution information, contact:

**AST Trust Company (Canada)**
PO Box 700 Station B
Montreal, QC H3B 3K3
**P. 1-800-387-0825**
**F. 1-888-249-6189**
**E. inquiries@astfinancial.com**
**W. www.astfinancial.com/ca**

## Tax Information

**Regular Income** – 55%
**Capital Gains** – 8%
**Return of Capital** – 37%

## Auditors

PricewaterhouseCoopers LLP

## Exchange Listing

Toronto Stock Exchange:
**REIT Units: MR.UN**

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

## Legal Counsel

Bryan & Company LLP

## Investor Relations

**Nicole Forsythe**
**P. 1-855-673-6937**
**E. IR@MelcorREIT.ca**

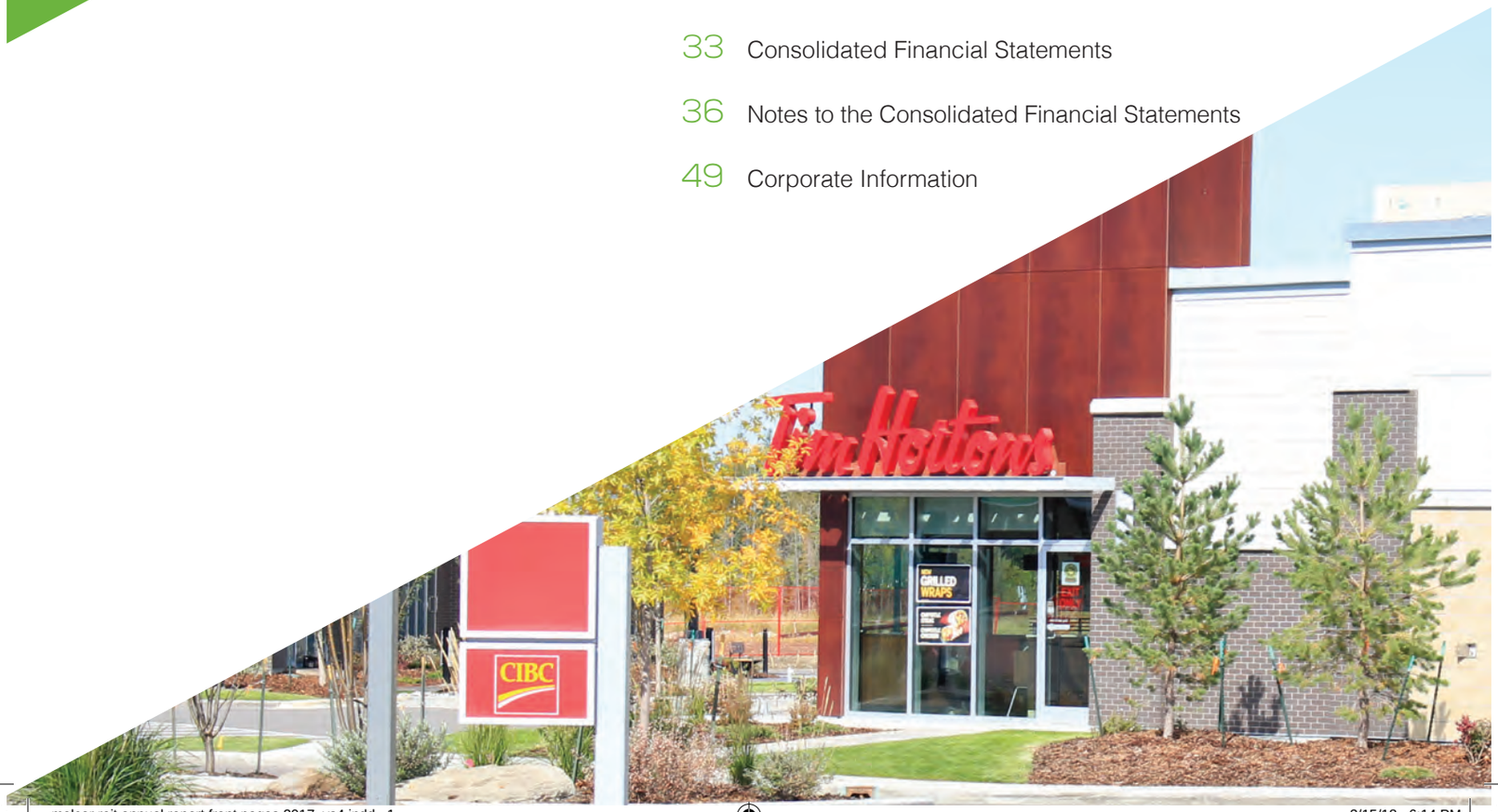
Suite 900, 10310 Jasper Avenue
Edmonton, AB T5J 1Y8
780-423-6931
1-855-673-6931
IR@MelcorREIT.ca
www.MelcorREIT.ca

MELCOR | REIT

MELCOR | REIT

# 2017






5 YEARS OF STRONG RETURNS

Ralph Young

## Message from the Chairman

I am pleased to report to you for the first time as Chairman of the Board of Trustees. May 2018 marks the fifth anniversary of the Melcor REIT. Our anniversary is a time to reflect on our results and our progress toward our goal of providing a solid platform for unitholders to invest in real estate assets. While we have faced headwinds with our focus on western Canadian assets, we have performed well in comparison with our peers in unit valuation and unitholder distributions.

During the year we have made significant transitions in the leadership of the REIT. We welcomed Andrew Melton as our President and Chief Executive Officer. As the founding Chair of the Board, he has overseen the creation and the strategic direction of the REIT and is well positioned to take on this leadership role. Darin Rayburn, our founding Chief Executive Officer was instrumental in guiding the REIT through its formation and growth. As the President and CEO of Melcor Developments Ltd., he remains actively involved in the success of Melcor REIT through his responsibilities to oversee the operating relationships and also as a member of our Board of Trustees.

We express our deep appreciation to Andrew and Darin for their continued successful leadership, which has enabled a seamless transition.

The relationship that we have with Melcor Developments Ltd. and the Melcor team is unique and beneficial. Melcor's 50 years as a public company provides a depth of experience through many market cycles. In addition to professionally managing, leasing and maintaining our properties, they also develop new commercial properties that fuel our future growth. With our fourth vend-in from Melcor completed in 2018, we've demonstrated again that this is a model that works to build the REIT to a more balanced and sustainable entity.

2017 was a year focused on sustainability, stability of distributions and modest growth, while managing the challenges of economic disruptions of office oversupply and retail realignments in our markets.

I would like to thank our Trustees for their governance, wisdom and oversight which has ensured that our unitholders and other stakeholders have been well served.

Finally, thank you to 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 continue to provide strong returns for our unitholders.







Andrew Melton

## Letter from the President & CEO

It is my privilege to report to you for the first time as your President and CEO and it is a special honor to hold this office as the REIT celebrates its fifth birthday and resumes its growth story.

Since our inception, we've witnessed all sorts of market conditions - the decline of oil and its impact on Alberta where the majority of our assets are, an influx of new office product in downtown Edmonton, where 12% of our portfolio is located, and new governments both provincially and nationally.

Against this backdrop we have consistently executed on our strategy, leading to stable results. We've paid out total distributions of $3.21 per unit to our unitholders. We've maintained occupancy of over 90% through some challenging markets. We've achieved our target of 95%+ on-time response on service calls for the past five years.

We've also grown our portfolio gross leasable area by 82% 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. We also acquired three assets from third parties and sold two assets, monetizing the value we created while at the same time diversifying our portfolio. Through these transactions, we've acquired 1.38 million square feet and sold 90,000.

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.

The vend-in completed in January 2018 further strengthens and diversifies our portfolio to position us well for 2018 and beyond. Through this vend-in, we added 128,301 square feet of retail and 44,328 square feet of industrial to our portfolio, both of which we have targeted for growth in our overall portfolio mix.

$3.21 TOTAL DISTRIBUTIONS PAID PER UNIT

## 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.

95%+
ON-TIME RESPONSE RATE

82%
GLA GROWTH

## Growth

Over the past 5 years, we've grown our REIT significantly – by 70% in asset value, 69% in revenue and 82% in gross leasable area, including the recently completed vend-in. In 2017 and early 2018, we also recycled capital with the sale of 2 buildings. We continue to look at opportunities to grow our portfolio via acquisition and densification and to recycle capital to strengthen our portfolio.

## Strategic Leasing

Our strategic leasing program resulted in 248,600 square feet in renewals and 91,900 square feet in new leasing in 2017. We continue to focus on leasing activity throughout our portfolio.





4
VEND-INS

## Outlook

We are seeing signs of an economic recovery. Retail continues to show strength and resilience. We are renewing leases and are 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 have seen so far this year across our portfolio.

With 16.1% of total GLA expiring in 2018, we are working towards securing early renewals, particularly on larger tenants. There can be no assurance that this strategy will be successful or that we will 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.

With a strong, diversified portfolio, focus on property management and client relationships, and a solid pipeline of over 6.68 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 Darin Rayburn for his years of services as CEO of the REIT, for launching it and guiding its growth and development for four years. I also thank Ralph Young for agreeing to be appointed as the Chair of the Board of Trustees. To our Trustees, thank you for your support and guidance to ensure a smooth transition of leadership.

Thank you also to the Melcor team for the exceptional roles you play in providing asset and property management to the REIT, building strong relationships with our clients and taking care of our properties with pride.

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

1.38M
SQUARE FEET ACQUIRED


# Corporate Governance

## 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 directors. The audit committee is 100% independent. The independent directors 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 director, 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.

## 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 and 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. 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 2017, trustees increased their holdings by 6% to an average of 68,757 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 2017 Information Circular.





## Board of Trustees



**Andrew Melton**
**Calgary, Alberta**

**RELATED**

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

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation[1]:** $nil
**Unitholdings:** 120,400
**Committees:** Investment



**Brian Hunt**
**Calgary, Alberta**

**INDEPENDENT**

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

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $49,000
**Unitholdings:** 40,000
**Committees:** Audit (Chair), Investment, Special



**Larry Pollock**
**Edmonton, Alberta**

**INDEPENDENT**

**Principal Occupation:** Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $44,000
**Unitholdings:** 75,800
**Committees:** Audit, Governance, Investment, Special (Chair)



**Ralph Young**
**Edmonton, Alberta**

**RELATED**

**Principal Occupation:** Chairman, Melcor REIT

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $32,621
**Unitholdings:** 23,800
**Committees:** None

**Darin Rayburn**
**Edmonton, Alberta**

**RELATED**

**Principal Occupation:** President & CEO, Melcor Developments Ltd.

**Trustee Since:** 2017
**Attendance:** 100%
**Compensation[1]:** $nil
**Unitholdings:** 133,702
**Committees:** Investment

**Donald Lowry ICD.D**
**Edmonton, Alberta**

**INDEPENDENT - LEAD TRUSTEE**

**Principal Occupation:** Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $48,385
**Unitholdings:** 59,600
**Committees:** Audit, Governance (Chair), Special

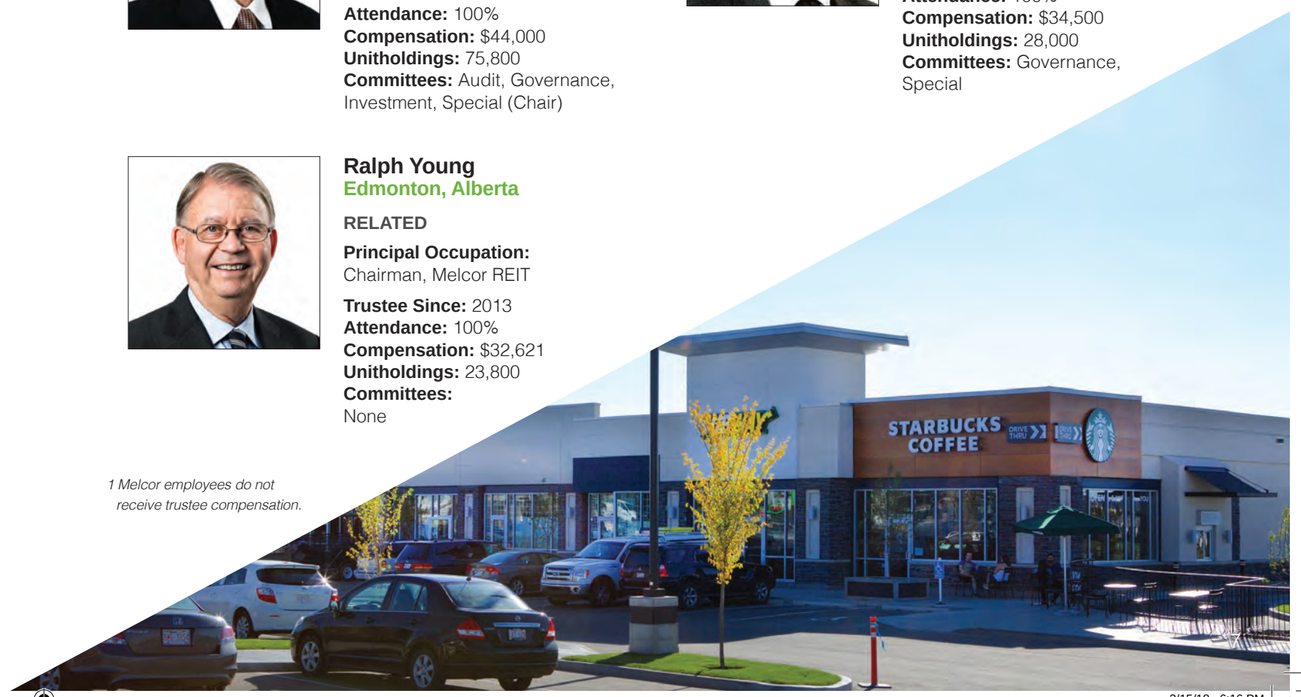
**Patrick Kirby**
**Edmonton, Alberta**

**INDEPENDENT**

**Principal Occupation:** Corporate Director

**Trustee Since:** 2013
**Attendance:** 100%
**Compensation:** $34,500
**Unitholdings:** 28,000
**Committees:** Governance, Special

*1 Melcor employees do not receive trustee compensation.*



## Table of Contents



# Management's Discussion & Analysis

March 1, 2018

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, 2017. 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 2016 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 1, 2018. Disclosure contained in this MD&A is current to March 1, 2018, unless otherwise indicated.

## 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 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 2018 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.

**Regulatory Filings**

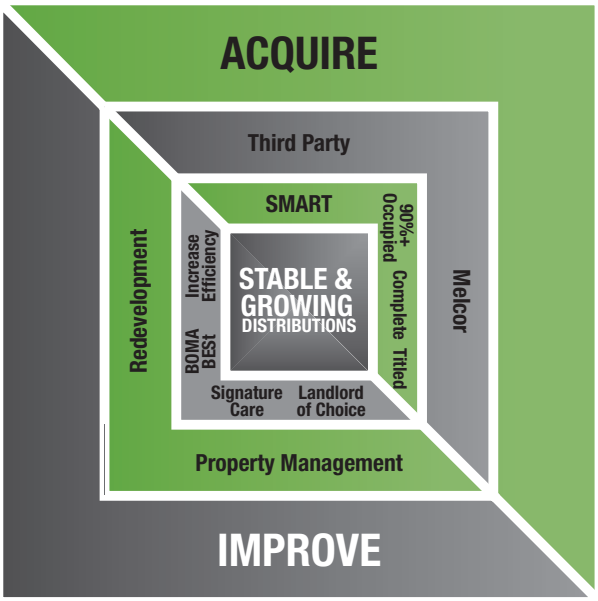
***Additional information about the REIT, including our annual information form, management information circular and quarterly reports, is available on our website at melcorREIT.ca and on SEDAR at sedar.com.***

# Our Business
## Vision, Goals & Strategy

The REIT has an established and diversified portfolio focused on western Canada. We currently own 37 income-producing office, retail and industrial properties representing 2.86 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

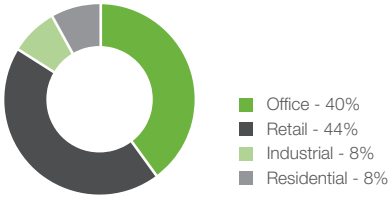
Our acquisition growth strategy is focused on:

- 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 6.68 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.

**Melcor GLA Under Development by Property Type**

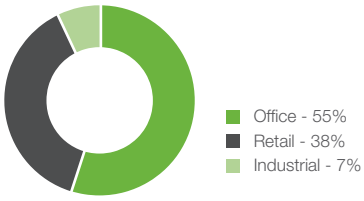



In 2017 we announced that the REIT had agreed to acquire 172,629 sf of GLA from Melcor (the Melcor Acquisition). These properties include additional phases at four existing properties and one new property. These recently constructed, high-quality properties were acquired for a purchase price of $80.88 million and represent our fourth acquisition from Melcor since IPO. Melcor currently has an additional 125,300 sf of GLA under development. The acquired properties add 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.

***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.

While we continue to actively pursue potential acquisitions, we did not complete any third party acquisitions in 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**




*The section titled Our Business: Vision, Goals & Strategy contains forward-looking statements. By their nature, forward-looking statements require us to make assumptions and are subject to inherent risks and uncertainties. Please refer to the Caution Regarding Forward-looking Statements on page 8.*

| SMART ACQUISITION STRATEGY | |
|---|---|
| **S**trategic<br>**M**arket<br>**A**ccretive<br>**R**ight Price<br>**T**argeted | **Acquisition Targets**<br>▪ Stable, accretive properties<br>▪ Penetrate existing geographic markets<br>▪ Expand into adjacent markets<br>▪ Properties with redevelopment and repositioning potential<br>**Acquisition & Integration Strengths**<br>▪ Proven due diligence process<br>▪ Agility to quickly execute on decisions<br>▪ Ability to close within 30 days (preferred access to unmarketed opportunities)<br>▪ Clustering of properties for efficient management & strong market knowledge |

## 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.

Our commitment to customer satisfaction shows in our 2017 survey of 2 office buildings. 100% of respondents rated our property management team as good, very good or excellent, and 100% rated our building operations team as good, very good or excellent.

This high level of satisfaction contributes to other metrics, such as our retention rate which was a healthy 80.6% in 2017.

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 EXPENDITURES STRATEGY | |
|---|---|
| PRESERVE | ▪ Inner works (boilers, roofs, maintenance)<br>▪ Maintain asset value through routine care<br>▪ Improve efficiencies through upgrades (lower building operating costs)<br>▪ Driven by annual building & equipment condition assessments |
| ENHANCE | ▪ Visible improvements such as common area upgrades, landscaping and aesthetics as well as improved comfort<br>▪ Upgrades that help lease buildings and retain tenants<br>▪ Driven by lease expiries/vacancies 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.

In February 2017, we received BOMA BESt certified Green & Responsible silver status on a sixth building. BOMA BESt is the leading environmental certification program for existing buildings in Canada.

### *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.

In 2017, we sold a 67,610 sf industrial property in Lethbridge, Alberta for gross proceeds of $8.00 million. The property was acquired by the REIT in 2014 from an unrelated third party. Over the past three years we improved the asset through 7,900 sf of new leasing, cultivation of strong tenant relationships and capital investment. Proceeds from the sale were used to repay amounts drawn under the revolving credit facility.

In January 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 owned by Melcor since 1974. Proceeds from the sale were used to repay amounts drawn under the revolving credit facility.

# Key Metrics & 2017 Accomplishments

| Metric | Target | 2017 |
|---|---|---|
| Debt/gross book value | 50-55% | 47% |
| Debt/gross book value including debenture | 55-60% | 56% |
| Tenant retention | 75% | 80.6% |
| Occupancy | 90%+ | 91.8% |
| Portfolio diversification | | |
| Retail | 40% | 36.1% |
| Office | 40% | 57.9% |
| Industrial | 20% | 6.0% |
| Weighted average base rent (by sf) | | |
| Retail | $18.50+ | $18.90 |
| Office | $14.00+ | $14.32 |
| Industrial | $8.00+ | $10.83 |
| Customer Care On-time Response | 95%+ | 99% |

# 2017 Highlights & Key Performance Indicators

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| ***Non-Standard KPIs*** | | | |
| Net operating income (NOI) | 42,101 | 42,329 | (1)% |
| Funds from operations (FFO) | 26,670 | 26,668 | — |
| Adjusted funds from operations (AFFO)[5] | 20,194 | 20,039 | 1% |
| Adjusted cash flows from operations (ACFO) | 19,969 | 19,812 | 1% |
| Rental revenue | 66,613 | 66,042 | 1% |
| Income before fair value adjustments | 13,742 | 13,586 | 1% |
| Fair value adjustment on investment properties[6] | (12,800) | (6,546) | nm |
| Distributions to unitholders | 7,527 | 7,527 | — |
| Cash flows from operations | 13,605 | 12,312 | 11% |
| Same-asset NOI | 41,398 | 41,351 | — |
| ***Per Unit Metrics*** | | | |
| Income (loss) - diluted | $0.07 | ($1.00) | |
| FFO | $1.04 | $1.03 | |
| AFFO[5] | $0.78 | $0.78 | |
| Distributions | $0.675 | $0.675 | |
| Payout ratio | 86% | 87% | |

| | As at December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Total assets ($000s) | 676,237 | 663,724 | 2% |
| Equity ($000s)[1] | 260,600 | 260,600 | — |
| Debt ($000s)[2] | 353,340 | 351,947 | — |
| Weighted average interest rate on debt | 3.75% | 3.63% | 3% |
| Debt to GBV, excluding convertible debentures (maximum threshold - 60%) | 47% | 50% | (6)% |
| Debt to GBV (maximum threshold - 65%) | 56% | 55% | 2% |
| Finance costs coverage ratio[3] | 2.93 | 2.88 | 2% |
| Debt service coverage ratio[4] | 2.60 | 2.65 | (2)% |

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 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 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.
5. We adopted REALpac's new guidance on AFFO in 2017 retroactive for the comparative period. See Adjusted Funds From Operations on page 16 for details.
6. The abbreviation nm is shorthand for not meaningful and is used through this MD&A where appropriate.

| | As at December 31 | | |
|---|---|---|---|
| | 2017 | 2016 | △% |
| ***Operational Highlights*** | | | |
| Number of properties | 37 | 38 | (3)% |
| Gross leasable area (GLA) (sf) | 2,710,862 | 2,775,782 | (2)% |
| Occupancy (weighted by GLA) | 91.8% | 92.4% | (1)% |
| Retention (weighted by GLA) | 80.6% | 71.0% | 14% |
| Weighted average remaining lease term (years) | 4.66 | 4.85 | (4)% |
| Weighted average base rent (per sf) | $15.88 | $15.73 | 1% |

## 2017 Highlights

Our portfolio performance remained steady throughout 2017. The stability and diversity of our portfolio with respect to both tenant profile and asset class position the REIT well for managing through economic cycles. We are focused on the real estate fundamentals of asset enhancement and property management while conservatively managing our debt. In 2017, we adopted REALpac's new guidance on AFFO retroactive to January 1, 2016, which resulted in a change from our previously reported payout ratios. We believe this is an improved disclosure and does not represent a fundamental change in our underlying results or strategy.

Highlights of our performance in the year include:

- We continued to execute on our proactive leasing strategy to both retain existing and attract new tenants. In 2017 we completed 340,546 sf in new and renewed leasing (including holdovers), achieving a retention rate of 80.6%.
- Same-asset NOI was steady over 2016, with 91.8% occupancy at December 31, 2017. Retail and office assets in Southern Alberta, British Columbia and Regina generated same-asset income and occupancy growth over 2016; offsetting downward trends within our Northern Alberta portfolio.
- We continue to experience negative market pressure on Edmonton downtown office space as approximately 1.8 million sf in new inventory comes online. Edmonton downtown office spaces makes up 12% of the REIT's GLA.
- Net income in the current and comparative periods were negatively impacted by non-cash fair value losses on investment properties due to an increase in capitalization rates and on Class B LP Units due to appreciation in the REIT's unit price. Management believes adjusted funds from operations (AFFO) is a better reflection of our true operating performance.
- AFFO was stable over 2016 at $20.19 million.
- We took advantage of favourable lending conditions and early re-financed $26.97 million in mortgages at an average interest rate of 3.39% in 2017. Early re-financing was a strategy employed to mitigate and re-balance our risk in 2018, reducing our percentage of mortgage maturing from 21% to 9%. An additional $7.44 million in new financings were completed in the year at an average interest rate of 3.70%.
- We paid monthly distributions of $0.05625 per trust unit during 2017 for an annual payout ratio of 86% (2016 - 87%).
- On December 21, 2017, we issued and sold $23.00 million in 5.25% convertible debentures and $17.30 million in subscription receipts at a price of $8.50 on a bought deal basis. The issuance was fully subscribed with the over-allotment options exercised in full. Proceeds were used to acquire an $80.88 million portfolio of commercial properties from Melcor, which closed January 12, 2018, and upon closing of such transaction all subscription receipts were converted into trust units. The Melcor Acquisition adds 128,301 sf to our retail portfolio in three existing and one new property and 44,328 sf to our industrial portfolio in one existing property. Both retail and industrial are targeted for growth in our overall portfolio mix.

## Consolidated Revenue & NOI

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Base rent | 41,019 | 41,673 | (2)% |
| Recoveries | 25,209 | 24,054 | 5% |
| Other | 2,373 | 2,372 | — |
| Amortization of tenant incentives | (3,062) | (3,216) | (5)% |
| Straight-line rent adjustments | 1,074 | 1,159 | (7)% |
| **Rental revenue** | 66,613 | 66,042 | 1 |
| Operating expenses | 12,802 | 12,822 | —% |
| Utilities and property taxes | 13,698 | 12,948 | 6% |
| **Direct operating expenses** | 26,500 | 25,770 | 3% |
| **Net rental income** | 40,113 | 40,272 | —% |
| **NOI** | 42,101 | 42,329 | (1)% |
| **Same-asset NOI** | 41,398 | 41,351 | —% |
| **Operating margin** | 60% | 61% | (2)% |

### *Revenue*

Rental revenue increased $0.57 million or 1% over 2016. Higher operating cost and realty tax recoveries ("recoveries") in 2017 are due to an increase in direct operating expenses. The sale of LC Industrial in April 2017 combined with slightly lower same-asset average occupancy resulted in a 2% decrease in base rent.

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 2017 we signed 340,546 sf of new and renewed leases (including holdovers) for occupancy of 91.8%. We exceeded our retention rate target, with the renewal of 80.6% of expiring leases (representing 77 leases) in spite of challenging market conditions in many of our operating regions.

The table below summarizes leasing activity for 2017:

| | Square feet | Weighted average base rent (per sf) | Occupancy |
|---|---|---|---|
| **Opening occupancy** | 2,564,822 | $15.73 | 92.40% |
| Expiring Leases | (308,365) | $15.72 | |
| Early Terminations | (50,160) | $13.06 | |
| Renewals/Holdovers | 248,603 | $15.56 | |
| New Leasing | 91,943 | $12.11 | |
| New GLA Developed | 8,341 | $— | |
| Other Adjustments | (67,610) | $8.68 | |
| **Closing occupancy** | 2,487,574 | $15.88 | 91.8% |

Weighted average base rent was $15.88 per sf at December 31, 2017, an increase of 1% compared to 2016. Excluding LC Industrial, which had a base rate of $8.68 base rates were down $0.04 over 2016. This reduction is primarily due to market conditions and significant new inventory creating downward pressure on downtown Edmonton office rates, partially offset by step-ups on leases with multiple rent escalations. Leasing activity across Alberta and increased industrial rates offset the rate compression in our office portfolio. Increases in weighted average base rents were tempered by the compression of net effective rent due to increases in tenant incentives.

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

| | 31-Dec-17 | 31-Dec-16 | △% |
|---|---|---|---|
| Weighted average base rent (per sf) | $15.88 | $15.73 | 1% |
| Weighted average remaining lease term | 4.66 | 4.85 | (4)% |
| GLA | 2,710,862 | 2,775,782 | (2)% |
| Occupancy | 91.8% | 92.4% | (1)% |
| Retention | 80.6% | 71.0% | 14% |

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. During 2017, recovery revenue was up 5% and direct operating expenses were up 3% over 2016. Our recovery ratio (calculated as recoveries divided by direct operating expenses) improved over 2016 on account of lower non-recoverable costs and additional income in 2017 related to 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. The decrease in straight-line rent adjustments is a result of rent-steps on escalating leases kicking in and fewer tenants on rent-free periods. Straight-line rent adjustments fluctuate due to the timing of signed leases.

### *Direct operating expenses*

Direct operating expenses were up 3% over 2016. A 5% increase in property taxes due to higher mill rates while the introduction of the carbon tax in Alberta effective January 1, 2017 contributed to an 8% increase in utilities. In spite of continued pressure on property taxes and utilities, we were able to hold operating expenses at 2016 levels in 2017. As a cornerstone of our property management strategy, we are committed to efficient and cost effective building maintenance 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.

Slightly lower average occupancy and the sale of LC Industrial contributed to the 1% decline in NOI. On a same-asset basis, NOI was stable over 2016 on account of improved recovery ratio.

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

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Same-asset NOI | 41,398 | 41,351 | — % |
| Disposition/Held for Sale/Development | 703 | 978 | |
| NOI | 42,101 | 42,329 | (1)% |
| Amortization of tenant incentives | (3,062) | (3,216) | |
| Straight-line rent adjustments | 1,074 | 1,159 | |
| Net rental income | 40,113 | 40,272 | — % |

## Property Profile

At December 31, 2017 our portfolio includes interests in 37 retail, office and industrial income-producing properties located in Western Canada for a total of 2,710,862 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 ($000s) | Net Rental Income ($000s) |
|---|---|---|---|---|---|
| Retail | 13 | 977,945 | 36.1% | 309,456 | 17,809 |
| Office | 20 | 1,569,154 | 57.9% | 290,057 | 19,481 |
| Industrial | 3 | 163,763 | 6.0% | 27,200 | 1,895 |
| Land Lease Community | 1 | 308 lots | n/a | 16,050 | 928 |
| | 37 | 2,710,862 | 100.0% | 642,763 | 40,113 |

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

| | Retail | | Office | | Industrial | | Land Lease Community | |
|---|---|---|---|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| *Year ended December 31 ($000s)* | | | | | | | | |
| Rental revenue | **26,337** | 25,798 | **36,500** | 35,983 | **2,471** | 2,960 | **1,305** | 1,301 |
| Net rental income | **17,809** | 17,477 | **19,481** | 19,423 | **1,895** | 2,404 | **928** | 968 |
| Same-asset NOI | **17,637** | 17,523 | **21,074** | 21,130 | **1,759** | 1,730 | **928** | 968 |
| *As at December 31* | | | | | | | | |
| Average base rent (sf) | **$18.90** | $19.04 | **$14.32** | $14.43 | **$10.83** | $9.61 | **n/a** | n/a |
| Occupancy | **96.0%** | 96.3% | **88.3%** | 88.9% | **100%** | 100% | **100%** | 100% |

***Retail*** - our 13 retail properties include 5 multi-building retail power centres and 8 neighborhood shopping centres. At December 31, 2017 Corinthia Plaza, a 23,179 sf neighborhood shopping centre was classified as held for sale and subsequently sold in January 2018. In May 2016 we built a new CRU at Westgrove Common, increasing GLA by 7,732 sf. Occupancy and average base rents have remained stable across the portfolio. Same-asset revenue and net rental income increased 2%, while NOI was up 1% as a result of improved recovery ratio, primarily the result of true-up of prior year recoveries. In January 2018 we acquired 128,301 sf of newly constructed grade A retail product as part of the Melcor Acquisition. The acquisition adds new phases at three existing properties and one new property, which is part of a multi-phased business park Melcor is developing in Calgary.

***Office*** - our 20 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. Increased competition due to new office buildings constructed in downtown Edmonton contributed to the decrease in average base rent. Comparatively, assets in our secondary markets (Lethbridge, AB; Regina, SK; and Kelowna, SK) realized an increase in revenues and margins, partially offsetting the downward pressure in Edmonton. Across the portfolio we completed 200,349 sf in new and renewed leasing, maintaining occupancy at 88.3%. Higher recoveries on direct operating costs and higher straight-line rent adjustments offset the decline in base rent resulting in a 1% increase in revenue over 2016, while net rental income and NOI were stable.

***Industrial*** - our 3 industrial properties include single and multi-tenant buildings. We divested LC Industrial in Q2-2017 as part of our capital recycling initiative. This sale contributed to the increase in average base rent. All industrial assets were 100% occupied through the end of 2017 (2016 - 100%). On a same-asset basis, rental revenue and NOI were stable. We continue to look for opportunities to expand our industrial portfolio as part of our diversification strategy and added 44,328 sf in January 2018 as part of the Melcor Acquisition.

***Land Lease Community*** – we have one land lease community in Calgary, AB consisting of 308 pad lots. It was 100% occupied at December 31, 2017 (2016 – 100%). Revenue on our land lease community was steady over 2016. NOI declined 4% over 2016 as a result of higher property taxes and utilities.

## Regional Analysis

The following table summarizes the composition of our properties at December 31, 2017 by geographic region:

| | Number of Properties | GLA (sf)/Lots | % of Portfolio (GLA) | Fair Value ($000s) | Net Rental Income ($000s) |
|---|---|---|---|---|---|
| Northern Alberta | 24 | 1,632,291 | 60.2% | 396,405 | 23,574 |
| Southern Alberta | 6 | 711,782 | 26.3% | 178,700 | 12,371 |
| Saskatchewan & British Columbia | 7 | 366,789 | 13.5% | 67,658 | 4,168 |
| | 37 | 2,710,862 | 100.0% | 642,763 | 40,113 |

The following table details key financial and operational metrics for each of our geographic regions for the year ended December 31, 2017:

| | Northern AB | | Southern AB | | SK & BC | |
|---|---|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| *Year ended December 31 ($000s)* | | | | | | |
| Rental revenue | **40,321** | 40,423 | **18,866** | 18,821 | **7,426** | 6,798 |
| Net rental income | **23,574** | 24,069 | **12,371** | 12,598 | **4,168** | 3,605 |
| Same-asset NOI | **24,585** | 25,206 | **12,349** | 12,108 | **4,464** | 4,037 |
| *As at December 31* | | | | | | |
| Average base rent (sf) | **$16.61** | $16.70 | **$15.38** | $14.67 | **$13.68** | $13.63 |
| Occupancy | **90.5%** | 92.2% | **94.4%** | 95.3% | **92.1%** | 87.2% |

***Northern Alberta*** - our Northern Alberta assets are located throughout the greater Edmonton area, including Leduc and Spruce Grove, and in Red Deer. Declines in Northern Alberta rental revenue and net rental income are primarily due to increased competition in downtown Edmonton office space creating downward pressure on rents and occupancy offset by higher recoveries on direct operating expenses. With approximately 22% of Northern Alberta leases up for renewal in 2018, we expect continued pressure on both occupancy and average base rents. Our leasing team continues to work proactively to engage existing tenants and attract new tenants.

***Southern Alberta*** - our Southern Alberta assets are located throughout the greater Calgary area, including Chestermere and Airdrie, and in Lethbridge. The sale of LC Industrial in Q2-2017 resulted in a $0.45 million decrease in rental revenue in 2017 and contributed to higher average base rents. Our 449,682 sf office and retail property in Lethbridge, Alberta drove growth for the region with an increase of 8% in annual revenues and 9% in NOI.

Step ups in rent escalations and increasing office occupancy resulted in stable revenue over 2016.

***Saskatchewan and British Columbia*** - our Saskatchewan and British Columbia assets are located in Regina, SK and Kelowna, BC. Rental revenue was up 9% over 2016 as a result of higher occupancy and improved recovery ratio.

## General & Administrative Expense

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Asset management fee | 1,583 | 1,592 | (1)% |
| Professional fees | 413 | 412 | —% |
| Public company costs | 293 | 244 | 20% |
| Other | 429 | 405 | 6% |
| | 2,718 | 2,653 | 2% |

General & administrative (G&A) expense was $2.72 million (4% of rental revenue) in 2017. Public company costs were up over 2016 due to additional trustee compensation for extra meetings. Other expenses can fluctuate from period to period due to the timing of costs incurred. We are committed to prudent financial stewardship, including carefully monitoring discretionary G&A expenses to ensure maximum value to our unitholders. We expect G&A to be approximately 5% of rental revenue.

## Finance Costs

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Interest on mortgages payable and revolving credit facility | 8,160 | 8,564 | (5)% |
| Interest on Class C LP Units | 2,858 | 3,080 | (7)% |
| Amortization of fair value adjustment on Class C LP Units | (225) | (227) | (1)% |
| Interest on convertible debentures | 1,931 | 1,898 | 2% |
| Interest on subscription receipts | 114 | — | 100% |
| Fair value adjustment on derivative instruments | (521) | (54) | nm |
| Amortization of deferred financing fees | 1,011 | 887 | 14% |
| Finance costs before distributions | 13,328 | 14,148 | (6)% |
| Distributions on Class B LP Units | 9,866 | 9,866 | —% |
| Finance costs | 23,194 | 24,014 | (3)% |

Finance costs were down $0.82 million or 3% compared to 2016. Excluding the swing in fair value adjustments on the derivative instruments, finance costs declined 1%. Interest on mortgages payable and our revolving credit facility decreased primarily as a result of lower average amounts drawn under our credit facility, combined with a decrease in interest rates on certain mortgage re-financings completed during the year. Interest on Class C LP Units was down over the comparative period due to the repayment of the maturing balance on 295,327 Class C LP Units in August 2017 as well as the reduced interest rate on the extension of 997,220 Class C LP Units in August 2016.

On December 21, 2017, the REIT completed the public offering of $23.00 million in convertible debentures (2017 Debentures) and $17.30 million in subscription receipts, which converted to trust units on the closing of the Melcor Acquisition on January 12, 2018. Holders of subscription receipts were entitled to receive cash payments equivalent to distributions declared by the REIT in the period they were outstanding.

The 2017 Debentures pay a coupon of 5.25% annually. The $34.50 million 2014 Debentures pay a coupon of 5.50% annually.

Distributions on Class B LP Units were unchanged over 2016 at $9.87 million. Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units which were $0.675 per unit during the year.

Non-cash finance costs increased over 2016 as a result of fully unwinding the discount recognized on a 2014 mortgage assumption which was re-refinanced during Q1-2016. This was partially offset by higher amortization of deferred finance costs on recent re-financings.

We recognized a fair value gain of $0.52 million in 2017 on our derivative instruments. Rising interest rates resulted in an appreciation 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 modest decline in the value of the conversion features on our convertible debentures.

As at December 31, 2017, the weighted average interest rate on our revolving credit facility, mortgages payable, Class C LP Units and convertible debenture was 3.75% based on period end balances (December 31, 2016 – 3.63%).

## Income Taxes

As at December 31, 2017, 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.

## Funds From Operations, Adjusted Funds From Operations and Adjusted Cash Flow From Operations

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.

### *Funds from operations & adjusted funds from operations*

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.

In February 2017, REALpac issued a White Paper which defines AFFO as FFO, adjusted for, among other things, straight-line rent adjustments, capital expenditures, tenant incentives and leasing commissions. The REIT adopted REALpac's new guidance on AFFO retroactive to January 1, 2017 during Q2-2017. The REIT's previous definition of AFFO included adjustments for amortization of deferred financing fees and the net impact of amortization of fair value adjustment and interest subsidy, which are no longer included. In addition, the guidance provided on capital expenditures, tenant incentives and leasing commissions allows for use of a reserve; however, is weighted more heavily toward historical results than projected results. Due to the fact that the REIT was newly formed on May 1, 2013, our previous determination of these reserves was based on a percentage of NOI over a 10 year projected horizon. Based on the new guidance we have reassessed our reserves as follows:

- 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). Normalized capital expenditures include only costs related to sustaining/maintaining existing space, including space acquired during the historical period.
- Normalized tenant incentives and leasing commissions 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).

Refer to additional commentary on capital expenditures and tenant incentives and leasing commissions as included below.

The comparative period has been restated to comply with the new definition of AFFO, which resulted in AFFO of $20.04 million or $0.78 per unit (previously $22.28 million or $0.86 per unit) and a payout ratio of 87% (previously 78%).

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 flows 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.

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s, except per unit amounts)* | 2017 | 2016 | △% |
| Net income (loss) for the year | 732 | (11,176) | |
| Add / (deduct) | | | |
| Fair value adjustment on investment properties | 12,800 | 6,546 | |
| Fair value adjustment on Class B LP Units | 731 | 18,270 | |
| Amortization of tenant incentives | 3,062 | 3,216 | |
| Distributions on Class B LP Units | 9,866 | 9,866 | |
| Fair value adjustment on derivative instruments | (521) | (54) | |
| **Funds From Operations (FFO)** | 26,670 | 26,668 | —% |
| Deduct | | | |
| Straight-line rent adjustments | (1,074) | (1,159) | |
| Normalized capital expenditures | (2,312) | (2,298) | |
| Normalized tenant incentives and leasing commissions | (3,090) | (3,172) | |
| **Adjusted Funds from Operations (AFFO)** | 20,194 | 20,039 | 1% |
| **FFO/Unit** | $1.04 | $1.03 | |
| **AFFO/Unit** | $0.78 | $0.78 | |

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:

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s, except per unit amounts)* | 2017 | 2016 | △% |
| **Funds From Operations (FFO)** | 26,670 | 26,668 | —% |
| Interest on convertible debentures | 1,931 | 1,898 | |
| Amortization of deferred financing fees on convertible debentures | 549 | 503 | |
| **Funds From Operations - Diluted (FFO - Diluted)** | 29,150 | 29,069 | —% |
| **FFO - Diluted/Unit** | $1.02 | $1.02 | |

### *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.

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Investment in property improvements and development | 2,315 | 3,869 |
| Less development | — | (1,641) |
| Less non-recoverable | — | — |
| Actual capital expenditures | 2,315 | 2,228 |
| Normalized capital expenditures | 2,312 | 2,298 |
| Variance | 3 | (70) |

## 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.

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Actual tenant incentives and direct leasing expenditures | 3,385 | 3,410 |
| Normalized tenant incentives and direct leasing expenditures | 3,090 | 3,172 |
| Variance | 295 | 238 |

## Adjusted cash flows from operations

In February 2017, REALpac issued a White Paper defining ACFO as a new metric. ACFO is an additional measure of sustainable, economic cash flow. The White Paper defines ACFO as cash flows from operations adjusted for, among other things, changes in operating assets and liabilities, payments of tenant incentives and direct leasing costs, amortization of deferred financing fees, normalized capital expenditures and normalized tenant incentives and direct leasing costs. We calculate ACFO substantially in accordance with the guidelines set out by REALpac; however, there is no specific adjustment defined for the effects of puttable instruments classified as financial liabilities such as the distributions on Class B LP Units, which is a departure from REALpac guidance. We consider the current presentation to be more meaningful as we do not consider distributions on Class B LP Units to represent a true borrowing cost as the amounts are payable only to the extent of those declared on trust units, both of which are at the discretion of the REIT's Board of Trustees.

In Q2-2017 the REIT adopted REALpac's guidance on ACFO retroactively to January 1, 2017 and for the comparative periods.

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| **Cash flows from operations** | 13,605 | 12,312 | 11% |
| Distributions on Class B LP Units | 9,866 | 9,866 | |
| Actual payment of tenant incentives and direct leasing costs | 3,192 | 3,410 | |
| Changes in operating assets and liabilities | (281) | 581 | |
| Amortization of deferred financing fees | (1,011) | (887) | |
| Normalized capital expenditures | (2,312) | (2,298) | |
| Normalized tenant incentives and leasing commissions | (3,090) | (3,172) | |
| **Adjusted Cash Flows from Operations (ACFO)** | 19,969 | 19,812 | 1% |

## Distributions

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 $7.53 million (2016 - $7.53 million).

Distributions made during the year ended December 31, 2017 represent a payout ratio of approximately 86% of AFFO (2016 - 87%). We 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 $6.08 million in 2017 (2016 - $4.79 million) as illustrated below.

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Cash flows from operations | 13,605 | 12,312 | 11% |
| Distributions on Class B LP Units | 9,866 | 9,866 | —% |
| Cash flows from operations before Class B LP Unit distributions | 23,471 | 22,178 | 6% |
| Distributions on unitholders | (7,527) | (7,527) | —% |
| Distributions on Class B LP Units | (9,866) | (9,866) | —% |
| Total Distributions | (17,393) | (17,393) | —% |
| Cash flows from operations before Class B LP Unit distributions less total distributions | 6,078 | 4,785 | 27% |
| Total distributions as a % of cash flows from operations before Class B LP Unit distributions | 74% | 78% | (5)% |

## Investment Properties

As at December 31, 2017 we owned 37 income-producing office, retail and industrial properties representing 2.71 million sf in GLA and a fair value of $642.76 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 |
|---|---|---|---|
| **Balance, December 31, 2016** | 659,611 | | 659,611 |
| Additions: | | | |
| Property improvements | 2,315 | — | 2,315 |
| Direct leasing costs | 800 | — | 800 |
| Tenant inducements additions | 2,585 | — | 2,585 |
| Dispositions | — | (7,760) | (7,760) |
| Reclassification of investment properties as held for sale | (14,455) | 14,455 | — |
| Straight-line rent adjustments | 1,074 | — | 1,074 |
| Amortization of tenant incentives | (3,062) | — | (3,062) |
| Fair value adjustment on investment properties | (12,837) | 37 | (12,800) |
| **Balance, December 31, 2017** | **636,031** | **6,732** | **642,763** |

***Disposition of LC Industrial*** – on April 28, 2017 we sold a 67,610 sf industrial property, LC Industrial, in Lethbridge, Alberta for $7.76 million (net of transaction costs). The property was 100% leased at the time of sale and anchored by provincial government tenants.

***Investment property held for sale*** – in 2017 we re-classified Corinthia Plaza as held for sale. As at December 31, 2017 the property was 86.9% occupied. In January 2018, the property sold for $6.73 million (net of transaction costs).

***Additions*** – during 2017 we invested $2.32 million in asset enhancement and preservation projects. 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. The majority of building improvement expenditures are recoverable from the tenants over 5-25 years. We also spent $3.39 million on tenant inducements and direct leasing costs in connection with 340,546 sf of leasing completed during the period.

***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:

| | 31-Dec-17 | 31-Dec-16 |
|---|---|---|
| Number of properties | **37** | 38 |
| Total GLA (sf) | **2,830,368** | 2,895,306 |
| GLA (REIT owned %) (sf) | **2,710,862** | 2,775,782 |
| Fair value of portfolio ($000s) | **642,763** | 659,611 |
| Value per square foot | **$237** | $238 |
| NOI ($000s) | **42,101** | 42,329 |
| Weighted average capitalization rate | **6.68%** | 6.63% |
| Weighted average terminal cap rate | **6.79%** | 6.83% |
| Weighted average discount rate | **7.75%** | 7.70% |

For the year ended December 31, 2017, Melcor's internal valuation team performed the valuation assessment. In 2017, 27 phases of 46 legal phases with a fair value of $392.70 million were valued by qualified independent external valuation professionals. Valuations performed during the year resulted in fair value losses of $12.80 million. In 2016, 22 phases of 47 legal phases with a fair value of $287.00 million were valued by qualified independent external valuation professionals, resulting in a fair value loss of $6.55 million. Refer to note 27 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:

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | **2017** | **2016** | **$△** |
| Northern Alberta | **(16,959)** | (3,773) | (13,186) |
| Southern Alberta | **4,710** | (3,322) | 8,032 |
| Saskatchewan & British Columbia | **(551)** | 549 | (1,100) |
| | **(12,800)** | (6,546) | (6,254) |

Fair value losses in Northern Alberta were primarily driven by continued pressure on Edmonton office capitalization rates, which increased 25 to 100 basis points over Q4-2016 on certain properties. The significant drop is the result of recent asset transactions on comparable properties. Capitalization rates on retail assets have remained stable through 2017; however, lower projected market rents resulted in fair value losses on two retail properties in the greater Edmonton area. Fair value gains in Southern Alberta were the result of the sale of LC Industrial in Q2-2017 where the sale price exceeded the carrying value. We also realized fair value gains on certain office and retail assets in the portfolio as a result of higher NOI. 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 (refer to discussion above). 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, 2017 | | | December 31, 2016 | | |
|---|---|---|---|---|---|---|
| | Min | Max | Weighted Average | Min | Max | Weighted Average |
| Capitalization rate | 5.50% | 8.75% | 6.68% | 5.50% | 8.75% | 6.63% |
| Terminal capitalization rate | 5.75% | 9.00% | 6.79% | 5.75% | 9.00% | 6.83% |
| Discount rate | 6.50% | 9.75% | 7.75% | 6.50% | 9.75% | 7.70% |

A capitalization rate increase of 50 basis points (+0.5%) would decrease the fair value of investment properties by $44.31 million (2016 - $46.37 million) while a 50 basis points decrease (-0.5%) would increase it by $51.48 million (2016 - $53.94 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:

| | Year ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | $△ |
| Cash from operating activities | 13,605 | 12,312 | 1,293 |
| Cash from (used in) investing activities | 1,905 | (2,828) | 4,733 |
| Cash used in financing activities | (4,951) | (7,854) | 2,903 |
| Increase in cash and cash equivalents | 10,559 | 1,630 | 8,929 |
| Cash and cash equivalents, beginning of year | 1,630 | — | 1,630 |
| Cash and cash equivalents, end of year | 12,189 | 1,630 | 10,559 |

### *Operating activities*

Cash from operating activities increased $1.29 million over 2016 as a result of adjustments for working capital and expenditures on tenant incentives and direct leasing costs. Our tenant incentives and direct leasing cost investments were $3.19 million in the year (2016 - $3.41 million) as we completed 340,546 sf of new and renewed leasing, resulting in year-end occupancy of 91.8%. 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 were up $0.21 million over 2016. Lower average indebtedness resulted in a $0.48 million reduction in cash finance costs (finance costs less non-cash adjustments) during the year. Interest savings were partially offset by a decrease in NOI as a result of the sale of LC Industrial.

### *Investing activities*

During 2017, we invested $2.32 million in our capital program (2016 - $2.23 million). Asset enhancement investments fluctuate based on the nature and timing of projects undertaken and whether execution of a project is impacted by weather.

During 2016, we invested $1.64 million to construct a 7,732 sf single-tenant CRU at an existing regional shopping center.

On April 27, 2017, we disposed of LC Industrial in Lethbridge, Alberta for a sale price of $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.

During 2016, we recognized $1.04 million in cash inflows on the expiration of our restricted cash covenant with the underwriters, thus allowing us to use the remaining balance for general purposes.

### *Financing activities*

On December 21, 2017, we received net proceeds of $21.54 million from the issuance of the 2017 Debentures. We also received gross proceeds of $17.30 million from the issuance of subscription receipts. These were used to fund the Melcor Acquisition on January 12, 2018. The subscription receipts were held in escrow pending the close of the Melcor Acquisition and are presented as restricted cash as at December 31, 2017.

During 2017, we re-financed the mortgages on three properties with principal balances of $23.08 million for $3.89 million net proceeds. In September 2017, we financed a previously unencumbered commercial property for gross proceeds of $3.74 million. In August 2017, we repaid the maturing balance on 295,327 Class C LP Units with a carrying value of $2.58 million on one of our retail properties by issuing a $3.70 million mortgage. Partial proceeds from mortgage financings in the current period combined with cash proceeds from the sale of LC Industrial were used to repay amounts drawn under our revolving credit facility. During 2016, we re-financed the mortgages on two properties with a principal balance of $19.20 million for $7.30 million net proceeds. We also obtained mortgage financing on a recently acquired and previously unencumbered property for proceeds of $2.80 million. Partial proceeds from mortgage financings were used to repay amounts drawn under the revolving credit facility.

During 2016, we recognized $1.25 million in cash inflows related to the expiration of our restricted cash covenant with the underwriters, thus allowing us to use the remaining balance for general purposes.

We continued our monthly distribution of $0.05625 per unit for total annual distributions of $7.53 million to unitholders (2016 - $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 to purchase investment properties.

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, 2017, we had $12.19 million in cash and cash equivalents and $16.96 million in restricted cash in addition to funds available under our revolving credit facility. On January 12, 2018 we used $34.03 million to complete the Melcor Acquisition.

## 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 47% as at December 31, 2017 (56% including the convertible debenture).

As at December 31, 2017, the REIT's total capitalization was $613.94 million and is comprised as follows:

| *($000s)* | 31-Dec-17 |
|---|---|
| Revolving credit facility[1] | — |
| Mortgages payable[1] | 218,332 |
| Class C LP Units[2] | 73,838 |
| Mortgage payable held for sale | 3,670 |
| **Indebtedness, excluding convertible debentures** | **295,840** |
| Convertible debentures[3] | 57,500 |
| **Indebtedness** | **353,340** |
| Class B LP Units[4] | 147,708 |
| Trust units | 112,892 |
| **Equity** | **260,600** |
| **Total capitalization** | **613,940** |
| **Gross Book Value ("GBV")[5]** | **630,832** |
| Debt to GBV, excluding convertible debentures (maximum threshold - 60%) | 47% |
| 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. An additional 1,331,202 Class C LP Units, representing $13,312 in Retained Debt were issued in January 2018 as part of the Melcor Acquisition.
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 subject to financial covenants on our $35.00 million revolving credit facility, including:

- 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.

As at December 31, 2017, 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, 2017, and throughout the period, we were in compliance with 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.

### *Indebtedness*

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

| *($000s)* | Revolving credit facility [1] | Mortgages payable[2] | Class C LP Units | Convertible debentures | Total | % of portfolio |
|---|---|---|---|---|---|---|
| **Total** | — | **218,332** | **73,838** | **57,500** | **349,670** | **100%** |
| 2018 | — | 24,348 | 14,637 | — | 38,985 | 11% |
| 2019 | — | 66,973 | 9,634 | 34,500 | 111,107 | 33% |
| 2020 | — | 9,578 | 26,299 | — | 35,877 | 10% |
| 2021 | — | 34,693 | 8,088 | — | 42,781 | 12% |
| 2022 | — | 29,164 | 673 | 23,000 | 52,837 | 15% |
| Thereafter | — | 53,576 | 14,507 | — | 68,083 | 19% |

1. There was $nil drawn on the line of credit at December 31, 2017.
2. Mortgage payable held for sale is excluded from the table above and was settled in 2018 through sale.

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.

Our revolving credit facility matures May 1, 2018, with an extension option of up to three years at the discretion of the lenders. We expect to be able to be able to renew the facility.

In September 2017 we obtained new mortgage financing on a previously unencumbered asset for $3.74 million at an interest rate of 3.69%. During 2017 we also re-financed three mortgages scheduled to mature in 2018, securing $26.97 million in gross proceeds ($3.89 million net) at an average interest rate of 3.39% (previously 3.96%). We re-financed these mortgages early to spread re-financing out and reduce our risk of re-financing at less favourable rates and terms. No mortgages were scheduled to mature in 2017, while 21% of our portfolio mortgage balance was set to mature in 2018. We had one scheduled Class C LP Unit maturity in 2017 which was financed in the third quarter for $3.70 million at an interest rate of 3.72%. Proceeds were used to repay the existing Class C LP Units held by Melcor (295,327 units) with a carrying value of $2.58 million and interest rate of

3.13%. We continue to look ahead to 2018 and 2019 maturities to identify opportunities to reduce risks related to re-financing.

***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 | Mortgages payable | Class C LP Units | Convertible debenture | Total |
|---|---|---|---|---|---|
| **Total** | — | **218,332** | **73,838** | **57,500** | **349,670** |
| Fixed | — | 200,728 | 73,838 | 57,500 | **332,066** |
| Variable | — | 17,604 | — | — | **17,604** |
| Weighted average interest rate | —% | 3.40% | 3.39% | 5.40% | **3.75%** |
| Weighted average term to maturity | 0.33 | 3.91 | 2.91 | 3.20 | **3.83** |

The weighted average interest rate on our debts increased to 3.75% (December 31, 2016 - 3.63%) as a result of issuance of the 2017 Debentures, which bear interest at an annual rate of 5.25%.

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 year. 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 debts. These metrics are not calculated for purposes of covenant compliance on any of our debt facilities.

| *($000s)* | 2017 | 2016 |
|---|---|---|
| FFO | **26,670** | 26,668 |
| Principal repayments on Mortgages payable | **6,751** | 6,491 |
| Principal repayments on Class C LP Units | **3,489** | 3,590 |
| **Debt service coverage ratio** | **2.60** | 2.65 |
| FFO plus finance costs | **40,519** | 40,870 |
| Finance costs[1] | **13,849** | 14,202 |
| **Finance costs coverage ratio** | **2.93** | 2.88 |

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.

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)* | December 31, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Units | $ Amount | Units | $ Amount |
| **Balance, end of year** | **11,151** | **112,892** | 11,151 | 112,892 |
| *Dilutive securities* | | | | |
| Class B LP Units | **14,616** | **147,708** | 14,616 | 147,708 |
| Convertible debentures | **4,727** | **57,500** | 2,727 | 34,500 |
| **Diluted balance, end of year** | **30,494** | **318,100** | 28,494 | 295,100 |

On January 12, 2018, the REIT issued 283,447 Class B LP Units at a price of $8.82 as partial consideration for the Melcor Acquisition. Concurrent with the closing of the Melcor Acquisition, the REIT issued 2,035,500 trust units in exchange for each subscription receipt previously issued.

## *Off Balance Sheet Arrangements*

As at December 31, 2017, we had no off-balance-sheet arrangements.

# Quarterly Results

| 2017 | Q4 | Q3 | Q2 | Q1 |
|---|---|---|---|---|
| Revenue ($000s) | 16,263 | 16,791 | 16,559 | 17,000 |
| Net income (loss) ($000s) | 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 (AFF) ($000s)[2] | 4,567 | 5,158 | 5,219 | 5,250 |
| ***Per unit metrics*** | | | | |
| Income (loss) - diluted[1] | $0.35 | $0.25 | $(0.16) | $(1.21) |
| FFO | $0.23 | $0.27 | $0.27 | $0.26 |
| AFFO[2] | $0.18 | $0.20 | $0.20 | $0.21 |
| 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 (%)[3] | 7.93% | 7.63% | 7.62% | 7.94% |

| 2016 | Q4 | Q3 | Q2 | Q1 |
|---|---|---|---|---|
| Revenue ($000s) | 16,170 | 16,439 | 16,807 | 16,626 |
| Net income (loss) ($000s) | 2,790 | 153 | (4,153) | (9,966) |
| Funds from operations (FFO) ($000s) | 6,306 | 6,843 | 6,822 | 6,697 |
| Adjusted funds from operations (AFF) ($000s)[2] | 4,723 | 5,174 | 5,158 | 4,984 |
| ***Per unit metrics*** | | | | |
| Income (loss) - diluted[1] | $0.10 | $0.01 | $(0.37) | $(0.89) |
| FFO | $0.24 | $0.27 | $0.26 | $0.26 |
| AFFO[2] | $0.18 | $0.20 | $0.20 | $0.19 |
| Annualized distribution rate | $0.675 | $0.675 | $0.675 | $0.675 |
| Payout ratio | 92% | 84% | 84% | 87% |
| Period-end closing unit price | $8.46 | $8.67 | $8.50 | $8.00 |
| Annualized distribution yield on closing unit price (%)[3] | 7.98% | 7.79% | 7.94% | 8.44% |

1. Net income (loss) is significantly impacted by the results of non-cash fair value adjustments on assets and liabilities carried at fair value. 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 2017 retroactive for the comparative period. See Adjusted Funds From Operations on page 16 for details.
3. Annualized distribution yield is calculated as the annualized distribution rate divided by the period-end closing unit price.

# Fourth Quarter Results

## Consolidated Revenue & NOI

| | Three months ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Base rent | 10,178 | 10,403 | (2)% |
| Recoveries | 6,232 | 5,766 | 8% |
| Other | 560 | 572 | (2)% |
| Amortization of tenant incentives | (781) | (787) | (1)% |
| Straight-line rent adjustment | 74 | 216 | (66)% |
| **Rental revenue** | 16,263 | 16,170 | 1% |
| | | | |
| Operating expenses | 3,334 | 3,415 | (2)% |
| Utilities and property taxes | 3,399 | 3,075 | 11% |
| **Direct operating expenses** | 6,733 | 6,490 | 4% |
| | | | |
| **Net rental income** | 9,530 | 9,680 | (2)% |
| **NOI** | 10,237 | 10,251 | —% |
| **Same-asset NOI** | 10,134 | 10,033 | 1% |
| **Operating margin** | 59% | 60% | (2)% |

Fourth quarter rental revenue increased 1% to $16.26 million over Q4-2016 due to higher recoveries on direct operating expenses. Fourth quarter base rent was down due to the sale of LC Industrial in Q2-2017 and a decline in portfolio occupancy, which also resulted in a 2% decrease in operating margins in the quarter. Operating expenses were down 2% over Q4-2016 as a result of lower non-recoverable costs offset by higher utilities and property taxes. Same-asset NOI was stable in the fourth quarter.

## General & Administrative Expense

| | Three months ended December 31 | | |
|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% |
| Asset management fee | 394 | 398 | (1)% |
| Professional fees | 137 | 89 | 54% |
| Public company costs | 69 | 39 | 77% |
| Other | 180 | 106 | 70% |
| | 780 | 632 | 23% |

Public company costs were up due to additional trustee compensation for extra meetings. Other expenses can fluctuate from period to period due to the timing of costs incurred.

## Finance Costs

| ($000s) | Three months ended December 31 2017 | 2016 | △% |
|---|---|---|---|
| Interest on mortgages payable and revolving credit facility | 2,051 | 2,078 | (1)% |
| Interest on Class C LP Units | 711 | 767 | (7)% |
| Amortization of fair value adjustment on Class C LP Units | (56) | (56) | —% |
| Interest on convertible debentures | 508 | 475 | 7% |
| Interest on subscription receipts | 114 | — | 100% |
| Fair value adjustment on derivative instruments | (182) | (268) | (32)% |
| Amortization of deferred financing fees | 234 | 276 | (15)% |
| **Finance costs before distributions** | 3,380 | 3,272 | 3% |
| Distributions on Class B LP Units | 2,467 | 2,467 | —% |
| **Finance costs** | 5,847 | 5,739 | 2% |

Finance costs for the fourth quarter were $5.85 million or 2% higher than Q4-2016. Excluding the swing in fair value adjustments on the derivative instruments, finance costs were steady over 2016. Interest on mortgages, our revolving credit facility and Class C LP Units were down 3% due to lower average amounts drawn under our credit facility, combined with interest rate reductions on certain re-financings completed during the year. Securities issued in connection with the Melcor Acquisition resulted in an increase in interest on convertible debentures as well as interest on subscription receipts.

## Funds From Operations & Adjusted Funds from Operations

| ($000s, except per unit amounts) | Three months ended December 31 2017 | 2016 | △% |
|---|---|---|---|
| Net income for the period | 11,723 | 2,790 | |
| Add / (deduct) | | | |
| Fair value adjustment on investment properties | (3,829) | 3,600 | |
| Fair value adjustment on Class B LP Units | (4,969) | (3,070) | |
| Amortization of tenant incentives | 781 | 787 | |
| Distributions on Class B LP Units | 2,467 | 2,467 | |
| Fair value adjustment on derivative instruments | (182) | (268) | |
| **Funds From Operations (FFO)** | 5,991 | 6,306 | (5)% |
| Deduct | | | |
| Straight-line rent adjustments | (74) | (216) | |
| Normalized capital expenditures | (578) | (640) | |
| Normalized tenant incentives and leasing commissions | (772) | (427) | |
| **Adjusted Funds from Operations (AFFO)**[1] | 4,567 | 5,297 | (3)% |
| **FFO/Unit** | 0.23 | 0.24 | |
| **AFFO/Unit**[1] | 0.18 | 0.21 | |

1. We adopted REALpac's new guidance on AFFO in 2017 retroactive for the comparative period. See Adjusted Funds from operations on page 16 for details.

FFO and AFFO were 5% and 3% lower in Q4-2017 than the comparative period as a result of the sale of LC Industrial in Q2-2017 combined with the drag in finance costs related to the Melcor Acquisition.

Fourth quarter distributions to unitholders were $1.88 million (2016 - $1.88 million).

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

| ($000s) | Three months ended December 31 2017 | 2016 | △% |
|---|---|---|---|
| Cash flows from operations | 3,326 | 3,078 | 8% |
| Distributions on Class B LP Units | 2,467 | 2,467 | |
| Actual payment of tenant incentives and direct leasing costs | 990 | 971 | |
| Changes in operating assets and liabilities | (688) | (206) | |
| Amortization of deferred financing fees | (234) | (276) | |
| Normalized capital expenditures | (578) | (574) | |
| Normalized tenant incentives and leasing commissions | (772) | (793) | |
| **Adjusted cash flows from Operations (ACFO)** | 4,511 | 4,667 | (3)% |

# 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 competitive pressure in the downtown office market in Edmonton with significant new supply coming online from 2016 - 2018. 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 91.8% compared to 92.4% at the end of the 2016. 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 16.1% of total GLA expiring in 2018, 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:

| | Revolving credit facility | Mortgages payable | Class C LP Units | Total |
|---|---|---|---|---|
| 2018 | — | 17,375 | 11,421 | **28,796** |
| 2019 | — | 60,653 | 6,576 | **67,229** |
| 2020 | — | 5,318 | 23,863 | **29,181** |
| 2021 | — | 30,513 | 7,181 | **37,694** |
| 2022 | — | 26,096 | — | **26,096** |
| Thereafter | — | 48,294 | 14,265 | **62,559** |
| Total | — | 188,249 | 63,306 | **251,555** |

| | FV of Collateral | Leverage (%) | Weighted Average Interest Rate |
|---|---|---|---|
| 2018 | 128,844 | 22% | **3.43%** |
| 2019 | 153,695 | 44% | **3.29%** |
| 2020 | 69,400 | 42% | **3.26%** |
| 2021 | 86,500 | 44% | **2.96%** |
| 2022 | 43,422 | 60% | **3.73%** |
| Thereafter | 139,811 | 45% | **3.38%** |
| Total | 621,672 | | |

*The section titled Outlook contains forward-looking statements. By their nature, forward-looking statements require us to make assumptions and are subject to inherent risks and uncertainties. Please refer to the Caution Regarding Forward-looking Statements on page 8.*

Over the next 12 months, four mortgages are up for renewal. These mortgages had an outstanding principal balance of $18.24 million and a weighted average interest rate of 3.33% at December 31, 2017. In addition, we have two properties encumbered by Class C LP Units where the underlying mortgages - held by Melcor - are up for renewal in the next 12 months. These Class C LP Units have an outstanding principal balance of $11.62 million and a weighted average interest rate of 4.37% (3.58% including interest rate subsidy). We expect to be able to re-finance these debts at market competitive terms.

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

Our revolving credit facility matures May 1, 2018, with an extension option of up to three years at the discretion of the lenders. We expect to be able to be able to renew the facility.

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 6.68 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 March 1, 2018. Consequently, the market value of 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 2016-2018.

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 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 flow 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 |
|---|---|---|---|---|
| 2018 | 91 | 437,397 | 16.1% | $13.64 |
| 2019 | 74 | 249,558 | 9.2% | $16.88 |
| 2020 | 74 | 245,839 | 9.1% | $17.95 |
| 2021 | 88 | 216,042 | 8.0% | $18.88 |
| 2022 | 68 | 255,395 | 9.4% | $14.53 |
| Thereafter | 164 | 1,083,345 | 40.0% | $14.41 |
| Vacant Space | — | 223,286 | 8.2% | — |
| | **559** | **2,710,862** | | |

The following table illustrates the 2018 maturities by property type and geographic area:

| | Northern AB | Southern AB | BC & SK | Total |
|---|---|---|---|---|
| Retail | 142,887 | 1,643 | 58,477 | **203,007** |
| Office | 186,375 | 25,208 | 22,807 | **234,390** |
| Industrial | — | — | — | **—** |
| | 329,262 | 26,851 | 81,284 | **437,397** |

## 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 2018 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 | Government of Alberta | 4.4% | 109,652 | 4.0% | 4 | 5 | A+ /Aa1/AA |
| 2 | Royal Bank of Canada | 3.7% | 60,515 | 2.2% | 2 | 5 | AA-/A1/AA |
| 3 | Shoppers Drug Mart | 2.9% | 44,228 | 1.6% | 9 | 3 | BBB/-/BBB |
| 4 | Alberta Health Services | 3.5% | 88,997 | 3.3% | 8 | 2 | --- |
| 5 | BasinTek LLC | 2.5% | 88,699 | 3.3% | 6 | 1 | --- |
| 6 | Fountain Tire Ltd. | 2.1% | 30,514 | 1.1% | 11 | 1 | --- |
| 7 | TD Bank | 1.6% | 25,675 | 0.9% | 4 | 4 | AA-/Aa1/AA |
| 8 | The Brick Warehouse LP | 1.5% | 39,481 | 1.5% | 5 | 3 | --- |
| 9 | Melcor Developments Ltd. | 1.3% | 35,820 | 1.3% | 4 | 3 | --- |
| 10 | Select Engineering Consultants Ltd. | 1.1% | 23,432 | 0.9% | 9 | 1 | --- |

## Significant Ownership by Melcor

Melcor holds a 56.7% (53.0% as of March 1, 2018) 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.

## 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 2017, we had three joint arrangements (2016 - three). Refer to note 22 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 JV% | | Joint arrangement activity at 100% | |
|---|---|---|---|---|
| *($000s)* | 31-Dec-17 | 31-Dec-16 | 31-Dec-17 | 31-Dec-16 |
| Revenue | 5,119 | 5,182 | 10,238 | 10,364 |
| Earnings | 2,596 | 3,559 | 5,192 | 7,118 |
| Assets | 62,001 | 61,417 | 124,002 | 122,834 |
| Liabilities | 32,192 | 30,802 | 64,384 | 61,604 |

## Related Party Transactions

Please refer to note 21 to the consolidated financial statements for information pertaining to transactions with related parties.

## Subsequent Events

### *Acquisition*

On January 12, 2018, the REIT closed the purchase of five newly-constructed commercial properties from Melcor for a total purchase price of $80.88 million. The purchase included cash, the assumption of mortgages and the issuance of Class B LP Units and Class C LP Units to Melcor. Upon closing the Melcor Acquisition, the REIT also issued 2,035,500 trust units in exchange for each subscription receipt previously issued and outstanding and the maturity date of the 2017 Debentures was extended to December 31, 2022. Melcor's interest in the REIT is now approximately 53.0%.

The Melcor Acquisition adds 128,301 sf to our retail portfolio in three existing and one new property and 44,328 sf to our industrial portfolio in one existing property. Both retail and industrial are targeted for growth in our overall portfolio mix. All properties acquired are in Alberta, with 86,470 sf in the Edmonton area and 86,159 sf in the Calgary area.

All acquired properties were 100% leased and, as newer construction, have longer lease terms remaining.

### *Disposition*

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.

In January 2018 we sold Corinthia Plaza, a 23,179 sf retail property in Leduc, Alberta for gross proceeds of $6.85 million. The REIT acquired Corinthia Plaza from Melcor in 2013 with the initial properties. Proceeds from the sale were used to repay amounts drawn under the revolving credit facility.

Please refer to note 28 to the consolidated financial statements for additional 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

Refer to note 5 to the consolidated financial statements for information pertaining to accounting pronouncements that will be effective in future years.

# 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, 2017. 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, 2017.

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, 2017, 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 and is available on request to all unitholders. At March 1, 2018, 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:

| | Three months ended December 31 | | | Year ended December 31 | | |
|---|---|---|---|---|---|---|
| *($000s)* | 2017 | 2016 | △% | 2017 | 2016 | △% |
| **Net income (loss)** | 11,723 | 2,790 | | 732 | (11,176) | |
| Net finance costs | 5,825 | 5,728 | | 23,132 | 23,979 | |
| Fair value adjustment on Class B LP Units | (4,969) | (3,070) | | 731 | 18,270 | |
| Fair value adjustment on investment properties | (3,829) | 3,600 | | 12,800 | 6,546 | |
| General and administrative expenses | 780 | 632 | | 2,718 | 2,653 | |
| Amortization of tenant incentives | 781 | 787 | | 3,062 | 3,216 | |
| Straight-line rent adjustment | (74) | (216) | | (1,074) | (1,159) | |
| **NOI** | 10,237 | 10,251 | —% | 42,101 | 42,329 | (1)% |

***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.

***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.

***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.

***Payout ratio:*** is calculated as per unit distributions divided by per unit 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 instrument.

***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 (including mortgage held for sale), Class C LP Units, excluding unamortized fair value adjustment on Class C LP Units 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 Trusts'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, CA**
Chief Financial Officer

Edmonton, Alberta | March 1, 2018

## Auditor's Report to Unitholders

We have audited the accompanying consolidated financial statements of Melcor Real Estate Investment Trust and its subsidiaries, which comprise the consolidated statements of financial position as at December 31, 2017 and December 31, 2016 and the consolidated statements of income (loss) and comprehensive income (loss), changes in unitholders' equity and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

### *Management's responsibility for the consolidated financial statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, 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.

### *Auditor's responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Melcor Real Estate Investment Trust and its subsidiaries as at December 31, 2017 and December 31, 2016 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP

**Chartered Professional Accountants**
Edmonton, Alberta | March 1, 2018

# Consolidated Statements of Financial Position

| *As at December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and cash equivalents | 12,189 | 1,630 |
| Restricted cash (note 11) | 16,956 | — |
| Accounts receivable | 1,764 | 1,364 |
| Other assets (note 8) | 1,161 | 1,009 |
| Assets held for sale (note 6) | 6,732 | — |
| | 38,802 | 4,003 |
| **Non-Current Assets** | | |
| Investment properties (note 7 and 27) | 617,278 | 641,365 |
| Other assets (note 8) | 18,753 | 18,246 |
| Loan receivable (note 7) | 900 | — |
| Derivative financial asset (note 12 and 27) | 504 | 110 |
| | 637,435 | 659,721 |
| **TOTAL ASSETS** | 676,237 | 663,724 |
| | | |
| **LIABILITIES** | | |
| **Current Liabilities** | | |
| Revolving credit facility (note 9) | — | 17,324 |
| Accounts payable | 1,649 | 1,516 |
| Distribution payable | 1,453 | 1,449 |
| Accrued liabilities and other payables (note 10 and 21) | 7,195 | 5,820 |
| Subscription receipts (note 11) | 16,623 | — |
| Class C LP Units (note 13) | 14,637 | 6,074 |
| Mortgages payable (note 12) | 24,348 | 6,821 |
| Liability held for sale (note 6) | 3,670 | — |
| | 69,575 | 39,004 |
| **Non-Current Liabilities** | | |
| Accrued liabilities and other payables (note 10) | 1,524 | 1,475 |
| Class B LP Units (note 15 and 27) | 124,381 | 123,650 |
| Class C LP Units (note 13) | 59,639 | 74,494 |
| Mortgages payable (note 12) | 192,892 | 212,045 |
| Convertible debentures (note 14) | 54,046 | 32,749 |
| Derivative financial liabilities (note 14 and 27) | 729 | 61 |
| **TOTAL LIABILITIES** | 502,786 | 483,478 |
| **UNITHOLDERS' EQUITY** | 173,451 | 180,246 |
| **TOTAL LIABILITIES AND UNITHOLDERS' EQUITY** | 676,237 | 663,724 |

See accompanying notes to the consolidated financial statements.

By order of the REIT's Board of Trustees:

Larry Pollock | Trustee

Ralph Young | Chairman

# Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Rental revenue (note 17 and 21) | 66,613 | 66,042 |
| Direct operating expenses (note 21) | (26,500) | (25,770) |
| Net rental income | 40,113 | 40,272 |
| General and administrative expenses (note 21) | (2,718) | (2,653) |
| Fair value adjustment on investment properties (note 7 and 27) | (12,800) | (6,546) |
| Fair value adjustment on Class B LP Units (note 15 and 27) | (731) | (18,270) |
| Income before finance costs | 23,864 | 12,803 |
| Interest income | 62 | 35 |
| Finance costs (note 18 and 21) | (23,194) | (24,014) |
| Net finance costs | (23,132) | (23,979) |
| Net income (loss) and comprehensive income (loss) | 732 | (11,176) |
| Basic earnings (loss) per trust unit (note 20) | $0.07 | ($1.00) |
| Diluted earnings (loss) per trust unit (note 20) | $0.07 | ($1.00) |

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 |
|---|---|---|---|---|---|
| **Balance at December 31, 2015** | 11,151,297 | 102,707 | 40,448 | 55,794 | 198,949 |
| Net loss for the year | — | — | — | (11,176) | (11,176) |
| Distributions to unitholders | — | — | — | (7,527) | (7,527) |
| **Balance at December 31, 2016** | 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) |
| **Balance at December 31, 2017** | 11,151,297 | 102,707 | 40,448 | 30,296 | 173,451 |

See accompanying notes to the consolidated financial statements.

# Consolidated Statements of Cash Flows

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| **CASH FLOWS FROM (USED IN)** | | |
| **OPERATING ACTIVITIES** | | |
| Net income (loss) for the year | 732 | (11,176) |
| Non cash items: | | |
| Amortization of tenant incentives (note 8 and 17) | 3,062 | 3,216 |
| Straight-line rent adjustments (note 17) | (1,074) | (1,159) |
| Fair value adjustment on investment properties (note 7 and 27) | 12,800 | 6,546 |
| Fair value adjustment on Class B LP Units (note 15 and 27) | 731 | 18,270 |
| Amortization of fair value adjustment on Class C LP Units (note 18) | (225) | (227) |
| Fair value adjustment on derivative financial instruments (note 18) | (521) | (54) |
| Amortization of deferred financing fees (note 18) | 1,011 | 887 |
| | 16,516 | 16,303 |
| Payment of tenant incentives and direct leasing costs | (3,192) | (3,410) |
| Changes in operating assets and liabilities (note 3(p)) | 281 | (581) |
| | 13,605 | 12,312 |
| **INVESTING ACTIVITIES** | | |
| Net proceeds from disposal of investment property (note 7) | 4,220 | — |
| Investment property improvements and development | (2,315) | (3,869) |
| Change in restricted cash (note 3(d)) | — | 1,041 |
| | 1,905 | (2,828) |
| **FINANCING ACTIVITIES** | | |
| Proceeds from issuing convertible debenture, net of costs (note 14) | 21,543 | — |
| Change in revolving credit facility | (17,480) | (1,821) |
| Proceeds from mortgages payable | 34,407 | 29,300 |
| Repayment of mortgages payable | (29,827) | (25,690) |
| Repayment on Class C LP Units | (6,067) | (3,363) |
| Change in restricted cash (note 3(d)) | — | 1,247 |
| Distributions to unitholders | (7,527) | (7,527) |
| | (4,951) | (7,854) |
| **INCREASE IN CASH & CASH EQUIVALENTS DURING THE YEAR** | 10,559 | 1,630 |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR** | 1,630 | — |
| **CASH AND CASH EQUIVALENTS, END OF THE YEAR** | 12,189 | 1,630 |

See accompanying notes to the consolidated financial statements.

# Notes to the Consolidated Financial Statements

*($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 21).

As at March 1, 2018, 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") as issued by the International Accounting Standard Board ("IASB").

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 1, 2018.

## 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 (2016 – three) with 50% interests. Refer to note 22 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 represents amounts held in escrow pending the closing of the Melcor Acquisition (note 11 and 28). During 2016 the REIT's restricted cash represented subsidies funded by Melcor as part of the IPO to subsidize finance costs on assumed debt and Class C LP Units, and to fund capital expenditures, environmental expenditures, tenant incentives and lease costs. On May 1, 2016 the term of the covenant elapsed, at which point the remaining restricted cash was re-classified to cash and cash equivalents.

### E. INVESTMENT PROPERTIES

Investment properties include commercial 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 valuators 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.

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 21), 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. Revenue from investment properties includes base rents, recoveries of operating expenses including property taxes, parking revenue and incidental income. 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 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. Recoveries from tenants are recognized as revenues in the period in which the corresponding costs are incurred. Other revenues are recorded as earned.

### 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 debenture, 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.

### 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:

#### *LOANS AND RECEIVABLES*
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans to third parties and receivables are initially recognized at fair value plus transaction costs. Subsequently, loans and receivables are measured at amortized cost using the effective interest rate method less a provision for impairment, if necessary. Loans and receivables are comprised of cash and cash equivalents, restricted cash, accounts receivable and loan receivable.

At each reporting date, we assess whether there is objective evidence that a financial asset is impaired, considering delinquencies in payments and financial difficulty of the debtor. The amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows discounted at the asset's original effective interest rate. The carrying amount of the asset is reduced through use of an allowance account. The amount of any losses is recognized in income.

#### *FINANCIAL LIABILITIES*
We record our financial liabilities at fair value on initial recognition. Subsequently, "other 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. Other liabilities include the revolving credit facility, 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 3(e). In applying this policy, judgment is required in determining whether certain costs are additions to the carrying amount of an investment property.

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 27 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 interpretation effective January 1, 2017.

***IAS 7, Statement of Cash Flows,*** was amended to require disclosures about changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

Additional disclosures (note 12 and 13) have been added to comply with this amended standard.

### NEW AND AMENDED STANDARDS NOT YET ADOPTED

***IFRS 15, Revenue from Contracts with Customers*** was issued in May 2014 by the IASB and 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.

IFRS 15 is to be applied to each prior reporting period presented retrospectively or through the recognition of the cumulative effect to opening retained earnings.

An amendment was issued in September 2015 to defer the effective date of IFRS 15 to the first interim period within years beginning on or after January 1, 2018.

Amendment to IFRS 15 was issued in April 2016 to clarify the guidance on identifying performance obligations, licenses of intellectual property and principal versus agent, and to provide additional practical expedients on transition. Amendments are effective for annual reporting periods beginning on or after January 1, 2018. We have completed our initial assessment of the impact of adopting this standard on our consolidated financial statements and no material changes are expected.

***IFRS 9, Financial Instruments*** was issued in its finalized version in July 2014 to replace IAS 39. The IASB has previously published versions of IFRS 9 that introduced a new classification and measurement model with only two classification categories, 'amortized cost' and 'fair value' (in 2009 and 2010), and a new hedge accounting model in 2013.

This final version introduces a third measurement category, '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. Additional disclosures on transition from IAS 39 to IFRS 9 will be required under IFRS 7, the application of which is effective on adoption of IFRS 9.

IFRS 9 is required to be applied for accounting periods beginning on or after January 1, 2018, with earlier adoption permitted. We are currently in the process of evaluating the impact this standard will have on our financial statements.

***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:

- All leases will be on the balance sheet of lessees, except those that meet the limited exception criteria;
- Rent expense for leases on the balance sheet will be recorded as depreciation and finance expenses;
- 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 are currently in the process of evaluating the impact this standard will have on our financial statements.

## 6. ASSETS HELD FOR SALE

As at December 31, 2017, we classified a retail property as an asset held for sale with a fair value of $6,732 (including investment property of $6,642, tenant incentives of $66 and straight line rent of $24) and associated mortgage payable of $3,670. As at December 31, 2017 management has committed to a plan of sale of the property, with a contract in place. Subsequent to year-end, the property was sold to a third party for a purchase price of $6,732 (net of transaction costs) (note 28).

## 7. INVESTMENT PROPERTIES

| *($000s)* | 2017 | 2016 |
|---|---|---|
| Balance - beginning of year | **641,365** | 643,421 |
| Additions | | |
| Property improvements | **2,315** | 2,228 |
| Property development activities | **—** | 1,641 |
| Direct leasing costs | **800** | 621 |
| Fair value adjustment on investment properties (note 27) | **(12,800)** | (6,546) |
| Investment property classified as held for sale during the year (note 6) | **(6,642)** | — |
| Invesment property disposed of during year | **(7,760)** | — |
| Balance - end of year | **617,278** | 641,365 |

In accordance with our policy, as detailed in note 3(e), 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 27.

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.

Presented separately from investment properties is $13,478 (December 31, 2016 - $14,021) in tenant incentives and $5,275 (December 31, 2016 - $4,225) 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)* | 2017 | 2016 |
|---|---|---|
| Within one year | **36,682** | 38,626 |
| Later than one year but not later than 5 years | **112,109** | 113,324 |
| Later than 5 years | **55,611** | 68,764 |
| | **204,402** | 220,714 |

## 8. OTHER ASSETS

| *($000s)* | 2017 | 2016 |
|---|---|---|
| **Current Assets** | | |
| Prepaid expense, and other | 1,161 | 1,009 |
| | | |
| **Non-Current Assets** | | |
| Straight-line rent adjustments | 5,275 | 4,225 |
| Tenant incentives | 13,478 | 14,021 |
| | 18,753 | 18,246 |

During the year we recorded tenant incentives of $2,585 (December 31, 2016 - $2,789) and $3,062 (December 31, 2016 - $3,216) of amortization expense respectively. During the year we also reclassified $66 in tenant incentives and $24 in straight line rent adjustments to asset held for sale (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

The REIT has an available credit limit based upon the carrying values of specific investment properties up to a maximum of $35,000 for general purposes, including a $5,000 swingline sub-facility. The agreement also provides the REIT with $5,000 in available letters of credit which bear interest at 2.25%. The facility matures on May 1, 2018, with an extension option of up to three years at the discretion of the lenders. Depending on the form under which the new facility is accessed, rates of interest will vary between prime plus 1.15% or bankers' acceptance plus 2.25% stamping fee. 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.

As at December 31, 2017, the carrying value of pledged properties was $56,258 (December 31, 2016 - $55,647). We initially capitalized $341 in transaction costs associated with the facility, of which $28, included in other assets, was unamortized at December 31, 2017 (December 31, 2016 - $114).

As at December 31, 2017 we had $nil (December 31, 2016 - $17,480) drawn from the facility; and posted letters of credit of $nil (December 31, 2016 - $nil). The weighted average effective interest rate on borrowings, based on December 31, 2016 period end balances is 3.48%.

The following table summarizes the components of the balance:

| *($000s)* | 2017 | 2016 |
|---|---|---|
| Amount drawn on facility | — | 17,480 |
| Unamortized transaction fees | — | (114) |
| Unamortized discount on bankers acceptance | — | (42) |
| | — | 17,324 |

## 10. ACCRUED LIABILITIES AND OTHER PAYABLES

| | 2017 | 2016 |
|---|---|---|
| **Current Liabilities** | | |
| Tenant security deposits and pre-payments | 2,488 | 2,404 |
| Accrued finance costs | 533 | 488 |
| Other accrued liabilities and payables | 4,174 | 2,928 |
| | 7,195 | 5,820 |
| **Non-Current Liabilities** | | |
| Decommissioning obligation | 1,524 | 1,475 |

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, 2016 - $2,014). At December 31, 2017, a discount rate of 4.00% (December 31, 2016 - 4.00%) and an inflation rate of 2.00% (December 31, 2016 - 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. SUBSCRIPTION RECEIPTS

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 entitle the holder to receive one trust unit of the REIT upon closing of the Melcor Acquisition from Melcor Developments Ltd. ("Melcor Acquisition") (note 28). While the subscription receipts remain outstanding, holders are entitled to receive cash payments per subscription receipt that are equivalent to distributions declared by the REIT on trust units. The gross proceeds, less 50% of the underwriter's fees, representing $16,956 are held in escrow pending the closing of the Melcor Acquisition and have been recorded as Restricted Cash. The remaining 50% of the underwriter's fee, representing $346, is payable upon closing of the Melcor Acquisition and has been disclosed as a contingent liability (note 24).

A reconciliation of the subscription receipts are as follows:

| *($000s)* | Amount |
|---|---|
| Gross proceeds | 17,302 |
| Accrued interest payable for distribution declared (note 18) | 114 |
| Transaction costs | (793) |
| | 16,623 |

## 12. MORTGAGES PAYABLE

| *($000s)* | 2017 | 2016 |
|---|---|---|
| Mortgages amortized over 15-25 years at fixed interest rates | 200,728 | 201,926 |
| Mortgage amortized over 25 years at a fixed interest rate (via a floating for fixed interest rate swap) | 17,604 | 18,136 |
| Unamortized deferred financing fees | (1,092) | (1,196) |
| | 217,240 | 218,866 |
| Current portion of mortgages payable | (24,348) | (6,821) |
| | 192,892 | 212,045 |
| Interest rate ranges | (2.48%-4.91%) | (2.48%-4.91%) |

Specific investment properties with a carrying value of $425,173 (December 31, 2016 - $428,272) 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 3.40% (December 31, 2016 – 3.45%).

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 |
|---|---|---|---|
| 2018 | 6,973 | 17,375 | 24,348 |
| 2019 | 6,320 | 60,653 | 66,973 |
| 2020 | 4,260 | 5,318 | 9,578 |
| 2021 | 4,180 | 30,513 | 34,693 |
| 2022 | 3,068 | 26,096 | 29,164 |
| Thereafter | 5,282 | 48,294 | 53,576 |
| | 30,083 | 188,249 | 218,332 |

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, 2017 the fair value of the interest rate swap contract is $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 27.

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

| *($000s)* | |
|---|---|
| Balance at December 31, 2016 | 218,866 |
| Principal repayments: | |
| Scheduled amortization on mortgages | (6,751) |
| Mortgage repayments | (23,076) |
| Mortgage payable disposed through sale during the year (note 7) | (2,640) |
| Mortgage payable classified as held for sale during the year (note 6) | (3,670) |
| New mortgages | 34,407 |
| Deferred financing fees capitalized | (195) |
| Amortization of deferred financing fees | 299 |
| Balance at December 31, 2017 | 217,240 |

## 13. 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, 2017 the carrying value of the Class C LP Units, included in the consolidated statement of financial position, were as follows:

| *($000s)* | 2017 | 2016 |
|---|---|---|
| Class C LP Units amortized over 15-25 years at fixed interest rates | 73,838 | 79,905 |
| Unamortized fair value adjustment | 438 | 663 |
| | 74,276 | 80,568 |
| Current portion of Class C LP Units | (14,637) | (6,074) |
| | 59,639 | 74,494 |
| Effective interest rate | 3.39% | 3.38% |

In 2016 Melcor extended the mortgage that secures retained debt relating to one of the initial properties from August 1, 2016 to August 1, 2021. The interest rate on this mortgage of 3.854% was reduced to 2.543%. Concurrent with the extension of the mortgage we extended the maturity of 977,220 Class C LP Units with a current balance of $9,030 from August 1, 2016 to August 1, 2021 at the reduced interest rate of 2.543%.

Specific investment properties with a carrying value of $140,242 (December 31, 2016 - $153,868) 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 |
|---|---|---|---|
| 2018 | 3,216 | 11,421 | **14,637** |
| 2019 | 3,058 | 6,576 | **9,634** |
| 2020 | 2,436 | 23,863 | **26,299** |
| 2021 | 907 | 7,181 | **8,088** |
| 2022 | 673 | — | **673** |
| Thereafter | 242 | 14,265 | **14,507** |
| | 10,532 | 63,306 | **73,838** |

During the year $2,633 (2016 - $2,853) was recognized in finance costs (note 18) and $3,714 (2016 - $3,590) was recognized as a reduction in the Class C LP Units liability related to these distributions. In addition, during the year we repaid the maturing balance on 295,327 Class C LP units with a carrying value of $2,578.

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

| *($000s)* | |
|---|---|
| Balance at December 31, 2016 | **80,568** |
| Principal repayments: | |
| Scheduled amortization on Class C LP Units | **(3,489)** |
| Class C LP Units repayments | **(2,578)** |
| Amortization of fair value adjustment on Class C LP Units (note 18) | **(225)** |
| Balance at December 31, 2017 | **74,276** |

As at December 31, 2017 we had 9,454,411 Class C LP Units issued and outstanding (December 31, 2016 - 9,454,411).

## 14. CONVERTIBLE DEBENTURE

### 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 28), 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)* | | | | | Dec 31, 2017 | Dec 31, 2016 |
|---|---|---|---|---|---|---|
| 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** | **33,291** | 32,749 |
| 2017 Debentures | Dec 21, 2017 | Dec 31, 2022 | 5.25% | **23,000** | **20,755** | — |
| | | | | **57,500** | **54,046** | 32,749 |

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 Instrument | Conversion Feature | Total |
|---|---|---|---|
| **Balance at December 31, 2015** | 32,246 | 5 | 32,251 |
| Amortization of discount and transaction costs | 503 | — | 503 |
| Fair value adjustment on conversion feature (note 27) | — | 56 | 56 |
| **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 27) | — | (127) | (127) |
| **Balance at December 31, 2017** | 54,046 | 729 | 54,775 |

During the year $1,931 of interest expense was recognized in finance costs (note 18) (2016 - $1,898).

At December 31, 2017 we remeasured the conversion feature to fair value resulting in a fair value adjustment of $127 (2016 - $56). Supplemental information on fair value measurement, including valuation techniques and key inputs, is included in note 27.

## 15. CLASS B LP UNITS

Melcor, through an affiliate, holds an approximate 56.7% 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 16(b)). Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units.

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

| *($000s except unit amounts)* | 2017 | | 2016 | |
|---|---|---|---|---|
| Balance - beginning of year | 14,615,878 | 123,650 | 14,615,878 | 105,380 |
| Fair value adjustment on Class B LP Units (note 27) | — | 731 | — | 18,270 |
| Balance - end of year | 14,615,878 | 124,381 | 14,615,878 | 123,650 |

Distributions on Class B LP Units for the year were $9,866 (2016 - $9,866), and are included in finance costs (note 18).

In accordance with our policy, as detailed in note 3(h), we record Class B LP Units at fair value. We remeasured the Class B LP Units at December 31, 2017 and recognized a fair value loss of $731 during the year (2016 - fair value loss of $18,270). Supplemental information on fair value measurement, including valuation technique and the key input, is included in note 27.

At December 31, 2017 there were 14,615,878 Class B LP Units issued and outstanding at a fair value of $8.51 per unit or $124,381 (December 31, 2016 - 14,615,878 Class B LP Units issued and outstanding at a fair value of $8.46 per unit or $123,650).

## 16. 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

Issued and outstanding trust units at December 31, 2017 are 11,151,297 (December 31, 2016 - 11,151,297).

## 17. RENTAL REVENUE

The components of rental revenue are as follows:

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Rental revenue | 68,601 | 68,099 |
| Amortization of tenant incentives (note 8) | (3,062) | (3,216) |
| Straight-line adjustments | 1,074 | 1,159 |
| | 66,613 | 66,042 |

## 18. FINANCE COSTS

The components of finance costs are as follows:

| *For the years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Interest on mortgages payable and revolving credit facility | 8,160 | 8,564 |
| Interest on Class C LP Units | 2,858 | 3,080 |
| Amortization of fair value adjustments on Class C LP Units | (225) | (227) |
| Distributions on Class B LP Units | 9,866 | 9,866 |
| Interest on convertible debentures | 1,931 | 1,898 |
| Interest on subscription receipts (note 11) | 114 | — |
| Fair value adjustment on derivative financial instruments | (521) | (54) |
| Amortization of deferred financing fees | 1,011 | 887 |
| | 23,194 | 24,014 |

Total finance costs paid during the year were $22,512 (2016 - $23,170).

## 19. INCOME TAXES

As at December 31, 2017 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 years ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| Net income (loss) | 732 | (11,176) |
| Statutory rate | 27% | 27% |
| | 198 | (3,018) |
| Non-deductible expenses | 1 | 4 |
| Non-taxable portion of capital gains and fair value adjustments | 1,959 | 884 |
| Allocation of taxable (loss) income to unitholders (note 3(m)) | (2,158) | 2,130 |
| | — | — |

## 20. INCOME PER UNIT

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

| *($000s except unit amounts)* | 2017 | 2016 |
|---|---|---|
| Net income (loss) - basic | 732 | (11,176) |
| Impact of Class B LP Unit fair value adjustment and distributions | 10,597 | 28,136 |
| Impact of convertible debentures interest, fair value adjustment and amortization | 2,353 | 2,457 |
| Net income - diluted | 13,682 | 19,417 |
| | | |
| Basic weighted average trust units outstanding | 11,151,297 | 11,151,297 |
| Impact of conversion of Class B LP Units | 14,615,878 | 14,615,878 |
| Impact of conversion of convertible debentures | 2,787,547 | 2,727,273 |
| Diluted weighted average trust units outstanding | 28,554,722 | 28,494,448 |
| Basic earnings (loss) per trust unit | $0.07 | ($1.00) |
| Diluted earnings (loss) per trust unit | $0.07 | ($1.00) |

## 21. 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.

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

| *For the year ended December 31 ($000s)* | 2017 | 2016 |
|---|---|---|
| **Asset Management Agreement** | | |
| Base Annual Management Fee | 1,583 | 1,592 |
| Capital Expenditure Fee | — | 38 |
| **Property Management Agreement** | | |
| Monthly Fee | 1,897 | 1,905 |
| Lease Fee | 743 | 621 |
| | 4,223 | 4,156 |

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 (3(e)), Acquisition Fees and Lease Fees are capitalized to investment properties. As at December 31, 2017 there was $579 payable to Melcor related to these fees (December 31, 2016 - $583) 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 $9,866 in distributions were recorded on Class B LP Units held by Melcor (2016 - $9,866). These distributions were recorded as finance costs (note 18). As at December 31, 2017 there was $822 payable to Melcor for the December distribution (December 31, 2016 - $822) which is included in distribution payable.

Also during the year, Melcor, as holder of all Class C LP Units, was paid $6,347 to fund principal and interest payments on the Retained Debt (2016 - $6,443). These redemptions were recorded as a reduction of the Class C LP Unit liability and as finance costs (note 18). In addition, during the year we repaid the maturing balance on 295,327 Class C LP units with a carrying value of $2,578.

### C. RENTAL REVENUE

During the year the REIT collected $963 in rental revenue from Melcor and an affiliate for use of office space (2016 - $961). In addition, pursuant to the Head and Bridge Lease Agreements, the REIT collected $344 in rental revenue from Melcor as compensation for certain vacant spaces at the properties acquired (2016 - $279).

### 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.

All related party transactions occurred in the normal course of operations, at market rates and under normal commercial terms.

## 22. JOINT ARRANGEMENTS

The table below discloses our rights to and share of the assets, liabilities, revenues, and earnings of three joint arrangements (2016 – 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% |

| *($000's)* | Assets | Liabilities | Revenue | Earnings |
|---|---|---|---|---|
| *For the year ended and as at December 31* | | | | |
| **2017** | **62,001** | **32,192** | **5,119** | **2,596** |
| 2016 | 61,417 | 30,802 | 5,182 | 3,559 |

## 23. 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.

## 24. 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 $440 (2016 - $1,111).

In connection with the issuance of subscription receipts (note 11), the REIT has entered into an underwriter's agreement that will require the remaining 50% of the underwriter's fee, representing $346, to be paid upon closing of the Melcor Acquisition (note 28).

## 25. MANAGEMENT OF CAPITAL RESOURCES

We define capital as unitholders' equity, Class B LP Units, Class C LP Units, mortgages payables, convertible debentures and our revolving credit facility. 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.

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, 2017, 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, 2017, 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, 2017, 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.

## 26. 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, restricted cash, accounts receivable and loan receivable. 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. Management has reviewed outstanding receivable balances at December 31, 2017 and has provided for $133 of outstanding receivables related to accounts where collectability is doubtful (2016 - $76). We expect full payment of remaining balances outstanding, and accordingly, no additional allowance for doubtful accounts has been recorded.

### 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 12, 13 and 14 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 May 1, 2018. 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. Subscription receipts were converted to trust units subsequent to year-end.

### 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, 2016 - $175) 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.

## 27. 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, revolving credit facility, 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 1).

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, 2017 | | |
|---|---|---|---|---|---|
| *($000s)* | Fair Value Hierarchy | Fair Value | Amortized Cost | Total Carrying Value | Total Fair Value |
| **Non-financial assets** | | | | | |
| Investment properties | Level 3 | 617,278 | — | 617,278 | 617,278 |
| Assets held for sale | Level 3 | 6,732 | — | 6,732 | 6,732 |
| **Financial liabilities** | | | | | |
| Mortgages payable | Level 3 | — | 217,240 | 217,240 | 219,700 |
| Class B LP Units | Level 1 | 124,381 | — | 124,381 | 124,381 |
| Class C LP Units | Level 3 | — | 74,276 | 74,276 | 74,276 |
| Convertible debenture | Level 1 | — | 54,046 | 54,046 | 58,018 |
| Liability held for sale | Level 3 | — | 3,670 | 3,670 | 3,670 |
| **Derivative financial instruments** | | | | | |
| Interest rate swap | Level 3 | 504 | — | 504 | 504 |
| Conversion feature on convertible debenture | Level 3 | 729 | — | 729 | 729 |

| | | | December 31, 2016 | | |
|---|---|---|---|---|---|
| *($000s)* | Fair Value Hierarchy | Fair Value | Amortized Cost | Total Carrying Value | Total Fair Value |
| **Non-financial assets** | | | | | |
| Investment properties | Level 3 | 641,365 | — | 641,365 | 641,365 |
| **Financial liabilities** | | | | | |
| Mortgages payable | Level 3 | — | 218,866 | 218,866 | 222,116 |
| Class B LP Units | Level 1 | 123,650 | — | 123,650 | 123,650 |
| Class C LP Units | Level 3 | — | 80,568 | 80,568 | 80,568 |
| Convertible debenture | Level 1 | — | 32,749 | 32,749 | 35,018 |
| **Derivative financial instruments** | | | | | |
| Interest rate swap | Level 3 | 110 | — | 110 | 110 |
| Conversion feature on convertible debenture | Level 3 | 61 | — | 61 | 61 |

### *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.

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 valuators 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, 2017 of which 27 investment 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 resulted in fair value losses of $12,800. During the year ended December 31, 2016 Melcor's internal valuation team valued investment properties of which 22 invest properties (of 47 legal phases valued) with a fair value of $287,000 were valued by qualified independent external valuation professionals during the year. Valuations performed during the year ended December 31, 2016 resulted in fair value losses of $6,546.

Weighted average stabilized net operating income for investment properties is $1,534 (2016 - $1,503). 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, 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% |

| | December 31, 2016 | | |
|---|---|---|---|
| | Min | Max | Weighted Average |
| Capitalization rate | 5.50% | 8.75% | 6.63% |
| Terminal capitalization rate | 5.75% | 9.00% | 6.83% |
| Discount rate | 6.50% | 9.75% | 7.70% |

An increase in the capitalization rates by 50 basis points would decrease the carrying amount of investment properties by $44,312 (2016 - $46,366). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by $51,480 (2016 - $53,936).

### *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, 2017 the fair value of the interest rate swap contract is $504 (2016 - $110).

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, 2017 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, 2017. Volatility was 21.70% (2016 - 16.73%).
- Credit spread - the credit spread of the convertible debenture was imputed from the traded price of the convertible debenture as at December 31, 2017. The credit spread used was 2.81% (2016 - 3.71%).

As at December 31, 2017 the fair value of the conversion features on our convertible debentures was $729 (2016 - $61).

Valuations performed during the year resulted in fair value gains of $521 (2016 - $54).

### *CLASS B LP UNITS*

Class B LP Units are remeasured to fair value on a recurring basis and categorized as Level 1 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, 2017 the fair value of the Class B LP Units was $124,381, resulting in a fair value loss of $731 in income for the year (2016 - fair value loss of $18,270).

## 28. SUBSEQUENT EVENTS

### CLOSING OF THE MELCOR ACQUISITION

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. The purchase price was settled through assumption of $31,038 in mortgages payable; issuance of 1,331,202 Class C LP Units, representing $13,312 in Retained Debt by Melcor; issuance of 283,447 Class B LP Units at a price of $8.82, representing $2,500; and cash of $34,025.

Concurrent with closing of the Melcor Acquisition, the REIT issued 2,035,500 trust units in exchange for each subscription receipt previously issued and outstanding and the maturity date of the 2017 Debentures was extended to December 31, 2022. Melcor's interest in the REIT on closing the Melcor Acquisition is approximately 53.0%.

### DISTRIBUTION DECLARED

On January 15, 2018 we declared a distribution of $0.05625 per unit for the months of January, February and March 2018. The distributions will be payable as follows:

| Month | Record Date | Distribution Date | Distribution Amount |
|---|---|---|---|
| January 2018 | January 31, 2018 | February 15, 2018 | $0.05625 per unit |
| February 2018 | February 28, 2018 | March 15, 2018 | $0.05625 per unit |
| March 2018 | March 29, 2018 | April 16, 2018 | $0.05625 per unit |

### ASSET DISPOSITION

On January 31, 2018 we sold an investment property for gross proceeds of $6,850. The purchase price was settled through mortgage assumption of $3,673 (including accrued interest) and cash of $3,177 (excluding working capital adjustments).

Subsequent to year end, conditions were removed on a pending sale of a property which did not meet the requirements to be classified as held for sale at December 31, 2017. The property with a sale price of $13,800 is expected to close in Q2 2018.