



MELCOR REAL ESTATE INVESTMENT TRUST

Condensed Interim Consolidated Financial Statements

For the three and six-months ended June 30, 2014

(Unaudited)

Condensed Interim Consolidated Statements of Financial Position

As at June 30, 2014

(Unaudited)

(\$000s)	June 30, 2014	December 31, 2013
ASSETS		
Current Assets		
Cash and cash equivalents	—	5,932
Accounts receivable	1,850	1,478
Other assets (note 6)	1,181	1,015
	3,031	8,425
Non-Current Assets		
Restricted cash	4,272	5,969
Investment properties (note 5 and 17)	456,934	429,117
Other assets (note 6)	12,231	11,232
	473,437	446,318
TOTAL ASSETS	476,468	454,743
LIABILITIES		
Current Liabilities		
Revolving credit facility (note 7)	22	23,748
Accounts payable	701	1,989
Distribution payable	1,209	1,050
Accrued liabilities and other payables (note 8)	4,594	3,690
Class C LP Units (note 10)	3,108	3,059
Mortgages payable (note 9)	20,472	19,911
	30,106	53,447
Non-Current Liabilities		
Accrued liabilities and other payables (note 8)	1,235	1,459
Class B LP Units (note 11 and 17)	105,222	99,120
Class C LP Units (note 10)	89,406	91,188
Mortgages payable (note 9)	95,655	78,911
	321,624	324,125
TOTAL LIABILITIES	321,624	324,125
UNITHOLDERS' EQUITY	154,844	130,618
TOTAL LIABILITIES AND UNITHOLDERS' EQUITY	476,468	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 six-months ended June 30

(Unaudited)

	Three-months ended June 30		Six-months ended June 30	
(\$000s)	2014	2013	2014	2013
Rental revenue (note 13 and 16)	11,119	9,773	21,766	19,461
Direct operating expenses (note 16)	(4,406)	(3,840)	(8,751)	(7,682)
Net rental income	6,713	5,933	13,015	11,779
General and administrative expenses (note 16)	(659)	(417)	(1,022)	(811)
Fair value adjustment on investment properties (note 5 and 17)	568	1,792	737	4,386
Fair value adjustment on Class B LP Units (note 11 and 17)	2,603	(1,244)	1,173	(1,244)
Income before finance costs and income taxes	9,225	6,064	13,903	14,110
Interest income	21	17	39	23
Finance costs (note 14 and 16)	(3,950)	(3,045)	(7,768)	(5,086)
Net finance costs	(3,929)	(3,028)	(7,729)	(5,063)
Net income before income taxes	5,296	3,036	6,174	9,047
Current income tax expense	—	871	—	—
Deferred income tax expense	—	40,585	—	40,261
Income tax expense	—	41,456	—	40,261
Net income and comprehensive income	5,296	44,492	6,174	49,308

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 six-months ended June 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	—	—	—	—	6,174	6,174
Distributions to unitholders	—	—	—	—	(3,323)	(3,323)
Balance at June 30, 2014	11,275,000	103,959	36,948	—	13,937	154,844

(\$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 contributions from Melcor Developments Ltd.	—	—	—	(7,447)	—	(7,447)
Balance at April 30, 2013	—	—	—	208,408	—	208,408
Reorganization and recapitalization	8,300,000	74,173	36,920	(208,408)	—	(97,315)
Conversion of Class B LP Units	830,000	7,823	767	—	—	8,590
Net income for the period May 1, 2013 to June 30, 2013	—	—	—	—	1,784	1,784
Distributions to unitholders	—	—	—	—	(1,027)	(1,027)
Balance at June 30, 2013	9,130,000	81,996	37,687	—	757	120,440

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Cash Flows

For the three and six-months ended June 30

(Unaudited)

	Three-months ended June 30		Six-months ended June 30	
(\$000s)	2014	2013	2014	2013
CASH FLOWS FROM (USED IN)				
OPERATING ACTIVITIES				
Net income for the period	5,296	44,492	6,174	49,308
Non cash items:				
Amortization of tenant incentives (note 13)	619	549	1,160	1,127
Straight-line rent adjustments (note 13)	(129)	(103)	(238)	(185)
Fair value adjustment on investment properties (note 5 and 17)	(568)	(1,792)	(737)	(4,386)
Fair value adjustment on Class B LP Units (note 11 and 17)	(2,603)	1,244	(1,173)	1,244
Amortization of fair value adjustment on Class C LP Units (note 14)	(110)	(73)	(220)	(73)
Amortization of deferred financing costs (note 14)	63	20	108	20
Accretion on decommissioning obligation	13	15	27	30
Deferred income tax expense	—	(40,585)	—	(40,261)
	2,581	3,767	5,101	6,824
Changes in operating assets and liabilities	(775)	(1,662)	(999)	2,317
	1,806	2,105	4,102	9,141
INVESTING ACTIVITIES				
Additions to investment properties (note 4 and 5)	(11,844)	—	(17,871)	—
Payment of tenant incentives (note 6)	(1,085)	(320)	(1,921)	(904)
Investment property improvements and direct leasing costs	(921)	(1,847)	(1,787)	(2,106)
Change in restricted cash	724	(4,367)	1,192	(4,367)
	(13,126)	(6,534)	(20,387)	(7,377)
FINANCING ACTIVITIES				
Proceeds from issuing units, net of costs (note 12)	21,250	74,173	21,250	74,173
Acquisition of Initial Properties	—	(65,919)	—	(65,919)
Revolving credit facility	(18,500)	—	(24,000)	—
Proceeds from mortgages payable	8,110	28,375	19,010	55,000
Repayment of mortgages payable	(824)	(26,615)	(1,576)	(48,609)
Repayment on Class C LP Units	(760)	(486)	(1,513)	(486)
Change in restricted cash	251	(3,375)	505	(3,375)
Net distributions from (to) Melcor Developments Ltd.	—	3,208	—	(7,447)
Distributions to unitholders	(1,782)	(1,027)	(3,323)	(1,027)
	7,745	8,334	10,353	2,310
INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS DURING THE PERIOD	(3,575)	3,905	(5,932)	4,074
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD	3,575	858	5,932	689
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	—	4,763	—	4,763

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.

As at August 5, 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 August 5, 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 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)	Six months ended June 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	1,147	3,035
Direct leasing costs	640	788
Fair value adjustment on investment property (note 17)	737	16,953
Change in provision	22	109
Balance - end of period	456,934	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 June 30, 2014 totalled \$233,050 (December 31, 2013 - \$205,992).

Presented separately from investment properties is \$11,147 (December 31, 2013 - \$10,386) in tenant incentives and \$1,084 (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)	June 30, 2014	December 31, 2013
Current Assets		
Prepaid expense, and other	1,181	1,015
Non-Current Assets		
Straight-line rent adjustments	1,084	846
Tenant incentives	11,147	10,386
	12,231	11,232
	13,412	12,247

During the six-month period we provided tenant incentives of \$1,921 (2013 - \$904) and recorded \$1,160 (2013 - \$1,127) of amortization expense respectively. 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 June 30, 2014 we had \$nil (December 31, 2013 - \$24,000) drawn from the facility; and posted letters of credit of \$nil. As at June 30, 2014 an additional \$127 was allocated by management under the revolving credit facility to reflect additional funds reserved by management in order to satisfy our restricted cash commitment. The following table summarizes the components of the balance at June 30, 2014.

(\$000s)	June 30, 2014	December 31, 2013
Amount drawn on facility	—	24,000
Unamortized transaction fees	(105)	(170)
Unamortized discount on bankers acceptance	—	(82)
Restricted cash	127	—
	22	23,748

8. ACCRUED LIABILITIES AND OTHER PAYABLES

(\$000s)	June 30, 2014	December 31, 2013
Current Liabilities		
Accrued liabilities and other payables	4,326	3,508
Decommissioning obligation	268	182
	4,594	3,690
Non-Current Liabilities		
Decommissioning obligation	1,235	1,459
	5,829	5,149

9. MORTGAGES PAYABLE

(\$000s)	June 30, 2014	December 31, 2013
Mortgages amortized over 15-25 years at fixed interest rates	116,457	99,023
Unamortized deferred financing fees	(330)	(201)
	116,127	98,822
Current portion of mortgages payable	(20,472)	(19,911)
	95,655	78,911
Interest rate ranges	(3.01%-5.86%)	(3.01%-5.86%)

Specific investment properties with a carrying value of \$234,166 (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 4.1% (December 31, 2013 - 4.2%).

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	1,751	16,939	18,690
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
	12,579	103,878	116,457

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 interest expense.

(\$000s)	June 30, 2014	December 31, 2013
Class C LP Units amortized over 2-6 years at fixed interest rates	91,065	92,578
Unamortized fair value adjustment	1,449	1,669
	92,514	94,247
Current portion of Class C LP Units	(3,108)	(3,059)
	89,406	91,188
Effective interest rate	3.84%	3.84%

At June 30, 2014 there were 9,106,541 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 June 30, 2014 and recognized a fair value gain of \$1,173 during the six-month period. Supplemental information on fair value measurement, including the valuation technique and the key input, is included in note 17.

At June 30, 2014 there were 10,225,634 Class B LP Units issued and outstanding at a fair value of \$10.29 per unit or \$105,222 (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 June 30, 2014 are 11,275,000 (December 31, 2013 - 9,130,000). The following table summarizes the changes in trust units during the period.

(\$000s except unit amounts)	June 30, 2014		December 31, 2013	
	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:

(\$000s)	Three-months ended June 30		Six-months ended June 30	
	2014	2013	2014	2013
Rental revenue	11,609	10,219	22,688	20,403
Amortization of tenant incentives	(619)	(549)	(1,160)	(1,127)
Straight-line adjustment	129	103	238	185
	11,119	9,773	21,766	19,461

14. FINANCE COSTS

The components of finance costs are as follows:

(\$000s)	Three-months ended June 30		Six-months ended June 30	
	2014	2013	2014	2013
Interest on mortgages payable	1,313	1,340	2,583	3,381
Interest on Class C LP Units	997	686	2,002	686
Amortization of fair value adjustments on Class C LP Units	(110)	(73)	(220)	(73)
Distributions on Class B LP Units (note 16)	1,687	1,072	3,295	1,072
Amortization of deferred financing costs	63	20	108	20
	3,950	3,045	7,768	5,086

Total finance costs paid during the three and six-month period were \$3,997 and \$7,880 (2013 - \$2,562 and \$4,603) respectively.

15. INCOME PER UNIT

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

	Three-months ended June 30		Six-months ended June 30	
	2014	2013	2014	2013
Income and comprehensive income - basic (\$000s)	5,296	1,784	6,174	1,784
Impact of Class B LP Unit fair value adjustment and distributions (\$000s)	(917)	—	2,121	—
Income and comprehensive income - diluted (\$000s)	4,379	1,784	8,295	1,784
Basic weighted average trust units outstanding during the period	10,392,500	9,005,500	9,761,250	9,005,500
Weighted average impact of conversion of Class B LP Units	9,932,259	—	9,731,528	—
Diluted weighted average trust units outstanding during the period	20,324,759	9,005,500	19,492,778	9,005,500
Basic earnings per trust unit	\$ 0.51	\$ 0.20	\$ 0.63	\$ 0.20
Diluted earnings per trust unit	\$ 0.22	\$ 0.20	\$ 0.43	\$ 0.20

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 six-month period:

	Three-months ended June 30		Six-months ended June 30	
(\$000s)	2014	2013	2014	2013
Asset Management Agreement				
Base Annual Management Fee	273	167	542	167
Acquisition Fee	56	—	115	—
Property Management Agreement				
Monthly Fee	307	198	594	198
Lease Fee	382	143	640	143
	1,018	508	1,891	508

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 June 30, 2014 there was \$409 (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 six-month period ended June 30, 2014, \$1,687 and \$3,295 in distributions were recorded on Class B LP Units held by Melcor (2013 - \$1,072 and \$1,072). These distributions were recorded as finance costs. As at June 30, 2014 there was \$575 payable to Melcor for the June distribution (December 31, 2013 - \$536 for the December distribution).

Also during the three and six-month period ended June 30, 2014, Melcor, as holder of all Class C LP Units, was paid \$1,758 and \$3,516 to fund principal and interest payments on the Retained Debt (2013 - \$1,172 and \$1,172). These redemptions were recorded as a reduction of the Class C LP Unit liability and as finance costs.

c) Rental Revenue

From the three and six-month period ended June 30, 2014 the REIT collected \$177 and \$357 in rental revenue from Melcor and an affiliate for use of office space (2013 - \$346 and \$346 for the three and six 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.

(\$000s)	June 30, 2014				December 31, 2013	
	Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value	Total Carrying Value	Total Fair Value
Non-financial assets						
Investment properties	456,934	—	456,934	456,934	429,117	429,117
Financial liabilities						
Mortgages payable	—	116,457	116,457	120,889	99,023	105,165
Class B LP Units	105,222	—	105,222	105,222	99,120	99,120
Class C LP Units	—	92,514	92,514	92,514	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 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	—	—	456,934	456,934
Financial liabilities				
Class B LP Units	105,222	—	—	105,222

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 June 30, 2014 and considered whether changes to any valuation model variables resulted in significant changes to any of the investment property fair values at June 30, 2014. Fair values of investment properties were revised based on the updated data and model variables resulting in fair value gains for the six-month period of \$737 (2013 - \$4,386) recorded as fair value adjustment on investment properties in the income statement. 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 \$1,134 (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.

	June 30, 2014			December 31, 2013		
	Min	Max	Weighted Average	Min	Max	Weighted Average
Capitalization rate	5.50%	9.00%	6.42%	5.50%	9.00%	6.41%
Terminal capitalization rate	5.75%	9.25%	6.71%	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 \$33,911 (December 31, 2013 - \$31,881). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by \$39,642 (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 June 30, 2014 the fair value of the Class B LP Units was \$105,222, resulting in a fair value gain of \$1,173 for the six-month period.

18. SUBSEQUENT EVENTS

Distributions declared

On July 15, 2014 we declared a distribution of \$0.05625 per unit for the months of July, August and September 2014. The distributions will be payable as follows:

Month	Record Date	Distribution Date	Distribution Amount
July 2014	July 31, 2014	August 15, 2014	\$0.05625 per unit
August 2014	August 29, 2014	September 15, 2014	\$0.05625 per unit
September 2014	September 30, 2014	October 15, 2014	\$0.05625 per unit