Management's Discussion & Analysis

Table of Contents

October 31, 2014

The following Management's Discussion and Analysis ("MD&A") of Melcor Real Estate Investment Trust's (the "REIT" or "Melcor REIT") results should be read in conjunction with the unaudited condensed interim consolidated financial statements and related notes for the quarter ended September 30, 2014 and the Management's Discussion & Analysis (MD&A) and consolidated financial statements and related notes for the year ended December 31, 2013.

The underlying financial statements in this MD&A, including 2013 comparative information, have been prepared in accordance with International Financial Reporting Standards (IFRS) unless otherwise noted.

The REIT's Board of Trustees, on the recommendation of the Audit Committee, approved the content of this MD&A on October 31, 2014. Disclosures contained in this MD&A are current to October 31, 2014, unless otherwise indicated.

All dollar amounts included in this MD&A are Canadian dollars unless otherwise specified.

Other Information

Additional information about the REIT, including our annual information form, information circular and annual and quarterly reports, is available on SEDAR at www.sedar.com.

Non-standard Measures

We refer to terms and measures which are not specifically defined in the CPA Canada Handbook and do not have any standardized meaning prescribed by IFRS. These measures include funds from operations ("FFO"), adjusted funds from operations ("AFFO") 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 on page 17 "Non-standard Measures."

Forward-looking Statements

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

Forward-looking statements are disclosures regarding possible events, conditions, or results of operations that are based on assumptions about future economic conditions, 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 2014 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 of 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 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.

Financial Reporting

As Melcor Developments Ltd. ("Melcor") retained control over the REIT, the May 1, 2013 initial public offering and acquisition of the Initial Properties was accounted for as a reorganization and recapitalization using the continuity of interests method. Financial information for the pre-acquisition period as included in the September 30, 2013 comparative period are presented based on historical combined financial information for the Initial Properties as previously reported by Melcor.

Throughout this MD&A we make reference to the terms “we”, “our” and “management”. These terms are used to describe the activities of the REIT through the eyes of management, as provided by Melcor under the asset management and property management agreements.

Certain comparative information has been amended to reflect revised calculation of the metrics which management considers to provide better and more meaningful information.

Formation of Melcor REIT

The REIT is an unincorporated, open-ended real estate investment trust established pursuant to a declaration of trust dated January 25, 2013, which was subsequently amended and restated May 1, 2013.

We began operations on May 1, 2013 when our trust units were issued for cash pursuant to the initial public offering (“IPO”). Units of the REIT trade on the Toronto Stock Exchange under the symbol MR.UN. The REIT is externally managed, administered and operated by Melcor Developments Ltd. ("Melcor") pursuant to the Property Management Agreement and Asset Management Agreement.

As at October 31, 2014, Melcor, through an affiliate, holds an approximate 47.6% effective interest in the REIT through ownership of all Class B LP Units of the Partnership and is the ultimate controlling party.

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 October 31, 2014, the REIT was in compliance with all investment guidelines and operating policies stipulated in the DOT.

Our Business: Vision, Goals & Strategy

Melcor REIT has an established and diversified portfolio focused on high-growth markets in Western Canada. We own 32 income-producing office, retail and industrial properties representing 1.84 million square feet in gross leasable area ("GLA") at September 30, 2014. 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 pursuant to the asset management and property management agreements entered into in connection with the IPO.

Melcor, a real estate company founded in 1923, has a rich history of growth and performance prior to the formation of the REIT. Our objective is to continue that tradition by expanding our portfolio of income-producing properties across Western Canada to provide stable and growing monthly cash distributions to unitholders. Our growth strategy is simple: acquire and improve. Melcor has a proven track record of doing both and, under its management, the REIT achieved the following in the nine-months ended September 30, 2014.

Acquire:

Through the first nine months of 2014 we have executed on our growth strategy through third party acquisitions and via our proprietary pipeline with Melcor, a cornerstone in our growth strategy. Acquisitions completed to date in 2014 have increased our portfolio GLA by 17% since IPO on May 1, 2013. Completed acquisitions are detailed as follows:

- During Q2-2014 we purchased two multi-tenant retail properties from Melcor for a purchase price of approximately $13.50 million (excluding transaction costs) (the "Acquisition"). The properties include an 11,555 sq. ft. commercial retail unit at our Kingsview Market retail complex in Airdrie, Alberta completed by Melcor in early 2013 and a 42,586 sq. ft. retail community strip centre (Market Mall) located in Regina, Saskatchewan that was substantially redeveloped by Melcor in 2009. In conjunction with the Acquisition, we completed a bought deal issuance of 2.15 million trust units (including over allotment exercise) at $10.65 per unit for total gross proceeds of $22.84 million.
- In Q1-2014 we completed the acquisition of a 67,610 sq. ft. industrial warehouse in Lethbridge, Alberta (LC Industrial) for the purchase price of $5.93 million (excluding transaction costs). We also acquired a 23,432 sq. ft. office building in Edmonton, Alberta (107 Avenue Building) for a purchase price of $5.55 million (excluding transaction costs) in Q2-2014. These acquisitions add depth to our industrial property offering and office portfolio while adhering to our strategy of growing in the markets that we know best.

During the third quarter we entered into an agreement with a third party to acquire a 158,320 sq. ft. office and retail property situated on a 18.98 acres site (including approximately 2 acres of undeveloped area) located in Edmonton, AB for a purchase price of $31.38 million. The purchase price will be settled through the assumption of approximately $15.10 million in mortgage debt and cash from the revolving credit facility. The acquisition is expected to close in Q4-2014.

We continue to monitor our proprietary pipeline via Melcor in assessing new acquisition opportunities. Year-to-date, Melcor has completed 12 buildings (279,115 sq. ft.) and redeveloped an underutilized shopping centre into office space (446,272 sq. ft.). An additional 346,600 sq. ft. is currently in progress. Under the Development and Opportunities Agreement with Melcor, the REIT has the right of first offer (ROFO) on commercial properties that meet our acquisition criteria. The properties completed in 2014 include high-quality office, retail, industrial and mixed-use properties. Comparable assets are not for sale in the commercial market at this time, so the ROFO provides a strategic advantage to achieving our growth plan. These assets complement our strategy of enhancing the quality and depth of our portfolio.

Improve:

We continued to improve our existing assets through both property management and asset enhancement programs.

In Q3-2014, our signature customer care program achieved an on-time response rate of 97%, exceeding our target of 95%. This compares to 96% in Q2-2014 and 97% in Q1-2014 . We use this metric as an indicator of our success in providing responsive care to our customers.

In January 2014 we received BOMA BESt certification on our Westcor property, bringing our total to 3 BOMA BESt certified Green & Responsible buildings at the end of the quarter. BOMA BESt is the leading environmental certification program for existing buildings in Canada. We continue to assess our buildings against the BOMA BESt standards.

Q3-2014 Highlights & Key Performance Indicators

Financial Highlights						
	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Non-standard KPIs						
Net operating income (NOI)	**7,164**	6,343	13 %	**21,101**	19,064	11 %
Funds from operations (FFO)	**4,766**	4,076	17 %	**13,485**	12,180	11 %
Adjusted funds from operations (AFFO)	**4,128**	3,581	15 %	**11,807**	10,572	12 %
Rental revenue	**11,074**	9,794	13 %	**32,840**	29,255	12 %
Income before fair value adjustments and taxes	**2,442**	1,913	28 %	**6,706**	7,818	(14)%
Fair value adjustment on investment properties	**(3,840)**	3,079	(225)%	**(3,103)**	7,465	(142)%
Distributions to unitholders	**1,902**	1,541	23 %	**5,225**	2,568	103 %
Cash flows from operations	**2,649**	(189)	nm	**6,751**	8,952	(25)%
Per unit metrics [1]						
Income - diluted	**0.02**	0.35	(94)%	**0.43**	0.57	(25)%
FFO	**0.22**	0.22	— %	**0.67**	0.65	3 %
AFFO	**0.19**	0.19	— %	**0.59**	0.57	4 %
Distributions	**0.17**	0.17	— %	**0.51**	0.28	80 %

	30-Sep-14	31-Dec-13	△%
Total assets ($000s)	**477,115**	454,743	5%
Equity ($000s)[2]	**216,852**	186,608	16%
Debt ($000s)[3]	**210,884**	215,601	(2)%
Weighted average interest rate on debt	**3.96%**	3.98%	(1%)
Debt to GBV ratio	**47%**	51%	(8)%
Finance costs coverage ratio[4]	**3.03**	2.96	2%
Debt service coverage ratio[5]	**2.85**	2.83	1%

Operational Highlights			
	30-Sep-14	31-Dec-13	△%
Number of properties	**32**	29	10 %
Gross leasable area (GLA) (sq. ft.)	**1,837,439**	1,691,920	9 %
Occupancy % (weighted by GLA)	**91.4%**	90.6%	1%
Retention % (weighted by GLA)	**74.0%**	75.5%	(2)%
Weighted average remaining lease term (years)	**4.58**	4.75	(4)%
Weighted average base rent (per sq. ft.)	**$16.22**	$16.63	(2)%

(1) The comparative 2013 figures are calculated as if the trust units and Class B LP Units which were issued in 2013 were outstanding during the entire comparative period, except for income - diluted which is calculated for the post formation period May 1, 2013 to September 30, 2013.
(2) 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.
(3) Calculated as the sum of total amount drawn on revolving credit facility, mortgages payable and Class C LP Units, excluding unamortized fair value adjustment on Class C LP Units, unamortized transaction costs and unamortized discount on bankers acceptance.
(4) Calculated as the sum of FFO and finance costs; divided by finance costs, excluding distributions on Class B LP Units.
(5) 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.

Q3-2014 Highlights:

- **Revenue growth of 13% over Q3-2013** as a result of our expanded portfolio and improved occupancy. Weighted average base rent (per sq. ft.) was down as a result of increased industrial square footage in our portfolio. Occupancy improved to 91.4% in the quarter. Higher revenue resulted in a **13% increase in NOI over Q3-2013.**
- **FFO and AFFO grew by 17% and 15% respectively over Q3-2013 with FFO of $4.77 million and AFFO of $4.13 million.** FFO and AFFO per unit was $0.22 and $0.19 respectively, consistent with Q3-2013. Growth in FFO and AFFO was offset by the impact of trust units issued in Q2-2014.
- **We continue to execute on property management and asset enhancement initiatives in order to maintain and improve our assets.** These initiatives led to strong occupancy and retention rates during the third quarter, with period end rates of 91.4% and 74.0% respectively. Year-to-date we completed 107,751 sq. ft. in new leasing and have renewed 74.7% of the GLA expiring in 2014.
- **Distributions of $0.05625 per trust unit were paid in July, August and September.** Distributions made during Q3-2014 represent a payout ratio of 89%.
- **As at September 30, 2014 we have $1.90 million in cash, $3.40 million in restricted cash and additional capacity under our revolving credit facility.** Available capital is expected to be deployed in the fourth quarter upon closing of a pending property acquisition. During the period we entered into an agreement with a third party to acquire a 158,320 sq. ft. office and retail property situated on a 18.98 acre site (including approximately 2 acres of undeveloped area) located in Edmonton, AB for a purchase price of $31.38 million. The purchase price will be settled through the assumption of approximately $15.10 million in mortgage debt and cash from the revolving line of credit. The acquisition is expected to close in Q4-2014.

Property Profile

At September 30, 2014 our portfolio includes interests in 32 income-producing retail, office and industrial properties comprising 1,837,439 square feet of GLA located in Western Canada, and a land lease community.

The following table summarizes the composition of our properties at September 30, 2014 by property type:

Property Type	Number of Properties	GLA (sq. ft.)/ Lots	% of Portfolio (GLA)	Fair Value of Investment Properties ($000s)	NOI for the nine-months ended September 30, 2014 ($000s)
Retail	10	662,350	36.0%	201,316	8,442
Office	18	1,042,506	56.8%	240,350	11,253
Industrial	3	132,583	7.2%	12,200	708
Land Lease Community	1	308 lots	n/a	14,350	698
	32	**1,837,439**	**100.0%**	**468,216**	**21,101**

Retail – our 10 retail properties include multi-building retail power centres and neighborhood shopping centres containing 662,350 sq. ft.

Office – our 18 office properties include low and medium-rise buildings located in strategic urban and suburban centres, containing 1,042,506 sq. ft.

Industrial – our Q1-2014 acquisition of LC Industrial increased our portfolio to three properties and more than doubled our industrial GLA to a total of 132,583 sq. ft.

Land Lease Community – we have one land lease community in Calgary, AB, consisting of 308 pad lots. It was 100% occupied at September 30, 2014 (December 31, 2013 – 100%).

Portfolio Occupancy - Occupancy at period end was 91.4% compared to 90.6% at the end of 2013. 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.

Consolidated Revenue & Net Operating Income

	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Base rent	**7,123**	6,269	14 %	**20,920**	18,762	12 %
Recoveries	**4,038**	3,632	11 %	**12,314**	10,875	13 %
Other	**284**	316	(10)%	**899**	983	(9)%
Amortization of tenant incentives	**(599)**	(554)	8 %	**(1,759)**	(1,681)	5 %
Straight-line rent adjustment	**228**	131	74 %	**466**	316	47 %
Rental revenue	**11,074**	9,794	13 %	**32,840**	29,255	12 %
Operating expenses	**2,187**	1,910	15 %	**6,442**	5,617	15 %
Utilities and property taxes	**2,094**	1,964	7 %	**6,590**	5,939	11 %
Direct operating expenses	**4,281**	3,874	11 %	**13,032**	11,556	13 %
Net rental income	**6,793**	5,920	15 %	**19,808**	17,699	12 %
NOI	**7,164**	6,343	13 %	**21,101**	19,064	11 %
Same asset NOI	**5,853**	5,857	— %	**17,525**	17,636	(1)%
Operating margin	**61%**	60%	2 %	**60%**	60%	— %

Revenue

Rental revenue in Q3-2014 grew 13% to $1.28 million over Q3-2013, which is consistent with the 13% growth in GLA over the same period. Same-asset rental revenue was steady over Q3-2013. Year-to-date rental revenue grew 12% to $3.59 million, with $2.96 million related to properties acquired over the past 12 months. The remainder of the increase was driven by higher recoveries for direct operating expenses incurred during the period.

Weighted average base rent decreased by 2% compared to year-end due to growth in industrial GLA, which is 7.2% of the total portfolio compared to 3.8% at year-end. Industrial properties typically have lower average base rent (per sq. ft.) when compared to our office and retail properties. Occupancy improved to 91.4% from 90.6% at the end of 2013. Retention rates were strong at 74.0%. The outlook for the fourth quarter remains within target. On a same asset basis base rent and occupancy were consistent with 2013 and reflect stability in the portfolio.

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

	Sep 30, 2014	Dec 31, 2013	△%
Weighted average base rent (per sq. ft.)	**$16.22**	$16.63	(2)%
Weighted average remaining lease term	**4.58**	4.75	(4)%
GLA	**1,837,439**	1,691,920	9 %
Occupancy %	**91.4%**	90.6%	1 %
Retention %	**74.0%**	75.5%	(2)%

Recoveries are amounts recovered from tenants for direct operating expenses incurred during the period and include a nominal administrative charge. During the the three and nine-months ended September 30, 2014 recoveries revenue increased by 11% and 13% respectively and correlates with the increase in direct operating expenses which were 11% and 13% higher over the respective comparative periods. New property additions completed over the past twelve months contributed to $241 and $616 of the respective increases, with timing of direct operating expenses on same assets making up the difference.

Other revenue is comprised of parking revenue and other miscellaneous revenue. These revenues can fluctuate from period to period.

Direct operating expenses

Direct operating expenses were higher by 11% or $0.41 million compared to Q3-2013. Excluding the impact of the newly acquired properties, direct operating expenses increased by $0.15 million. The timing of operating expenditures and differences in allocations in the comparative period drove the change over Q3-2013 on a same asset basis. Utilities and property taxes were steady over Q3-2013 on a same

asset basis. Higher property taxes due to a rise in appraised property values were offset by cost savings on renewed utility contracts in the Edmonton, AB region.

Year-to-date direct operating expenses were up by $1.48 million or 13% when compared to 2013. Newly acquired properties contributed $0.69 million while the remainder of the increase reflects the differences in the timing of repairs and maintenance projects and allocations of costs during the period. We expect to be on budget for 2014.

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 measurement most directly comparable to NOI and same asset NOI is net income.

Property acquisitions completed over the past twelve months drove the increase in NOI with 13% growth in the quarter and 11% growth year-to-date. On a same asset basis, NOI was steady over 2013. The calculation of same asset NOI is as follows (refer to *Non-standard Measures* for calculation of NOI and reconciliation to net income):

	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Same asset NOI	**5,853**	5,857	— %	**17,525**	17,636	(1)%
Acquisitions	**940**	63		**2,283**	63	
NOI before adjustments	**6,793**	5,920	15 %	**19,808**	17,699	12 %
Amortization of tenant incentives	**599**	554		**1,759**	1,681	
Straight-line rent adjustment	**(228)**	(131)		**(466)**	(316)	
NOI	**7,164**	6,343	13 %	**21,101**	19,064	11 %

Regional Analysis

The following table summarizes the composition of our properties at September 30, 2014 by geographic region:

Geographic Region	Number of Properties	GLA (sq. ft.)	% of Portfolio (GLA)	Fair Value of Investment Properties ($000s)	NOI for the nine-months ended September 30, 2014 ($000s)
Northern Alberta	19	1,207,657	65.7%	304,550	13,617
Southern Alberta	7	304,557	16.6%	108,166	4,989
Saskatchewan & British Columbia	6	325,225	17.7%	55,500	2,495
	32	1,837,439	100.0%	468,216	21,101

The following table details key financial and operational metrics for each of our geographic regions for the quarter ended September 30, 2014:

	Northern Alberta		Southern Alberta		Saskatchewan & British Columbia	
	2014	2013	**2014**	2013	**2014**	2013
Three-months ended September 30 ($000s)						
Rental revenue	**7,109**	6,311	**2,347**	2,096	**1,618**	1,387
NOI	**4,450**	4,036	**1,743**	1,499	**971**	808
Nine-months ended September 30 ($000s)						
Rental revenue	**21,603**	18,796	**6,794**	6,199	**4,443**	4,260
NOI	**13,617**	12,237	**4,989**	4,407	**2,495**	2,420
As at September 30						
Weighted average base rent (per sq. ft.)	**$16.31**	$16.49	**$18.90**	$21.08	**$13.24**	$13.02
Occupancy %	**89.3%**	90.1%	**98.7%**	98.0%	**92.5%**	92.1%

Northern Alberta: Rental revenue grew 13% over Q3-2013 and 15% year-to-date. The increase is a result of three property acquisitions in the region, contributing revenues of $0.69 million in Q3-2014 and $1.99 million year-to-date. On a same asset basis rental revenue growth was driven by higher recoveries for direct operating expenses.

Southern Alberta: Rental revenue increased by 12% over Q3-2013 and 10% year-to-date. Property acquisitions completed in the region resulted in 6% GLA growth and generated $0.28 million of revenues in Q3-2014 and $0.63 million year-to-date. Weighted average base rent decreased by $2.18 per sq. ft. as a result of the LC Industrial acquisition. Industrial properties typically have lower average rents.

Saskatchewan and BC: Rental revenue increased 17% during Q3-2014 as a result of the acquisition of Market Mall in May 2014. Market Mall contributed $0.24 million and $0.37 million in revenue during the three and nine-month periods respectively. Year-to-date rental revenue increased 4% over 2013 and was negatively impacted by tenant turnover at one of our Saskatchewan office properties.

During 2014 same asset NOI was steady across our Northern and Southern Alberta portfolio. Saskatchewan and BC decreased due to higher average vacancy.

General & Administrative Expenses

	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Asset management fee	**282**	252	12 %	**824**	419	97 %
Salaries and benefits	**—**	—	—%	**—**	315	(100%)
Professional fees	**60**	89	(33)%	**316**	205	54 %
Public company costs	**54**	59	(8)%	**145**	96	51 %
Other	**64**	58	10 %	**197**	234	(16)%
	460	458	—%	**1,482**	1,269	17%

General & administrative expense remained in line with Q3-2013. Analyzing the year-to-date components of general & administrative expense period over period is not meaningful due to the formation of the REIT on May 1, 2013 and the resulting change in cost structure. Public company costs and higher professional fees during the nine-months ended September 30, 2014 reflect the higher costs associated with the REIT being a stand-alone publicly traded entity. Property acquisitions completed over the last twelve months drove the increase in asset management fee which is charged at an annual rate of 0.25% of gross book value. Other expenses fluctuate from period to period due to the timing of costs incurred. During 2014 we reclassified costs related to tenant recoveries from operating expenses to general & administrative expense. Refer to note 16 of the condensed interim consolidated financial statements for additional discussion on the management fee structure.

Finance Costs

	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Interest on mortgages payable and revolving credit facility	**1,250**	1,036	21%	**3,833**	4,417	(13%)
Interest on Class C LP Units	**989**	1,021	(3)%	**2,991**	1,707	75 %
Amortization of fair value adjustment on Class C LP Units	**(110)**	(110)	—%	**(330)**	(183)	80%
Amortization of deferred financing costs	**52**	16	225 %	**160**	36	344 %
Finance costs before distributions	**2,181**	1,963	11%	**6,654**	5,977	11%
Distributions on Class B LP Units	**1,725**	1,609	7 %	**5,020**	2,681	87 %
Finance costs	**3,906**	3,572	9 %	**11,674**	8,658	35 %

Finance costs for the three-months ended September 30, 2014 were $0.33 million or 9% higher than Q3-2013. Finance costs before distributions on Class B LP Units were 11% higher as a result of higher average indebtedness during the period due to property acquisitions completed during the period. Analyzing the year-to-date components of finance costs is not meaningful due to the formation of the REIT and resulting conversion of certain mortgages into Class C LP Units. Distributions made on Class B LP Units are classified as finance costs, as the units are accounted for as a financial liability measured at fair value through profit and loss. Year-to-date finance costs were $3.02 million or 35% higher than 2013 as a result of the aforementioned factors.

Lower weighted average interest rates on the Class C LP Units and revolving credit facility partially offset the increase in the principle balance during the period. As at September 30, 2014 the weighted average interest rate on our revolving credit facility, mortgages payable and Class C LP Units was 3.96% based on period end balances.

Income Taxes

As at September 30, 2014, 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.

The comparative 2013 period includes income tax expense recognized prior to the IPO and subsequent de-recognition of the tax liability as a result of qualifying for the REIT Exception.

Funds from Operations & Adjusted Funds from Operations

Funds from Operations (FFO) and Adjusted funds from Operations (AFFO) are non-standard measures used in the real estate industry as a measure of operating performance of investment properties. We believe that AFFO is an important measure of economic performance and is indicative of the REIT's ability to pay distributions, while FFO is an important measure of operating performance and the performance of real estate properties. The IFRS measurement most directly comparable to FFO and AFFO is net income.

	Three-months ended September 30			Nine-months ended September 30		
($000s, except per unit amounts)	**2014**	2013	△%	**2014**	2013	△%
Net income for the period	**2,693**	5,945		**8,867**	55,253	
Add / (deduct)						
Fair value adjustment on investment properties	**3,840**	(3,079)		**3,103**	(7,465)	
Fair value adjustment on Class B LP Units	**(4,091)**	(953)		**(5,264)**	291	
Amortization of tenant incentives	**599**	554		**1,759**	1,681	
Distributions on Class B LP Units	**1,725**	1,609		**5,020**	2,681	
Deferred income taxes	**—**	—		**—**	(40,261)	
Funds From Operations (FFO)	**4,766**	4,076	17%	**13,485**	12,180	11%
Add / (deduct)						
Straight-line rent adjustment	**(228)**	(131)		**(466)**	(316)	
Amortization of deferred financing costs	**52**	16		**160**	36	
Accretion on decommissioning obligation	**13**	15		**40**	45	
Net impact of amortization of fair value adjustment and interest subsidy[1]	**139**	164		**424**	275	
Normalized capital expenditures[2]	**(205)**	(184)		**(612)**	(547)	
Normalized tenant incentives and leasing commissions[2]	**(409)**	(375)		**(1,224)**	(1,101)	
Adjusted Funds from Operations (AFFO)	**4,128**	3,581	15%	**11,807**	10,572	12%
FFO/Unit	**0.22**	0.22	1%	**0.67**	0.65	3%
AFFO/Unit	**0.19**	0.19	—%	**0.59**	0.57	4%

(1) Adjustment includes the following: amortization of the fair value adjustment recognized on the Class C LP Unit liability; and usage of the interest rate subsidy provided by Melcor as part of the transfer of the Initial Properties.
(2) Represents 3% and 6% of annual NOI for capital expenditures and tenant incentives and leasing commissions respectively. Amounts are net of usage of the capital expenditure subsidy provided by Melcor as part of the transfer of Initial Properties. Amounts presented in the comparative and pre-acquisition periods are based on the respective percentages of annual NOI for comparative purposes.

Distributions

In order to continue to qualify for the 'REIT Exception' as provided under the SIFT rules, we must allocate substantially all taxable income to unitholders. 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 three and nine-months ended September 30, 2014 were $1.90 million and $5.23 million respectively (year-ended December 31, 2013 - $4.11 million). Distributions made during the three and nine-months ended September 30, 2014 represent a payout ratio of approximately 89% and 86% of AFFO respectively.

Fair Value of Investment Properties

We carry our investment properties at fair value in accordance with IAS 40, *Investment property*. The following table summarizes key metrics of our investment properties and components of the fair value calculation:

	Sep 30, 2014	Dec 31, 2013
Number of properties	**32**	29
Total GLA (sq. ft)	**1,931,629**	1,786,447
GLA (REIT owned %) (sq. ft.)	**1,837,439**	1,691,920
Fair value of portfolio ($000s)	**468,216**	440,349
Weighted average capitalization rate	**6.41%**	6.41%
Weighted average discount rate	**7.58%**	7.57%
Weighted average terminal capitalization rate	**6.70%**	6.69%

Investment properties were valued by qualified independent external valuation professionals as at December 31, 2013. We obtained updated market data and considered whether changes to any valuation model variables resulted in significant changes to property fair values at September 30, 2014. This resulted in year-to-date fair value losses of $3.10 million (year-ended December 31, 2013 gains of $16.95 million) on investment properties recorded to income during the period. Refer to note 17 of the condensed interim consolidated financial statements for additional information on the calculation of fair value adjustments.

A breakdown of our fair value adjustment on investment properties by geographical region are as follows:

($000s)	**Nine months ended September 30, 2014**	Year ended December 31, 2013
Northern Alberta	**(1,921)**	7,969
Southern Alberta	**(436)**	6,178
Saskatchewan & British Columbia	**(746)**	2,806
	(3,103)	16,953

Fair value losses across the portfolio are not considered significant and represent a change of less than 1.0% on the fair value of the properties. Decreased fair value adjustments over 2013 reflect capitalization rate stabilization and continued capital investment across the portfolio.

Fair values are most sensitive to changes in capitalization rates.

	September 30, 2014			**December 31, 2013**		
	Min	**Max**	**Weighted Average**	**Min**	**Max**	**Weighted Average**
Capitalization rate	**5.50%**	**9.00%**	**6.41%**	5.50%	9.00%	6.41%
Terminal capitalization rate	**5.75%**	**9.25%**	**6.70%**	5.75%	9.25%	6.69%
Discount rate	**6.50%**	**10.00%**	**7.58%**	6.50%	10.00%	7.57%

A capitalization rate increase of 50 basis points (+0.5%) would decrease the fair value of investment properties by $33.85 million (December 31, 2013 - $31.88 million) while a 50 basis points decrease (-0.5%) would increase it by $39.57 million (December 31, 2013 - $37.28 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:

	Three-months ended September 30			Nine-months ended September 30		
($000s)	**2014**	2013	$△	**2014**	2013	$△
Cash from (used in) operating activities	**2,649**	(189)	2,838	**6,751**	8,952	(2,201)
Cash used in investing activities	**(2,458)**	(13,255)	10,797	**(22,845)**	(20,632)	(2,213)
Cash from financing activities	**1,709**	8,681	(6,972)	**12,062**	10,991	1,071
Increase (decrease) in cash and cash equivalents	**1,900**	(4,763)	6,663	**(4,032)**	(689)	(3,343)
Cash and cash equivalents, beginning of the period	**—**	4,763	(4,763)	**5,932**	689	5,243
Cash and cash equivalents, end of the period	**1,900**	—	1,900	**1,900**	—	1,900

Operating activities

Cash from operating activities in Q3-2014 were $2.84 million higher than Q3-2013. Changes in operating assets and liabilities contributed $2.33 million in additional cash flows during the quarter with the remainder of the increase driven by growth in NOI from property acquisitions. Year-to-date cash flows from operations were $2.20 million lower than 2013. Distributions on Class B LP Units, which are included in finance costs, reduced cash from operations by $5.02 million during 2014, compared to $2.68 million in the comparative period. Changes in operating assets and liabilities resulted in a decrease of $0.99 million in cash flows from operations. The decrease in cash flows was partially offset by higher NOI over 2013 as a result of property acquisitions.

Investing activities

During the nine-months ended September 30, 2014 we completed the acquisition of Market Mall in Regina, SK and phase three of Kingsivew Market in Airdrie, AB via our right of first offer (ROFO) on Melcor properties. The $13.50 million purchase price was partially settled through $6.10 million in cash consideration, with the balance fulfilled through the issuance of Class B LP Units. In addition, we acquired an office building in Edmonton, AB (107 Avenue Building) for $5.67 million and expanded our industrial portfolio in Lethbridge, AB (LC Industrial) for $6.03 million in 2014. During the comparative 2013 period we acquired Coast Home Centre, a retail building in Edmonton, AB for $12.45 million.

We continue to execute on our capital asset program for 2014 with $2.41 million invested in strategic value-adding asset enhancement projects year-to-date, including $1.26 million in Q3-2014.

Leasing activity on both new and renewed leases was strong during the period, driving $1.07 million in leasing fees paid to Melcor under the Property Management Agreement during the year, including $0.43 million in Q3-2014. Payments of tenant incentives correlates with lease activity increasing $0.76 million over Q3-2013 and $1.78 million year-to-date. We used $0.63 million of restricted cash to partially fund Q3-2014 investment activities ($1.82 million year-to-date). Timing of lease expiries impacts the level of spending on tenant incentives and leasing costs. Higher expenditures during the period reflects 17.6% or 297,298 of our portfolio GLA expiring in 2014, with 74.7% renewed as at September 30, 2014. In addition, we completed 107,751 sq. ft. in new leasing year-to-date.

Financing activities

On May 7, 2014 we received $18.75 million from the issuance of 1,900,000 trust units, net of transaction costs. On May 16, 2014, an additional 245,000 trust units were issued under the over allotment option for net proceeds of $2.50 million. These funds were used in the Melcor acquisitions and to reduce the amount outstanding under our revolving credit facility.

During 2014 we obtained mortgage financing on four recently acquired and previously unencumbered properties for proceeds of $19.01 million. Partial proceeds were used to repay the remaining amounts drawn under the revolving credit facility. In addition, we made $4.73

million in regular principal repayments on mortgages payable and Class C LP Units during the nine-months ended September 30, 2014. In 2013, we recognized $55.00 million in proceeds on the renewal and refinancing of five properties, extinguished mortgages on four properties totaling a repayment of $13.95 million, and made regular principal repayments on mortgages payable and Class C LP Units of $4.19 million.

We distributed $1.90 million to unitholders during Q3-2014, with year-to-date distributions of $5.23 million (2013 - $1.54 million and $2.57 million respectively).

During the comparative period, we recognized net distributions to Melcor of $7.45 million. Net distributions to Melcor represent the net financing funded/received by Melcor prior to the formation of the REIT to fund operating and investing activities.

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 September 30, 2014 we had $1.90 million in cash, $3.40 million in restricted cash and additional available funds under our revolving credit facility. Available funds will enable us to capitalize on future acquisition opportunities as well as meet ongoing capital needs.

Capital Structure

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

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 debentures).

At September 30, 2014, and throughout the period, we were in compliance with the Degree of Leverage Ratio and had a ratio of 47% as at period end, below our target range of 50%-55% debt to GBV, excluding convertible debentures. As at September 30, 2014, the REIT's total capitalization was $427.74 million and is comprised as follows:

($000s)	**Sep 30, 2014**
Revolving credit facility[1]	5,000
Mortgages payable[1]	115,587
Class C LP Units[2]	90,297
Indebtedness	210,884
Class B LP Units[3]	102,708
Trust units[4]	114,144
Equity	216,852
Total capitalization	**427,736**
Gross book value (GBV)[5]	**450,362**
Debt to GBV	**47%**
Maximum threshold[6]	**60%**

(1) Debts are presented excluding unamortized transaction costs and amounts allocated by management for restricted cash requirements.
(2) Class C LP Units excluding unamortized fair value adjustment on Class C LP Units.
(3) Class B LP Units are classified as equity for purposes of this calculation and are included at their book value.
(4) Trust units are included at their book value.
(5) GBV is calculated as the cost of the total assets acquired in the Initial Properties and subsequent asset purchases.
(6) As prescribed by the operating policies in the DOT (65% including any convertible debentures).

The capital raised in Q2-2014 has been only partially deployed allowing us the capacity to continue to execute on our growth strategy.

We have an available credit facility based on the minimum of the carrying value and adjusted NOI of specific investment properties to a maximum of $25.00 million. We are subject to financial covenants on our revolving credit facility. The covenants include a maximum debt to total capital ratio of 60%, a minimum interest coverage ratio of 1.50, and a minimum net book value of unitholders' equity of $140.00 million. As at September 30, 2014, and throughout the period, we were in compliance with our financial covenants with a debt to total capital ratio of 47%, interest coverage ratio of 1.69, and a net book value of unitholders' equity of $247.34 million.

We also have financial covenants on certain mortgages for investment properties. At September 30, 2014, 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.

Indebtedness

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

		As at September 30					
($000s)	**Total**	**2014**	**2015**	**2016**	**2017**	**2018**	**Thereafter**
Revolving credit facility	5,000	5,000	—	—	—	—	—
Mortgages payable	115,587	17,820	22,647	14,361	2,076	34,746	23,937
Class C LP Units	90,297	778	25,825	11,180	4,584	13,108	34,822
Total	**210,884**	**23,598**	**48,472**	**25,541**	**6,660**	**47,854**	**58,759**
% of portfolio	100%	11%	23%	12%	3%	23%	28%

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.

Debt Analysis – our mortgages payable and Class C LP Units bear interest at fixed rates; the following table summarizes the interest rates and terms to maturity:

($000s)	**Total**	**Fixed**	**Variable**	**Weighted average interest rate**	**Weighted average term to maturity**
Revolving credit facility	5,000	—	5,000	3.50%	0.58
Mortgages payable	115,587	115,587	—	4.08%	2.58
Class C LP Units	90,297	90,297	—	3.84%	4.15
Total	**210,884**	**205,884**	**5,000**	**3.96%**	**3.20**

The weighted average interest rate on our debts has remained steady since December 31, 2013. During the nine-months ended September 30, 2014 we obtained mortgage financing on four recently acquired and previously unencumbered properties for $19.01 million. A portion of these proceeds were used to repay the remaining balance drawn under the revolving credit facility. The weighted average interest rate on new financings obtained during the period was 3.45%.

Subsequent to period end, we refinanced two mortgages on one property for gross proceeds of $21.70 million at a fixed rate of 3.57%. Proceeds were used to repay the outstanding principal balance of $16.94 million and for general trust purposes.

Over the next 12 months, an additional five mortgages on four properties (three of which are held on two jointly owned properties) are up for renewal. These mortgages have an outstanding principal balance of $16.31 million (at REIT % interest) and a weighted average interest rate of 5.13% as at September 30, 2014. We expect to be able to refinance these mortgages at lower interest rates based on comparable recent refinancings.

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 twelve months. At maturity the value of the Class C LP Units will be $23.05 million, representing 2,304,469 Class C LP Units, with a weighted average interest rate of 4.00%. We expect to be able to obtain new mortgage financing, proceeds of which will be used to repay the Class C LP Unit liability to Melcor.

Our revolving credit facility matures May 1, 2015. Under the terms of the agreement we may request a one year extension to be granted at the discretion of the lenders. We expect to be able to renew or extend the facility.

Debt Service Coverage Ratio and Finance Costs Coverage Ratio – we calculate debt service coverage ratio as FFO for the period divided by principal repayments on mortgages payable and Class C LP Units made during the period. We calculate interest coverage as FFO plus finance costs for the period divided by finance costs expensed during the period, less distributions on Class B LP Units. We consider these measures to be useful in evaluating our ability to service our debts. These metrics are not calculated for purposes of covenant compliance on any of our debt facilities.

($000s)	**Sep 30, 2014**	Dec 31, 2013
FFO	**13,485**	15,903
Principal repayments on Mortgages payable	**2,446**	3,653
Principle repayments on Class C LP Units	**2,281**	1,966
Debt service coverage ratio	**2.85**	2.83
FFO plus finance costs[1]	**20,139**	24,025
Finance costs[1]	**6,654**	8,122
Finance costs coverage ratio	**3.03**	2.96

(1) Finance costs excluding finance expense recognized on Class B LP Unit distributions.

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 the unitholders and to receive any distributions by the REIT. Special voting units have no economic entitlement in the REIT but entitle the holder to one vote per special voting unit. Special voting units may only be issued in connection with securities exchangeable into trust units (including Class B LP Units).

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

On May 7, 2014 the REIT completed the issuance of 1,900,000 trust units at a price of $10.65 per unit to a syndicate of underwriters, on a bought deal basis, for gross proceeds of $20.24 million. Subsequently, the underwriters exercised their over-allotment option to purchase an additional 245,000 trust units at a price of $10.65 for gross proceeds of $2.61 million. The issuance was qualified under a short form prospectus filed April 30, 2014.

On May 9, 2014 the REIT issued 694,836 Class B LP Units at a price of $10.65 per unit, or $7.40 million, to Melcor as partial consideration for the Acquisition.

The following table summarizes the Units issued and the fully diluted number of Units outstanding as at September 30, 2014 and December 31, 2013:

	September 30, 2014		**December 31, 2013**	
Issued and fully paid units ($000s)	Units	$ Amount	Units	$ Amount
Balance, beginning of period	9,130,000	91,300	—	—
Issuance of Units - IPO	—	—	9,130,000	91,300
Issuance of Units	2,145,000	22,844	—	—
Balance, end of period	11,275,000	114,144	9,130,000	91,300
Dilutive securities	10,225,634	102,708	9,530,798	95,308
Diluted balance, end of period	21,500,634	216,852	18,660,798	186,608

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

(2) Units are presented at their book value.

Quarterly Results

	2014			2013				2012
($000s except per unit amount)	**Q3**	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Revenue	**11,074**	11,119	10,647	10,070	9,794	9,773	9,688	10,566
Net income	**2,693**	5,296	878	7,466	5,945	44,492	4,816	12,822
Basic earnings per unit[1]	**$ 0.24**	$ 0.52	$ 0.10	$ 0.51	$ 0.65	$ 2.38	$ 0.26	$ 0.68

(1) Calculated as if the trust units were outstanding during the entire period.

Off Balance Sheet Arrangements, Contractual Obligations, Business Environment & Risks, Related Party Transactions, Critical Accounting Estimates, Changes in Accounting Policies

There are no material changes to the above titled sections at September 30, 2014 in comparison to the December 31, 2013 annual MD&A.

Internal Control over Financial Reporting and Disclosure Controls

The Chief Executive Officer and the Chief Financial Officer have evaluated whether there were material changes to internal control over financial reporting during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. No such changes were identified.

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 operating income (NOI): NOI is defined as rental revenue, adjusted for amortization of tenant incentives 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 September 30			Nine-months ended September 30		
($000s)	**2014**	2013	△%	**2014**	2013	△%
Net income for the period	**2,693**	5,945		**8,867**	55,253	
Income tax recovery	**—**	—		**—**	(40,261)	
Net finance costs	**3,891**	3,549		**11,620**	8,612	
Fair value adjustment on Class B LP Units	**(4,091)**	(953)		**(5,264)**	291	
Fair value adjustment on investment properties	**3,840**	(3,079)		**3,103**	(7,465)	
General and administrative expenses	**460**	458		**1,482**	1,269	
Amortization of tenant incentives	**599**	554		**1,759**	1,681	
Straight-line rent adjustment	**(228)**	(131)		**(466)**	(316)	
NOI	**7,164**	6,343	13%	**21,101**	19,064	11%

Same asset NOI: this measure compares the NOI, less amortization on tenant incentives, plus straight-line rent adjustment, on assets that have been owned for the entire current and comparative period.

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; (vi) deferred income tax expense; and (vii) non-recurring current income taxes on formation of the REIT, 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) amortization of fair value mark-to-market adjustments on mortgages acquired; (ii) interest rate subsidy amounts received; (iii) amortization of deferred financing and leasing costs; (iv) accretion on decommissioning obligation; (v) adjusting for any differences resulting from recognizing property revenues on a straight-line basis; (vi) 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.

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

Debt to Gross Book Value: is calculated as the sum of mortgages payable and Class C LP Units, less unamortized fair value adjustment; divided by the total asset value assumed on acquisition of the Initial Properties plus total assets acquired from third parties subsequently.

Finance costs coverage ratio: is calculated as FFO plus finance costs for the period divided by finance costs expensed during the period, less distributions on Class B LP Units.

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.

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

MELCOR REAL ESTATE INVESTMENT TRUST

Condensed Interim Consolidated Financial Statements

For the three and nine-months ended September 30, 2014

(Unaudited)

Condensed Interim Consolidated Statements of Financial Position

As at September 30, 2014

(Unaudited)

($000s)	September 30, 2014	December 31, 2013
ASSETS		
Current Assets		
Cash and cash equivalents	**1,900**	5,932
Accounts receivable	**1,740**	1,478
Other assets (note 6)	**1,863**	1,015
	5,503	8,425
Non-Current Assets		
Restricted cash	**3,396**	5,969
Investment properties (note 5 and 17)	**455,094**	429,117
Other assets (note 6)	**13,122**	11,232
	471,612	446,318
TOTAL ASSETS	**477,115**	454,743
LIABILITIES		
Current Liabilities		
Revolving credit facility (note 7)	**4,925**	23,748
Accounts payable	**2,395**	1,989
Distribution payable	**1,209**	1,050
Accrued liabilities and other payables (note 8)	**3,683**	3,690
Class C LP Units (note 10)	**26,136**	3,059
Mortgages payable (note 9)	**38,970**	19,911
	77,318	53,447
Non-Current Liabilities		
Accrued liabilities and other payables (note 8)	**1,222**	1,459
Class B LP Units (note 11 and 17)	**101,132**	99,120
Class C LP Units (note 10)	**65,500**	91,188
Mortgages payable (note 9)	**76,308**	78,911
TOTAL LIABILITIES	**321,480**	324,125
UNITHOLDERS' EQUITY	**155,635**	130,618
TOTAL LIABILITIES AND UNITHOLDERS' EQUITY	**477,115**	454,743

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Income and Comprehensive Income

For the three and nine-months ended September 30

(Unaudited)

	Three-months ended September 30		Nine-months ended September 30	
($000s)	**2014**	**2013**	**2014**	**2013**
Rental revenue (note 13 and 16)	**11,074**	9,794	**32,840**	29,255
Direct operating expenses (note 16)	**(4,281)**	(3,874)	**(13,032)**	(11,556)
Net rental income	**6,793**	5,920	**19,808**	17,699
General and administrative expenses (note 16)	**(460)**	(458)	**(1,482)**	(1,269)
Fair value adjustment on investment properties (note 5 and 17)	**(3,840)**	3,079	**(3,103)**	7,465
Fair value adjustment on Class B LP Units (note 11 and 17)	**4,091**	953	**5,264**	(291)
Income before finance costs and income taxes	**6,584**	9,494	**20,487**	23,604
Interest income	**15**	23	**54**	46
Finance costs (note 14 and 16)	**(3,906)**	(3,572)	**(11,674)**	(8,658)
Net finance costs	**(3,891)**	(3,549)	**(11,620)**	(8,612)
Net income before income taxes	**2,693**	5,945	**8,867**	14,992
Deferred income tax recovery	**—**	—	**—**	40,261
Income tax recovery	**—**	—	**—**	40,261
Net income and comprehensive income	**2,693**	5,945	**8,867**	55,253

See note 15 for basic and diluted earnings per trust unit.

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Changes in Unitholders' Equity

For the nine-months ended September 30

(Unaudited)

($000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Divisional Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2013	9,130,000	82,709	36,823	—	11,086	130,618
Issuance of units (note 12)	2,145,000	21,250	—	—	—	21,250
Property purchase from Melcor Developments Ltd. (note 11)	—	—	125	—	—	125
Net income for the period	—	—	—	—	8,867	8,867
Distributions to unitholders	—	—	—	—	(5,225)	(5,225)
Balance at September 30, 2014	11,275,000	103,959	36,948	—	14,728	155,635

($000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Divisional Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2012	—	—	—	168,331	—	168,331
Net income for the period January 1, 2013 to April 30, 2013	—	—	—	47,524	—	47,524
Net distributions to Melcor Developments Ltd.	—	—	—	(7,447)	—	(7,447)
Balance at April 30, 2013	—	—	—	208,408	—	208,408
Reorganization and recapitalization	8,300,000	74,116	36,920	(208,408)	—	(97,372)
Conversion of Class B LP Units	830,000	7,823	767	—	—	8,590
Net income for the period May 1, 2013 to September 30, 2013	—	—	—	—	7,729	7,729
Distributions to unitholders	—	—	—	—	(2,568)	(2,568)
Balance at September 30, 2013	9,130,000	81,939	37,687	—	5,161	124,787

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Cash Flows

For the three and nine-months ended September 30

(Unaudited)

	Three-months ended September 30		Nine-months ended September 30	
($000s)	**2014**	**2013**	**2014**	**2013**
CASH FLOWS FROM (USED IN)				
OPERATING ACTIVITIES				
Net income for the period	**2,693**	5,945	**8,867**	55,253
Non cash items:				
Amortization of tenant incentives (note 13)	**599**	554	**1,759**	1,681
Straight-line rent adjustments (note 13)	**(228)**	(131)	**(466)**	(316)
Fair value adjustment on investment properties (note 5 and 17)	**3,840**	(3,079)	**3,103**	(7,465)
Fair value adjustment on Class B LP Units (note 11 and 17)	**(4,091)**	(953)	**(5,264)**	291
Amortization of fair value adjustment on Class C LP Units (note 14)	**(110)**	(110)	**(330)**	(183)
Amortization of deferred financing costs (note 14)	**52**	16	**160**	36
Accretion on decommissioning obligation	**13**	15	**40**	45
Deferred income tax recovery	**—**	—	**—**	(40,261)
	2,768	2,257	**7,869**	9,081
Changes in operating assets and liabilities	**(119)**	(2,446)	**(1,118)**	(129)
	2,649	(189)	**6,751**	8,952
INVESTING ACTIVITIES				
Additions to investment properties (note 4 and 5)	**—**	(12,447)	**(17,871)**	(12,447)
Payment of tenant incentives (note 6)	**(1,262)**	(503)	**(3,183)**	(1,407)
Investment property improvements, development and direct leasing costs	**(1,823)**	(993)	**(3,610)**	(3,099)
Change in restricted cash	**627**	688	**1,819**	(3,679)
	(2,458)	(13,255)	**(22,845)**	(20,632)
FINANCING ACTIVITIES				
Proceeds from issuing units, net of costs (note 12)	**—**	(57)	**21,250**	74,116
Acquisition of Initial Properties	**—**	—	**—**	(65,919)
Revolving credit facility	**5,000**	11,505	**(19,000)**	11,505
Proceeds from mortgages payable	**—**	—	**19,010**	55,000
Repayment of mortgages payable	**(870)**	(764)	**(2,446)**	(49,373)
Repayment on Class C LP Units	**(768)**	(736)	**(2,281)**	(1,222)
Change in restricted cash	**249**	274	**754**	(3,101)
Net distributions to Melcor Developments Ltd.	**—**	—	**—**	(7,447)
Distributions to unitholders	**(1,902)**	(1,541)	**(5,225)**	(2,568)
	1,709	8,681	**12,062**	10,991
INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS DURING THE PERIOD	**1,900**	(4,763)	**(4,032)**	(689)
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD	**—**	4,763	**5,932**	689
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	**1,900**	—	**1,900**	—

See accompanying notes to the condensed interim consolidated financial statements.

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 when its trust units were issued for cash pursuant to the initial public offering ("IPO").

The principal business of the REIT is to acquire, own and manage office, retail and industrial properties in select target markets in 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 16).

As at October 31, 2014, Melcor, through an affiliate, holds an approximate 47.6% effective interest in the REIT through ownership of all Class B LP Units of 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 condensed interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standard Board ("IASB") applicable to the preparation of interim financial statements, including IAS 34, *Interim Financial Reporting*.

As Melcor retained control over the REIT, the May 1, 2013 IPO and acquisition of the Initial Properties was accounted for as a reorganization and recapitalization using the continuity of interests method. Financial information for the pre-acquisition period as included in the comparative period are presented based on historical combined financial information for the Initial Properties as previously reported by Melcor.

These condensed interim consolidated financial statements should be read in conjunction with our annual consolidated financial statements for the year ended December 31, 2013, which have been prepared in accordance with IFRS as issued by the IASB. These condensed interim consolidated financial statements were authorized for issue by the Board of Trustees on October 31, 2014.

3. SIGNIFICANT ACCOUNTING POLICIES AND NEW STANDARD NOT YET ADOPTED

The accounting policies followed in these condensed interim consolidated financial statements are consistent with those of the previous financial year, except as described below.

Change in accounting policies

We have adopted the following new standard interpretation effective January 1, 2014.

IFRIC 21, Levies is an interpretation of IAS 37, 'Provisions, contingent liabilities and contingent assets'. IAS 37 sets out criteria for the recognition of a liability, one of which is the requirement for the entity to have a present obligation as a result of a past event (known as an obligating event). The interpretation clarifies that the obligating event that gives rise to a liability to pay a levy is the activity described in the relevant legislation that triggers the payment of the levy.

The adoption of IFRIC 21 did not result in a change in the recognition or timing of recognition of levies imposed on the REIT.

New standard not yet adopted

IFRS 15, Revenue from Contracts with Customers was issued in May 2014 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 retrospectively and is effective for annual periods beginning on or after January 1, 2017, with earlier application permitted.

We are currently assessing the impact of adopting this standard on our consolidated financial statements.

4. INVESTMENT PROPERTY ACQUISITIONS

Acquired from Melcor

On May 9, 2014, we completed the purchase of two multi-tenant retail properties from Melcor (the "Acquisition") for a purchase price of $13,500 (an additional $75 in transaction costs were capitalized to the properties). The REIT satisfied approximately $7,400 of the purchase price of the Acquisition by issuing 694,836 Class B LP Units at $10.65 per unit (note 11). The remainder of the purchase price was funded through the REIT's line of credit and available cash.

The purchase price approximates fair market value and the Acquisition has been accounted for as asset purchases.

Acquired from unrelated third parties

On January 10, 2014 we completed the acquisition of an industrial property, LC Industrial, located in Lethbridge, Alberta for $6,027 (including transaction costs).

On May 26, 2014 we completed the acquisition of an office building, 107 Avenue Building, located in Edmonton, Alberta for $5,669 (including transaction costs).

The acquisitions were funded through the REIT's line of credit and available cash.

In accordance with our policy these purchases have been accounted for as asset purchases.

5. INVESTMENT PROPERTIES

($000s)	**Nine months ended September 30, 2014**	Year ended December 31, 2013
Balance - beginning of period	**429,117**	382,381
Additions		
Direct acquisition (note 4)	**25,271**	25,851
Property improvements	**2,409**	3,035
Property development activities	**131**	—
Direct leasing costs	**1,070**	788
Fair value adjustment on investment properties (note 17)	**(3,103)**	16,953
Change in provision	**199**	109
Balance - end of period	**455,094**	429,117

In accordance with our policy, 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 17.

The cost of investment properties as at September 30, 2014 totalled $234,873 (December 31, 2013 - $205,992).

Presented separately from investment properties is $11,810 (December 31, 2013 - $10,386) in tenant incentives and $1,312 (December 31, 2013 - $846) in straight-line rent adjustments (note 6). The fair value of investment properties has been reduced by these amounts.

6. OTHER ASSETS

($000s)	September 30, 2014	December 31, 2013
Current Assets		
Prepaid expenses, and other	**1,863**	1,015
Non-Current Assets		
Straight-line rent adjustments	**1,312**	846
Tenant incentives	**11,810**	10,386
	13,122	11,232

During the nine-months ended September 30, 2014 we provided tenant incentives of $3,183 (2013 - $1,407) and recorded $1,759 (2013 - $1,681) of amortization expense. 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.

7. REVOLVING CREDIT FACILITY

As at September 30, 2014 we had $5,000 (December 31, 2013 - $24,000) drawn from the facility; and posted letters of credit of $nil. The following table summarizes the components of the balance at September 30, 2014.

($000s)	September 30, 2014	December 31, 2013
Amount drawn on facility	**5,000**	24,000
Unamortized transaction fees	**(72)**	(170)
Unamortized discount on bankers acceptance	**(3)**	(82)
	4,925	23,748

During the period we amended our revolving credit facility agreement, pledging two recently acquired and unencumbered properties as collateral for the facility. As at September 30, 2014, the carrying value of the pledged properties was $87,000 (December 31, 2013 - $66,700).

8. ACCRUED LIABILITIES AND OTHER PAYABLES

($000s)	September 30, 2014	December 31, 2013
Current Liabilities		
Accrued liabilities and other payables	**3,475**	3,508
Decommissioning obligation	**208**	182
	3,683	3,690
Non-Current Liabilities		
Decommissioning obligation	**1,222**	1,459

9. MORTGAGES PAYABLE

($000s)	September 30, 2014	December 31, 2013
Mortgages amortized over 15-25 years at fixed interest rates	**115,587**	99,023
Unamortized deferred financing fees	**(309)**	(201)
	115,278	98,822
Current portion of mortgages payable	**(38,970)**	(19,911)
	76,308	78,911
Interest rate ranges	**(3.01%-5.86%)**	(3.01%-5.86%)

Specific investment properties with a carrying value of $233,066 (December 31, 2013 - $197,866) 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 4.08% (December 31, 2013 - 4.20%).

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

	Principal Installment Repayments	Balance Maturing	Total
Remainder of 2014	881	16,939	**17,820**
2015	3,114	19,533	**22,647**
2016	2,460	11,901	**14,361**
2017	2,076	—	**2,076**
2018	2,154	32,592	**34,746**
Thereafter	1,024	22,913	**23,937**
	11,709	103,878	**115,587**

10. CLASS C LP UNITS

Class C LP Units are held by Melcor in consideration of debt retained on certain properties sold to the REIT. Distributions are made on the units in order 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.

($000s)	September 30, 2014	December 31, 2013
Class C LP Units amortized over 2-6 years at fixed interest rates	**90,297**	92,578
Unamortized fair value adjustment	**1,339**	1,669
	91,636	94,247
Current portion of Class C LP Units	**(26,136)**	(3,059)
	65,500	91,188
Effective interest rate	**3.84%**	3.84%

At September 30, 2014 there were 9,029,642 Class C LP Units issued and outstanding (December 31, 2013 - 9,257,820).

11. CLASS B LP UNITS

On May 1, 2013 the REIT issued 9,530,798 Class B LP Units at $10.00 per unit to Melcor as partial consideration for the initial properties sold to the REIT. On May 9, 2014 the REIT issued 694,836 Class B LP Units at $10.65 per unit to Melcor as partial consideration for the Acquisition (note 4). As at May 9, 2014 the fair value of the units issued was $10.47 per unit, or $7,275; the $125 difference between book value and fair value was recorded to contributed surplus.

The Class B LP Units are exchangeable at the option of the holder for one trust unit of the REIT and, therefore, are considered a puttable instrument and are required to be accounted for as a financial liability. Each unit is accompanied by one special

voting unit which entitle the holder to one vote at any meeting of the unitholders. Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units and are included in finance costs.

In accordance with our policy we record Class B LP Units at fair value. We remeasured the Class B LP Units at September 30, 2014 and recognized a fair value gain of $5,264 during the nine-month period (2013 - fair value loss of $291). Supplemental information on fair value measurement, including the valuation technique and the key input, is included in note 17.

At September 30, 2014 there were 10,225,634 Class B LP Units issued and outstanding at a fair value of $9.89 per unit or $101,132 (December 31, 2013 - 9,530,798 at $10.40 per unit or $99,120).

12. UNITHOLDERS' EQUITY

On May 7, 2014 the REIT issued 1,900,000 trust units at $10.65 per unit for gross proceeds of $20,235. On May 16, 2014 an additional 245,000 trust units were issued at $10.65 per unit pursuant to the underwriters over-allotment option for gross proceeds of $2,609. Issued and outstanding trust units at September 30, 2014 are 11,275,000 (December 31, 2013 - 9,130,000). The following table summarizes the changes in trust units during the period.

	September 30, 2014		**December 31, 2013**	
($000s except unit amounts)	**Units**	**Amount**	Units	Amount
Balance, beginning of period	**9,130,000**	**82,709**	—	—
Issuance of Units - IPO, net of $8,980 in costs	**—**	**—**	8,300,000	74,409
Conversion of Class B LP Units	**—**	**—**	830,000	8,300
Issuance of Units - net of $1,594 in costs	**2,145,000**	**21,250**	—	—
Balance, end of period	**11,275,000**	**103,959**	**9,130,000**	**82,709**

13. RENTAL REVENUE

The components of rental revenue are as follows:

	Three-months ended September 30		Nine-months ended September 30	
($000s)	**2014**	**2013**	**2014**	**2013**
Rental revenue	**11,445**	10,217	**34,133**	30,620
Amortization of tenant incentives	**(599)**	(554)	**(1,759)**	(1,681)
Straight-line adjustment	**228**	131	**466**	316
	11,074	9,794	**32,840**	29,255

14. FINANCE COSTS

The components of finance costs are as follows:

	Three-months ended September 30		Nine-months ended September 30	
($000s)	**2014**	**2013**	**2014**	**2013**
Interest on mortgages payable and revolving credit facility	**1,250**	1,036	**3,833**	4,417
Interest on Class C LP Units	**989**	1,021	**2,991**	1,707
Amortization of fair value adjustment on Class C LP Units	**(110)**	(110)	**(330)**	(183)
Distributions on Class B LP Units (note 16)	**1,725**	1,609	**5,020**	2,681
Amortization of deferred financing costs	**52**	16	**160**	36
	3,906	3,572	**11,674**	8,658

Total finance costs paid during the three and nine-month period were $3,964 and $11,844 (2013 - $3,666 and $8,805) respectively.

15. INCOME PER UNIT

Basic and diluted earnings per trust unit for the three and nine-months ended September 30, 2014 are calculated as follows (the comparative nine-months ended September 30, 2013 are presented for the post formation period May 1, 2013 to September 30, 2013):

	Three-months ended September 30		Nine-months ended September 30	
	2014	**2013**	**2014**	**2013**
Income and comprehensive income - basic ($000s)	**2,693**	5,945	**8,867**	7,729
Impact of Class B LP Unit fair value adjustment and distributions ($000s)	**(2,366)**	656	**(244)**	2,972
Income and comprehensive income - diluted ($000s)	**327**	6,601	**8,623**	10,701
Basic weighted average trust units outstanding during the period	**11,275,000**	9,130,000	**10,273,254**	9,080,855
Weighted average impact of conversion of Class B LP Units	**10,225,634**	9,530,798	**9,898,652**	9,530,798
Diluted weighted average trust units outstanding during the period	**21,500,634**	18,660,798	**20,171,906**	18,611,653
Basic earnings per trust unit	**$ 0.24**	$ 0.65	**$ 0.86**	$ 0.85
Diluted earnings per trust unit	**$ 0.02**	$ 0.35	**$ 0.43**	$ 0.57

16. RELATED PARTY TRANSACTIONS

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

a) Property and Asset Management Agreements

Pursuant to the terms of the Property and Asset Management Agreements the REIT incurred the following fees during the three and nine-month period:

	Three-months ended September 30		Nine-months ended September 30	
($000s)	**2014**	**2013**	**2014**	**2013**
Asset Management Agreement				
Base Annual Management Fee	**282**	252	**824**	419
Acquisition Fee	**—**	123	**115**	123
Property Management Agreement				
Monthly Fee	**316**	337	**910**	535
Lease Fee	**430**	282	**1,070**	425
	1,028	994	**2,919**	1,502

The Base Annual Management Fee is included in general and administrative expenses. Monthly Fees are included in direct operating expenses. Acquisition Fees and Lease Fees are capitalized to investment properties. As at September 30, 2014 there was $418 (December 31, 2013 - $447) payable to Melcor related to these fees.

b) Distributions on Class B LP Units and Redemptions of Class C LP Units

During the three and nine-month period ended September 30, 2014, $1,725 and $5,020 in distributions were recorded on Class B LP Units held by Melcor (2013 - $1,609 and $2,681). These distributions were recorded as finance costs. As at September 30, 2014 there was $575 payable to Melcor for the September distribution (December 31, 2013 - $536 for the December distribution).

Also during the three and nine-month period ended September 30, 2014, Melcor, as holder of all Class C LP Units, was paid $1,757 and $5,273 to fund principal and interest payments on the Retained Debt (2013 - $1,757 and $2,929). These redemptions were recorded as a reduction of the Class C LP Unit liability and as finance costs.

c) Rental Revenue

For the three and nine-month period ended September 30, 2014 the REIT collected $173 and $530 in rental revenue from Melcor and an affiliate for use of office space (2013 - $174 and $291 for the post-formation three and nine months respectively). This amount is included in rental revenue.

d) Key Management Remuneration

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

e) Purchase of Investment Properties

On May 9, 2014 the REIT purchased two properties from Melcor pursuant to the Development and Opportunities Agreement with Melcor. The total purchase price of $13,500 was satisfied by issuing 694,836 Class B LP Units at $10.65 per unit, approximating $7,400 of the purchase price. The remainder of the purchase price was funded through the REIT's line of credit and available cash.

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

17. 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, revolving credit facility, accounts payable and distribution payable approximate their fair values based on the short term maturities of these financial instruments.
- fair values of mortgages payable and Class C LP Units are estimated by discounting the future cash flows associated with the debt at market interest rates (Level 2).
- fair value of Class B LP Units are estimated based on the closing trading price of the REIT's trust units (Level 1).

In addition, the REIT carries its investment properties at fair value, which is determined by either the direct capitalization approach or by discounting future cash flows at a property specific discount rate (Level 3).

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.

	September 30, 2014				December 31, 2013	
($000s)	**Fair Value**	**Amortized Cost**	**Total Carrying Value**	**Total Fair Value**	Total Carrying Value	Total Fair Value
Non-financial assets						
Investment properties	**455,094**	**—**	**455,094**	**455,094**	429,117	429,117
Financial liabilities						
Mortgages payable	**—**	**115,587**	**115,587**	**118,873**	99,023	105,165
Class B LP Units	**101,132**	**—**	**101,132**	**101,132**	99,120	99,120
Class C LP Units	**—**	**91,636**	**91,636**	**91,636**	94,247	94,247

The table below analyzes assets and liabilities carried at fair value in the condensed interim consolidated statement of financial position, by the levels in the fair value hierarchy. 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.

($000s)	Level 1	Level 2	Level 3	Total
Non-financial assets				
Investment properties	—	—	455,094	455,094
Financial liabilities				
Class B LP Units	101,132	—	—	101,132

Investment properties

Investment properties are remeasured to fair value on a recurring basis and categorized as Level 3 in the fair value hierarchy. Investment properties were valued by qualified independent external valuation professionals as at December 31, 2013. We obtained updated market data at September 30, 2014 and considered whether changes to any valuation model variables resulted in significant changes to any of the investment property fair values at September 30, 2014. Fair values of investment properties were revised based on the updated data and model variables resulting in fair value losses for the nine-month period of $3,103 (2013 - fair value gains of $7,465) recorded as fair value adjustment on investment properties in income. Fair values are primarily determined by discounting the expected future cash flows over ten years plus a terminal value determined by applying a discount rate to estimated year eleven cash flows, or by applying a capitalization rate to the estimated future net operating income under the direct capitalization approach. 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 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 including verifying all major inputs included in the valuation and reviewing the results with the independent valuator. Melcor's management, along with the REIT's Audit Committee, discuss the valuation process and key inputs on a quarterly basis.

Weighted average stabilized net operating income for investment properties is $1,132 (December 31, 2013 - $1,176). Other significant valuation metrics and unobservable inputs are set out in the following table. Fair values are most sensitive to changes in capitalization rates.

	September 30, 2014			December 31, 2013		
	Min	**Max**	**Weighted Average**	Min	Max	Weighted Average
Capitalization rate	5.50%	9.00%	6.41%	5.50%	9.00%	6.41%
Terminal capitalization rate	5.75%	9.25%	6.70%	5.75%	9.25%	6.69%
Discount rate	6.50%	10.00%	7.58%	6.50%	10.00%	7.57%

An increase in the capitalization rates by 50 basis points would decrease the carrying amount of investment properties by $33,849 (December 31, 2013 - $31,881). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by $39,572 (December 31, 2013 - $37,278).

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 September 30, 2014 the fair value of the Class B LP Units was $101,132, resulting in a fair value gain of $5,264 for the nine-month period (2013 - fair value loss of $291).

18. SUBSEQUENT EVENT

Distributions declared

On October 15, 2014 we declared a distribution of $0.05625 per unit for the months of October, November and December 2014. The distributions will be payable as follows:

Month	Record Date	Distribution Date	Distribution Amount
October 2014	October 31, 2014	November 14, 2014	$0.05625 per unit
November 2014	November 28, 2014	December 15, 2014	$0.05625 per unit
December 2014	December 31, 2014	January 15, 2015	$0.05625 per unit