

Management's Discussion & Analysis

May 2, 2019

The following Management's Discussion and Analysis (MD&A) of Melcor Real Estate Investment Trust's (the REIT) results should be read in conjunction with the unaudited condensed interim consolidated financial statements and related notes for the quarter ended March 31, 2019 and the MD&A and consolidated financial statements and related notes for the year ended December 31, 2018. The discussion outlines strategies and provides analysis of our financial performance for the first quarter of 2019.

The underlying financial statements in this MD&A, including 2018 comparative information, have been prepared in accordance with International Financial Reporting Standards (IFRS) unless otherwise noted. All dollar amounts included in this MD&A are Canadian dollars unless otherwise specified.

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.

The REIT's Board of Trustees, on the recommendation of the Audit Committee, approved the content of this MD&A on May 2, 2019. Disclosure contained in this MD&A is current to May 2, 2019, unless otherwise indicated.

Regulatory Filings

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

Non-standard Measures

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

Non-standard measures included in this MD&A are defined on page 18 "*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 2019 and beyond, future leasing, acquisition and financing plans and objectives, targets, expectations of the real estate, financing and economic environments, our financial condition or the results of or outlook 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 on pages 23-27 of the 2018 annual report.

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.

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Our Business: Vision, Goals & Strategy

Melcor REIT has an established and diversified portfolio in western Canada. We currently own 38 income-producing office, retail and industrial properties representing 2.93 million square feet (sf) in gross leasable area (GLA). These high-quality properties feature stable occupancy and a diversified mix of tenants, some of whom have been in place for over 20 years. We are externally managed, administered and operated by Melcor pursuant to the asset management and property management agreements entered into at our IPO.

As at May 2, 2019, Melcor, through an affiliate, holds an approximate 53.1% effective interest in the REIT through ownership of all Class B LP Units of the Partnership and is the ultimate controlling party.

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 monthly cash distributions to unitholders. Our growth strategy is simple: acquire and improve. Together with Melcor, we have a proven track record of doing both.

Acquire/Divest:

Subsequent to the quarter we acquired a 56,084 sf single tenant retail building with warehouse space in Calgary, Alberta from a 3rd party for \$12.45 million. The purchase was funded through our revolving credit facility.

We continue to actively seek strategic third-party and proprietary property acquisitions that meet our investment criteria.

Improve:

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

Asset Enhancement:

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

Property Management:

We responded to 99% of calls to our signature customer care line within 30 minutes in Q1-2019, exceeding our target of a 95% on time response rate. We use this metric as an indicator of our success in providing responsive care to our customers.

Q1-2019 Highlights & Key Performance Indicators

Financial Highlights

(\$000s)	Three months ended March 31		
	2019	2018	△%
Non-standard KPIs			
Net operating income (NOI)	11,012	11,075	(1)%
Same-asset NOI	9,639	9,766	(1)%
Funds from operations (FFO)	6,531	6,702	(3)%
Adjusted funds from operations (AFFO)	4,617	4,893	(6)%
Adjusted Cash Flow from Operations (ACFO)	4,584	4,837	(5)%
Rental revenue	17,944	18,017	— %
Income before fair value adjustments	3,252	3,420	(5)%
Fair value adjustment on investment properties ⁽¹⁾	1,159	(1)	nm
Cash flows from operations	2,751	3,697	(26)%
Distributions to unitholders	2,225	2,225	— %
Distributions ⁽²⁾	\$0.17	\$0.17	
Per Unit Metrics			
Net income			
Basic	\$0.19	\$0.74	
Diluted	\$0.19	\$0.21	
Weighted average number of units for net income (000s): ⁽³⁾			
Basic	13,187	12,915	2 %
Diluted	13,187	27,777	(53)%
FFO			
Basic	\$0.23	\$0.24	
Diluted	\$0.23	\$0.24	
Payout ratio	73%	70%	
AFFO			
Basic	\$0.16	\$0.18	
Payout ratio	103%	96%	
Weighted average number of units for FFO & AFFO (000s): ⁽⁴⁾			
Basic	28,086	27,777	1 %
Diluted	32,813	32,504	1 %

1. The abbreviation nm is shorthand for not meaningful and is used through this MD&A where appropriate.

2. Distributions for the current and comparative periods have been paid out at a rate of \$0.05625 per unit per month.

3. For the purposes of calculating per unit net income the basic weighted average number of units includes Trust Units and the diluted weighted average number of units includes Class B LP Units and convertible debentures, to the extent that their impact is dilutive.

4. For the purposes of calculating per unit FFO and AFFO the basic weighted average number of units includes Trust Units and Class B LP Units. The diluted weighted average number of units includes convertible debentures.

	31-Mar-19	31-Dec-18	△%
Total assets (\$000s)	712,376	709,603	— %
Equity (\$000s) ⁽¹⁾	280,401	280,401	— %
Debt (\$000s) ⁽²⁾	391,240	390,918	— %
Weighted average interest rate on debt	3.81%	3.77%	1 %
Debt to GBV, excluding convertible debentures (maximum threshold - 60%)	48%	48%	—%
Debt to GBV (maximum threshold - 65%)	56%	56%	—%
Finance costs coverage ratio ⁽³⁾	2.60	2.60	— %
Debt service coverage ratio ⁽⁴⁾	2.32	2.30	1 %

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

Operational Highlights

	31-Mar-19	31-Dec-18	△%
Number of properties	37	37	— %
Gross leasable area (GLA) (sf)	2,869,743	2,868,901	— %
Occupancy (weighted by GLA)	89.3%	89.9%	(1%)
Retention (weighted by GLA)	88.9%	77.4%	15%
Weighted average remaining lease term (years)	4.53	4.67	(3)%
Weighted average base rent (per sf)	\$16.60	\$16.51	1 %

Q1-2019 Highlights:

Our portfolio performance remained stable through the first quarter of 2019. Market fundamentals remain challenging; particularly in our Edmonton office assets. We continue to proactively renew existing tenants and pursue new tenants, which resulted in a healthy retention rate of 88.9% at quarter end and overall occupancy of 89.3%. The diversity of our portfolio with respect to both tenant profile and asset class enable the REIT to continue navigating through economic cycles. We are focused on the real estate fundamentals of asset enhancement and property management while conservatively managing our debt.

Highlights of our performance in the first quarter include:

- Revenue and NOI were stable over Q1-2018.
- Same-asset NOI was down 1% over Q1-2018 and 2% from Q4-2018, trending with a decline in same-asset occupancy.
- We continued to execute on our proactive leasing strategy to both retain existing and attract new tenants. We completed lease renewals representing 56,939 sf (including holdovers) for a retention rate of 88.9% at March 31, 2019. New leasing has been steady across the portfolio with 10,122 sf in new deals commencing to date in 2019 and an additional 45,000 sf in committed leasing for future occupancy.
- Net income in the current and comparative periods is significantly impacted by non-cash fair value adjustments on investment properties due to changes in capitalization rates/NOI and Class B LP Units due to changes in the REIT's unit price. Management believes funds from operations (FFO) is a better reflection of our true operating performance. FFO was \$6.53 million or \$0.23 per unit, down 3% from Q1-2018 due to slightly lower net rental income.
- Adjusted funds from operations (AFFO) was \$4.62 million or \$0.16 per unit, down 6% from Q1-2018 and 4% over Q4-2018. The decrease was due to lower FFO and higher reserves for tenant incentives and leasing commissions on account of continued challenging market conditions.

- Subsequent to the quarter we acquired a 56,084 sf single tenant retail building with warehouse space in Calgary, Alberta from a 3rd party for \$12.45 million. This redeployment of capital is immediately accretive to AFFO.
- We paid distributions of \$0.05625 per trust unit in January, February and March for a quarterly payout ratio of 103% based on AFFO and 73% based on FFO.
- On April 1, 2019 we commenced a normal course issuer bid (NCIB) which allows the REIT to purchase approximately 5% of its issued and outstanding trust units for cancellation. The REIT believes that its units have been trading in a price range which does not reflect the value of the units in relation to the REIT's current and future business prospects. Since commencement, we have purchased 13,432 units for \$0.10 million at a weighted average cost of \$7.60 or 77% of book value. Purchases under the NCIB will have a positive impact on payout ratio going forward.
- As at March 31, 2019 we have \$1.55 million in cash and \$25.05 million in additional capacity under our revolving credit facility. We conservatively manage our debt, with a debt to GBV on the low end of our target range.

Consolidated Revenue & Net Operating Income

(\$000s)	Three months ended March 31		
	2019	2018	△%
Base rent	10,992	11,027	— %
Recoveries	6,850	6,795	1 %
Other	570	591	(4)%
Amortization of tenant incentives	(765)	(768)	— %
Straight-line rent adjustment	297	372	(20)%
Rental revenue	17,944	18,017	— %
Operating expenses	3,383	3,442	(2)%
Utilities and property taxes	4,017	3,896	3 %
Direct operating expenses	7,400	7,338	1 %
Net rental income	10,544	10,679	(1)%
NOI	11,012	11,075	(1)%
Same-asset NOI	9,639	9,766	(1)%
Operating margin	59%	59%	— %

Revenue

Rental revenue for the period was stable over Q1-2018. Properties acquired within the past fifteen months (LFS Building on December 3, 2018 and the Melcor Acquisition on January 12, 2018) contributed rental revenue of \$1.99 million (2018 - \$1.58 million). The increase in rental revenue was offset by a decrease in same-asset performance in our office portfolio as well as the sale of two retail assets in 2018, which contributed \$0.32 million to prior quarter revenues.

Year to date we signed 56,939 sf of new and renewed leasing (including holdovers) and maintained steady occupancy at 89.3%. In 2019, 85 leases representing 279,560 sf or 9.7% of our portfolio are up for renewal. We have retained 88.9% of expiring leases (representing 52,640 sf) as at March 31, 2019 in spite of challenging market conditions in many of our operating regions. We have received notice that one of our major tenants, Royal Bank of Canada, will be vacating their space at the Royal Bank Building in Edmonton, AB at the end of their lease in September 2019. The lease represents 47,088 sf and will significantly impact our retention rate in 2019. We are actively working on various strategies for the property to re-brand and lease-up and have already pre-leased one floor (7,900 sf) to an existing tenant who is outgrowing their space in another downtown building owned by the REIT.

The table below summarizes the leasing activity for 2019 year to date:

	Square feet	Weighted average base rent (per sf)	Occupancy %
Opening occupancy	2,579,470	\$16.51	89.9%
Expiring Leases	(52,640)	\$16.91	
Other Terminations	(28,540)	\$10.89	
Renewals/Holdovers	46,817	\$16.02	
New Leasing	10,122	\$21.56	
Lease Amendments	7,261	\$—	
Closing occupancy	2,562,490	\$16.60	89.3%

Weighted average base rent was \$16.60, up \$0.09 compared to December 31, 2018 due to leasing activity and fewer tenants on rent free periods. Weighted average base rent was down \$0.18 over Q1-2018 due to changes in the portfolio composition following the acquisition of LFS Building (office) and disposal of Miller Crossing (retail) in 2018.

The following table summarizes our average base rent, GLA, occupancy and retention:

	31-Mar-19	31-Mar-18	△%	31-Dec-18	△%
Weighted average base rent (per sf)	\$16.60	\$16.78	(1)%	\$16.51	1 %
Weighted average remaining lease term (years)	4.53	5.06	(10)%	4.67	(3)%
Gross leasable area (GLA) (sf)	2,869,743	2,861,546	— %	2,868,901	— %
Occupancy (weighted by GLA)	89.3%	90.5%	(1)%	89.9%	(1)%
Retention (weighted by GLA)	88.9%	67.1%	32 %	77.4%	15 %

Recoveries are amounts recovered from tenants for direct operating expenses incurred and include a nominal administrative charge. We typically expect recovery revenue to correlate with changes in recoverable operating expenses. Q1-2019 recovery revenue was up 1% over 2018 while direct operating expenses increased 1%. Our recovery ratio was stable over Q1-2018.

Other revenue includes parking and other miscellaneous revenue that is ancillary to our business and fluctuates from period to period.

Amortization of tenant incentives can fluctuate based on the timing of lease rollovers and leasing incentives. Straight-line rent adjustments relate to new leases which have escalating rent rates and/or rent-free periods. The increase in straight-line rent adjustments in the quarter is a result of new leases with rent-free periods and multiple rent escalations. Straight-line rent adjustments fluctuate due to the timing of signed leases.

Direct operating expenses

Direct operating expenses were up 1% in Q1-2019. On a same-asset basis, property taxes and utilities increased by 3% due to higher utility riders and fees as well as increases in property taxes, primarily on our retail assets. The timing of maintenance projects led to a 1% decrease in same-asset operating expenses in the first quarter. As a cornerstone of our property management strategy, we are committed to efficient and cost effective maintenance of our buildings to ensure maximum value to our tenants and unitholders.

NOI and Same-asset NOI

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

NOI was flat over Q4-2018 and down 1% over Q1-2018. On a same-asset basis, NOI was down 1% over Q1-2018 as a result of lower occupancy and weighted average base rates. Same-asset NOI compared to Q4-2018 was down 2%.

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

(\$000s)	Three months ended				
	31-Mar-19	31-Mar-18	△%	31-Dec-18	△%
Same-asset NOI	9,639	9,766	(1)%	9,810	(2)%
Acquisitions	1,373	1,074		1,196	
Disposals	—	235		—	
NOI	11,012	11,075	(1)%	11,006	— %
Amortization of tenant incentives	(765)	(768)		(809)	
Straight-line rent adjustment	297	372		159	
Net rental income per financial statements	10,544	10,679	(1)%	10,356	2 %

Property Analysis

At March 31, 2019 our portfolio included interests in 37 retail, office and industrial income-producing properties located in western Canada for a total of 2,869,743 sf of GLA, and a land lease community.

The following table summarizes the composition of our properties at March 31, 2019 by property type:

Property Type	Number of Properties	GLA (sf)/ Lots	% of Portfolio (GLA)	Fair Value of Investment Properties (\$000s)	Net rental income for the three months ended March 31, 2019 (\$000s)
Retail	12	1,057,599	36.9%	355,396	5,177
Office	21	1,604,053	55.8%	291,979	4,375
Industrial	3	208,091	7.3%	43,200	732
Land Lease Community	1	308 lots	n/a	16,200	260
	37	2,869,743	100.0%	706,775	10,544

The following table details key financial and operational metrics for each of our asset classes for the three months ended March 31, 2019:

	Retail		Office		Industrial		Land Lease Community	
	2019	2018	2019	2018	2019	2018	2019	2018
<u>Three months ended March 31 (\$000s)</u>								
Rental revenue	7,746	7,872	8,926	8,930	936	885	336	330
Net rental income	5,177	5,324	4,375	4,409	732	700	260	246
Same-asset NOI	4,241	4,175	4,670	4,885	468	460	260	246
<u>As at March 31</u>								
Weighted average base rent (sf)	\$20.67	\$20.27	\$13.86	\$14.40	\$14.51	\$14.12	n/a	n/a
Occupancy	92.7%	95.0%	85.7%	86.1%	100.0%	100.0%	100.0%	100.0%

Retail – our 12 retail properties include 5 multi-building regional power centres and 7 neighborhood shopping centres. Rental revenue was down 2% over Q1-2018 due to the sale of two retail properties in 2018 and higher vacancy. Occupancy decreased 2.30% from Q1-2018 due in part to the sale of Miller Crossing in April 2018 as well as tenant rollover within our Red Deer, AB and Regina, SK assets. Same-asset NOI was up 2% over Q1-2018 and Q4-2018 due to step ups on leases with multiple rent escalations and fewer tenants on rent-free periods.

Office – our 21 office properties include low and medium-rise buildings located in strategic urban and suburban centres. Our office portfolio is our most geographically diverse asset class, with properties across Alberta, in Regina, SK and Kelowna, BC. In December 2018 we acquired an office property in Lethbridge, AB which contributed \$0.11 million in Q1-2019. On a same-asset basis rental revenue was down 1% over Q1-2018 due to lower occupancy and weighted average base rents as well as increase in tenant incentive amortization due to higher deal costs. Ongoing competition for downtown Edmonton office tenants and its impact on the suburban market continues to drag on the portfolio. Same-asset NOI declined 4% compared to

Q1-2018 due to lower performance in our Edmonton, AB and Regina, SK assets and higher non-recoverable costs. Same-asset NOI was down 5% from Q4-2018.

Industrial – our 3 industrial properties include single and multi-tenant buildings. Our assets remained fully occupied through the first quarter of 2019. Weighted average base rents were up \$0.39 from Q1-2018 and \$0.19 from Q4-2018 due to step ups on leases with multiple rent escalations. Same-asset NOI was stable over Q1-2018 and Q4-2018.

Land Lease Community – we have one land lease community in Calgary, AB, consisting of 308 pad lots. It was 100% occupied at March 31, 2019 (December 31, 2018 – 100%). Revenue on our land lease community was up 2% over Q1-2018 due to increased pad rates. NOI was up 6% over Q1-2018 and 4% from Q4-2018 as a result of timing of operating expenses.

Regional Analysis

The following table summarizes the composition of our properties at March 31, 2019 by geographic region:

Geographic Region	Number of Properties	GLA (sf)	% of Portfolio (GLA)	Fair Value of Investment Properties (\$000s)	Net rental income for the three months ended March 31, 2019 (\$000s)
Northern Alberta	21	1,671,738	58.2%	408,449	5,781
Southern Alberta	9	831,216	29.0%	229,952	3,760
Saskatchewan & British Columbia	7	366,789	12.8%	68,374	1,003
	37	2,869,743	100.0%	706,775	10,544

The following table details key financial and operational metrics for each of our geographic regions for the three months ended March 31, 2019:

	Northern Alberta		Southern Alberta		Saskatchewan & British Columbia	
	2019	2018	2019	2018	2019	2018
<u>Three-months ended March 31 (\$000s)</u>						
Rental revenue	10,182	10,466	5,911	5,644	1,851	1,907
Net rental income	5,781	6,047	3,760	3,586	1,003	1,046
Same-asset NOI	5,425	5,541	3,113	3,089	1,101	1,136
<u>As at March 31</u>						
Weighted average base rent (per sf)	\$16.99	\$17.25	\$17.09	\$17.22	\$13.74	\$13.76
Occupancy	86.5%	87.6%	94.6%	95.3%	90.0%	93.0%

Northern Alberta - our Northern Alberta assets are located throughout the greater Edmonton area, including Leduc and Spruce Grove, and in Red Deer. Rental revenue and net rental income were down 3% and 4% respectively over Q1-2018 due to the sale of two retail buildings in 2018 and lower occupancy. Same-asset NOI was down 2% over Q1-2018 due to higher vacancy and declining lease rates. Same-asset NOI was stable over Q4-2018.

Southern Alberta - our Southern Alberta assets are located throughout the greater Calgary area, including Chestermere and Airdrie, and in Lethbridge. The acquisition of LFS Building in December 2018 contributed to the increase in rental revenue and net rental income. Same-asset NOI was up 1% over Q1-2018 and down 3% from Q4-2018 due to the timing of operating costs and fluctuations in the recovery ratio.

Saskatchewan and British Columbia - our Saskatchewan and British Columbia assets are located in Regina, SK and Kelowna, BC. Rental revenue and NOI were down 3% over Q1-2018 as a result of lower occupancy in our Regina, SK assets. NOI was down 5% from Q4-2018.

General & Administrative Expenses

	Three months ended March 31		
(\$000s)	2019	2018	△%
Asset management fee	437	437	— %
Professional fees	67	77	(13)%
Public company costs	131	137	(4)%
Other	87	95	(8)%
General & administrative expenses	722	746	(3)%

General & administrative expenses (G&A) were \$0.72 million or 4% of rental revenue in Q1-2019. G&A was down 3% over Q1-2018 due to timing of administrative activities and expenses incurred. We are committed to prudent financial stewardship and carefully monitor discretionary G&A expenses to ensure maximum value to our unitholders. We expect G&A to be approximately 5% of rental revenue.

Finance Costs

	Three months ended March 31		
(\$000s)	2019	2018	△%
Interest on mortgages payable and revolving credit facility	2,314	2,152	8 %
Interest on Class C LP Units	639	775	(18)%
Amortization of fair value adjustment on Class C LP Units	(33)	(56)	(41)%
Interest on convertible debentures	776	776	— %
Fair value adjustment on derivative instruments	145	(17)	nm
Amortization of deferred financing fees	388	388	— %
Finance costs before distributions	4,229	4,018	5 %
Distributions on Class B LP Units	2,514	2,514	— %
Finance costs	6,743	6,532	3 %

Finance costs were up \$0.21 million or 3% in 2019. Excluding the impact of fair value adjustment on derivative instruments, finance costs were flat over Q1-2018.

Higher interest on mortgages payable and revolving credit facility is due to higher amounts drawn under our revolving credit facility in the current quarter. Comparatively, lower interest on Class C LP units was due to repayments made in 2018, which reduced the outstanding balance.

The 2018 Debentures pay a coupon of 5.25% annually. The \$34.50 million 2014 Debentures pay a coupon of 5.50% annually.

Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units (\$0.17 per unit during the quarter).

As at March 31, 2019 the weighted average interest rate on our revolving credit facility, mortgages payable, Class C LP Units and convertible debentures was 3.81%.

Income Taxes

As at March 31, 2019, the REIT qualifies as a mutual fund trust within the meaning of the *Income Tax Act* (Canada) and as a real estate investment trust eligible for the 'REIT Exception' under the Specified Investment Flow-Through (SIFT) rules; accordingly, no current or deferred income tax expense has been recognized on income earned or capital gains recognized subsequent to the formation of the REIT.

Funds from Operations, Adjusted Funds from Operations & Adjusted Cash Flow From Operations

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

Funds from operations & adjusted funds from operations

REALpac defines Funds From Operations (FFO) as net income (calculated in accordance with IFRS), adjusted for, among other things, fair value adjustments, amortization of tenant incentives and effects of puttable instruments classified as financial liabilities (distributions on Class B LP Units). The REIT calculates FFO in accordance with REALpac.

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

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

	Three months ended March 31		
<i>(\$000s, except per unit amounts)</i>	2019	2018	△%
Net income for the period	2,478	9,544	
Add / (deduct)			
Fair value adjustment on investment properties	(1,159)	1	
Fair value adjustment on Class B LP Units	1,788	(6,108)	
Amortization of tenant incentives	765	768	
Distributions on Class B LP Units	2,514	2,514	
Fair value adjustment on derivative instruments	145	(17)	
Funds From Operations (FFO)	6,531	6,702	(3)%
Deduct			
Straight-line rent adjustments	(297)	(372)	
Normalized capital expenditures	(587)	(606)	
Normalized tenant incentives and leasing commissions	(1,030)	(831)	
Adjusted Funds from Operations (AFFO)	4,617	4,893	(6)%
FFO/Unit	\$0.23	\$0.24	
AFFO/Unit	\$0.16	\$0.18	
Weighted average number of units (000s): ⁽¹⁾	28,086	27,777	1 %

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

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

	Three months ended March 31		
(\$000s, except per unit amounts)	2019	2018	△%
Funds From Operations (FFO)	6,531	6,702	(3)%
Convertible debentures interest	776	776	
Amortization of deferred financing fees	255	241	
Funds From Operations - Diluted (FFO - Diluted)	7,562	7,719	(2)%
FFO - Diluted/Unit	\$0.23	\$0.24	
Diluted weighted average number of units (000s): ⁽¹⁾	32,813	32,504	1 %

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

Capital Expenditures

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

Normalized expenditures exclude new property development initiatives such as densification and non-recoverable capital as these are discretionary in nature. Normalized capital expenditures are calculated based on a trailing 5 year historical actual spend plus 5 year projected spend.

The following summarizes our actual expenditures compared to normalized amounts.

(\$000s)	Three months ended March 31, 2019	Year ended December 31, 2018
Investment in property improvements	882	2,592
Less non-recoverable	—	(318)
Actual capital expenditures	882	2,274
Normalized capital expenditures	587	2,424
Variance	295	(150)

Tenant Incentive & Direct Leasing Expenditures

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

The following summarizes our actual expenditures compared to normalized amounts.

	Three months ended March 31, 2019	Year ended December 31, 2018
(\$000s)		
Actual tenant incentives and direct leasing expenditures	863	4,981
Normalized tenant incentives and direct leasing expenditures	1,030	3,318
Variance	(167)	1,663

Normalized tenant incentives and direct leasing expenditures increased over 2018 reflecting higher incentives on deals, particularly in the downtown Edmonton office market.

Adjusted cash flow from operations

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

	Three months ended March 31		
(\$000s)	2019	2018	△%
Cash flows from operations	2,751	3,697	(26)%
Distributions on Class B LP Units	2,514	2,514	
Actual payment of tenant incentives and direct leasing costs	1,073	583	
Changes in operating assets and liabilities	251	(132)	
Amortization of deferred financing fees	(388)	(388)	
Normalized capital expenditures	(587)	(606)	
Normalized tenant incentives and leasing commissions	(1,030)	(831)	
Adjusted Cash flow from Operations (ACFO)	4,584	4,837	(5)%

In order to continue to qualify for the 'REIT Exception' as provided under the SIFT rules, we must allocate substantially all taxable income. As such, we allocate monthly distributions to unitholders as determined and approved by the Board of Trustees. We made monthly distributions to unitholders at a rate of \$0.05625 per unit, representing \$0.675 per unit on an annualized basis. Distributions to unitholders during the three-month period were \$2.23 million (2018 - \$2.23 million).

Distributions made during the first quarter represent a payout ratio of approximately 103% of AFFO (2018 - 96%). On an FFO basis, distributions represent a payout ratio of 73% (2018 - 70%).

We use ACFO in evaluating our ability to continue to fund distributions. The most similar IFRS measure is cash flows from operations. Cash flow from operations, which includes Class B LP Unit distributions as a financing charge, exceeded distributions by \$0.53 million in the quarter (2018 - \$1.47 million) as illustrated below.

	Three months ended March 31		
(\$000s)	2019	2018	△%
Cash flows from operations	2,751	3,697	(26)%
Distributions on Class B LP Units	2,514	2,514	— %
Cash flow from operations before Class B LP Unit Distributions	5,265	6,211	(15)%
Distributions to unitholders	(2,225)	(2,225)	— %
Distributions on Class B LP Units	(2,514)	(2,514)	— %
Total distributions	(4,739)	(4,739)	— %
Cash flow from operations before Class B LP Unit distributions less total distributions	526	1,472	(64)%
Total distributions as a % of cash flow from operations before Class B LP Unit distributions	90%	76%	18 %

Investment Properties

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

	Three months ended March 31, 2019	Year ended December 31, 2018
Number of properties	37	37
Total GLA (sf)	2,999,779	2,998,938
GLA (REIT owned %) (sf)	2,869,743	2,868,901
Fair value of portfolio (\$000s)	706,775	704,339
Value per square foot	\$246	\$246
NOI (\$000s)	11,012	43,983
Weighted average capitalization rate	6.70%	6.69%
Weighted average discount rate	6.75%	6.75%
Weighted average terminal capitalization rate	7.70%	7.70%

For the quarter ended March 31, 2019, Melcor's internal valuation team performed the valuation assessment. In the first quarter, 6 phases (of 51 legal phases) with a fair value of \$57.00 million were valued by qualified independent external valuation professionals. Valuations performed during the period resulted in fair value gains of \$1.16 million. In 2018, 24 phases (of 51 legal phases) with a fair value of \$367.55 million were valued by qualified independent external valuation professionals, resulting in fair value losses of \$11.39 million.

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

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

(\$000s)	Three months ended March 31, 2019	Year ended December 31, 2018
Northern Alberta	2,641	(12,816)
Southern Alberta	(126)	33
Saskatchewan & British Columbia	(1,356)	1,398
	1,159	(11,385)

Fair value gains in Northern Alberta were due to new leasing on certain Edmonton office properties. Fair value losses in Saskatchewan & British Columbia were due to tenant rollover at one of our Regina, AB retail properties and a decline in stabilized NOI. The remainder of fair value losses across the portfolio were due to capital and tenant incentive spending that did not result in a significant change in the fair value of the related property. Fair value adjustments represent a change of less than 1% in the fair value of our portfolio.

Fair values are most sensitive to changes in capitalization rates.

	March 31, 2019			December 31, 2018		
	Min	Max	Weighted Average	Min	Max	Weighted Average
Capitalization rate	5.50%	10.50%	6.70%	5.50%	10.50%	6.69%
Terminal capitalization rate	5.75%	9.00%	6.75%	5.75%	9.00%	6.75%
Discount rate	6.50%	9.75%	7.70%	6.50%	9.75%	7.70%

A capitalization rate increase of 50 basis points (+0.5%) would decrease the fair value of investment properties by \$48.80 million (December 31, 2018 - \$48.65 million) while a 50 basis points decrease (-0.5%) would increase it by \$56.68 million (December 31, 2018 - \$56.50 million).

Liquidity & Capital Resources

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

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

Cash Flows

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

(\$000s)	Three months ended March 31		
	2019	2018	△\$
Cash from operating activities	2,751	3,697	(946)
Cash used in investing activities	(882)	(31,288)	30,406
Cash from (used in) financing activities	(1,903)	16,660	(18,563)
Decrease in cash and cash equivalents	(34)	(10,931)	10,897
Cash and cash equivalents, beginning of the period	1,581	12,189	(10,608)
Cash and cash equivalents, end of the period	1,547	1,258	289

Operating activities

Cash from operating activities was down in Q1-2019 due primarily to fluctuations in adjustments for working capital and expenditures on tenant incentives and direct leasing costs. Our tenant incentives and direct leasing cost investments were \$1.07 million in the quarter (2018 - \$0.58 million) as we completed 56,939 sf of new and renewed leasing, resulting in period-end occupancy of 89.3%. The timing of lease expiries impacts the level of spending on tenant incentives and direct leasing costs and will fluctuate from period to period. Cash flows before adjustments for working capital and payment of tenant incentives and direct leasing costs were down \$0.07 million in the quarter. The decrease is due to lower NOI.

Investing activities

We commenced our 2019 capital program in the first quarter with \$0.88 million invested (2018 - \$0.18 million). We remain committed to strategic value-adding asset enhancement and preservation projects as a integral component of our strategy to improve our assets and retain and attract tenants. Asset enhancement investments fluctuate based on the nature and timing of projects undertaken.

In the comparative period we invested \$34.18 million in the Melcor Acquisition and received net proceeds of \$3.07 million following the disposal of Corinthia Plaza in Leduc, Alberta.

Financing activities

During Q1-2019 we drew \$9.95 million net from our revolving credit facility in order to repay a maturing mortgage and fund capital and leasing activities (2018 - net draw of \$5.48 million to fund the Melcor Acquisition).

We continued our monthly distribution of \$0.05625 per unit for quarterly distributions \$2.23 million paid during the quarter (2018 - \$2.11 million).

In the comparative period we received \$16.11 million from the issuance of 2,035,500 trust units, net of transaction costs. Proceeds were used to fund the Melcor Acquisition.

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 March 31, 2019 we had \$1.55 million in cash and cash equivalents in addition to \$25.05 million in funds available under our revolving credit facility.

Capital Structure

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

Pursuant to the DOT Degree of Leverage Ratio, we may not incur or assume any indebtedness if, after incurring or assuming such indebtedness, our total indebtedness would be more than 60% (65% including any convertible debentures) of Gross Book Value (GBV). Throughout the period we were in compliance with the Degree of Leverage Ratio and had a ratio of 56% as at March 31, 2019 (48% excluding convertible debentures).

As at March 31, 2019, our total capitalization was \$671.64 million and is comprised of:

(\$000s)	31-Mar-19
Revolving credit facility ⁽¹⁾	9,952
Mortgages payable ⁽¹⁾	252,333
Class C LP Units ⁽²⁾	71,455
Indebtedness, excluding convertible debentures	333,740
Convertible debentures ⁽³⁾	57,500
Indebtedness	391,240
Class B LP Units ⁽⁴⁾	150,207
Trust units	130,194
Equity	280,401
Total capitalization	671,641
Gross Book Value (GBV)⁽⁵⁾	699,207
Debt to GBV, excluding convertible debentures (maximum threshold - 60%)	48%
Debt to GBV (maximum threshold - 65%)	56%

(1) Debts are presented excluding unamortized transaction costs and discount on bankers acceptance (as applicable).

(2) Class C LP Units excluding unamortized fair value adjustment on Class C LP Units.

(3) Convertible debentures are presented at face value, excluding unamortized transaction costs and amounts allocated to conversion feature.

(4) Class B LP Units are classified as equity for purposes of this calculation and are included at their book value.

(5) GBV is calculated as the cost of the total assets acquired in the Initial Properties, subsequent asset purchases and development costs less dispositions.

We are also subject to financial covenants on our \$35.00 million revolving credit facility. The covenants include a maximum debt to gross book value ratio of 60% (excluding convertible debentures), a minimum debt service coverage ratio of 1.50, and a minimum adjusted unitholders' equity of \$140.00 million. As at March 31, 2019, and throughout the period, we were in compliance with our financial covenants. We also have financial covenants on certain mortgages for investment properties. At March 31, 2019 we were not in default or arrears on any of our obligations or any debt covenants. We prepare financial forecasts to monitor changes to our debt and capital levels and manage our ability to meet our financial covenants.

Indebtedness

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

	as at March 31						
(\$000s)	Total	2019	2020	2021	2022	2023	Thereafter
Revolving credit facility	9,952	9,952	—	—	—	—	—
Mortgages payable	252,333	35,443	21,453	37,006	31,566	40,117	86,748
Class C LP Units	71,455	2,732	27,092	14,675	1,095	14,932	10,929
Convertible debentures	57,500	34,500	—	—	23,000	—	—
Total	391,240	82,627	48,545	51,681	55,661	55,049	97,677
% of portfolio	100%	21%	12%	13%	14%	14%	24%

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.

During the quarter we repaid the \$6.81 million outstanding mortgage which was secured against our Red Deer, AB retail property. Over the next 12 months, five mortgage are up for renewal. These mortgage had an outstanding principal balance of \$30.47 million and a weighted average interest rate of 3.18% at March 31, 2019. We expect to be able to re-finance these debts at market competitive terms.

Our \$34.50 million 2014 Debentures mature December 31, 2019. We continue to actively review re-financing options and expect to be able to re-secure financing at market competitive terms.

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

Debt Analysis – our mortgages payable, Class C LP Units and convertible debenture bear interest at fixed rates (including one variable rate mortgage fixed via a floating for fixed interest rate swap contract); our revolving credit facility bears interest at variable 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	9,952	—	9,952	5.20%	2.17
Mortgages payable	252,333	235,398	16,935	3.51%	4.30
Class C LP Units	71,455	71,455	—	3.40%	3.30
Convertible debentures	57,500	57,500	—	5.40%	1.95
Total	391,240	364,353	26,887	3.81%	3.72

The weighted average interest rate on our debts was 3.81% (December 31, 2018 - 3.77%).

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

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

	Three months ended March 31, 2019	Year ended December 31, 2018
(\$000s)		
FFO	6,531	26,084
Principal repayments on Mortgages payable	1,924	7,654
Principal repayments on Class C LP Units	896	3,705
Debt service coverage ratio	2.32	2.30
FFO plus finance costs	10,615	42,426
Finance costs ⁽¹⁾	4,084	16,342
Finance costs coverage ratio	2.60	2.60

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

Equity

The REIT is authorized to issue an unlimited number of trust units and an unlimited number of special voting units. Each trust unit represents a holder's proportionate undivided beneficial ownership interest in the REIT and will confer the right to one vote at any meeting of 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 April 1, 2019 we commenced a normal course issuer bid (NCIB) to buy back our trust units. We are entitled to purchase up to 659,339 trust units for cancellation, representing approximately 5% of the REIT's issued and outstanding trust units. We believe that our units have been trading in a price range which does not reflect the value of the units in relation to our current and future business prospects. The trust units may be repurchased up to a maximum daily limit of 2,908. The price which the REIT will pay for trust units repurchased under the plan will be the market price at the time of acquisition. The NCIB ends one year from commencement, on March 31, 2020. As of May 2, 2019, we have purchased 13,432 units for \$0.10 million at a weighted average cost of \$7.60 or 77% of book value.

The following table summarizes the trust units issued and the fully diluted number of units outstanding as at March 31, 2019 and December 31, 2018:

	March 31, 2019		December 31, 2018	
	Units	\$ Amount	Units	\$ Amount
Issued and fully paid units (\$000s)				
Balance, beginning of period	13,186,797	130,194	11,151,297	112,892
Issuance of trust units	—	—	2,035,500	17,302
Balance, end of period	13,186,797	130,194	13,186,797	130,194
<i>Dilutive securities</i>				
Class B LP Units ⁽¹⁾	14,899,325	150,207	14,899,325	150,207
Convertible debentures	4,727,273	57,500	4,727,273	57,500
Diluted balance, end of period	32,813,395	337,901	32,813,395	337,901

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

Quarterly Results

	2019	2018				2017		
(\$000s except per unit amount)	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Revenue	17,944	17,336	17,283	17,537	18,017	16,263	16,791	16,559
Net income (loss) ⁽¹⁾	2,478	6,737	3,097	(1,768)	9,544	11,723	4,291	(1,792)
Funds from operations (FFO)	6,531	6,382	6,277	6,723	6,702	5,991	7,029	6,835
Adjusted funds from operations (AFFO) ⁽²⁾	4,617	4,792	4,494	4,973	4,893	4,567	5,158	5,219
Per unit metrics								
Basic earnings (loss) per unit	\$ 0.19	\$ 0.51	\$ 0.23	\$ (0.13)	\$ 0.74	\$ 0.35	\$ 0.25	\$ (0.16)
FFO (basic)	\$ 0.23	\$ 0.23	\$ 0.22	\$ 0.24	\$ 0.24	\$ 0.23	\$ 0.27	\$ 0.27
AFFO ⁽²⁾ (basic)	\$ 0.16	\$ 0.17	\$ 0.16	\$ 0.18	\$ 0.18	\$ 0.18	\$ 0.20	\$ 0.20
Annualized distribution rate	\$0.675	\$0.675	\$0.675	\$0.675	\$0.675	\$0.675	\$0.675	\$0.675
Payout Ratio	103%	99%	105%	95%	96%	95%	84%	83%
Period-end closing unit price	\$7.58	\$7.46	\$8.10	\$8.22	\$8.10	\$8.51	\$8.85	\$8.86
Annualized distribution yield on closing unit price (%) ⁽³⁾	8.91%	9.05%	8.33%	8.21%	8.33%	7.93%	7.63%	7.62%

(1) Net income (loss) is significantly impacted by the results of non-cash fair value adjustments on assets and liabilities carried at fair value. Management believes that FFO is a better measure of operating performance and that AFFO is a better measure of cash flows.

(2) We adopted REALpac's new guidance on AFFO in Q2-2017 retroactively. See Adjusted Funds From Operations for details.

(3) Annualized distribution yield is calculated as the annualized distribution rate divided by the period-end closing price.

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

We adopted IFRS 16, Leases effective January 1, 2019. Refer to note 3 of the interim financial statements for further discussion on the impact of adoption and an overview of our policy. There were no other material changes to the above titled sections at March 31, 2019 in comparison to the December 31, 2018 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 March 31, 2019 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. No such changes were identified.

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 May 2, 2019, the REIT was in compliance with all investment guidelines and operating policies stipulated in the DOT.

Non-standard Measures

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

We believe these non-standard measures will assist investors in understanding components of our financial results.

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

Calculations

We use the following calculations in measuring our performance.

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

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

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

(\$000s)	Three months ended				
	31-Mar-19	31-Mar-18	△%	31-Dec-18	△%
Net income for the period	2,478	9,544		6,737	
Net finance costs	6,715	6,496		6,203	
Fair value adjustment on Class B LP Units	1,788	(6,108)		(9,536)	
Fair value adjustment on investment properties	(1,159)	1		6,224	
General and administrative expenses	722	746		728	
Amortization of tenant incentives	765	768		809	
Straight-line rent adjustment	(297)	(372)		(159)	
NOI	11,012	11,075	(1)%	11,006	—%

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

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

FFO per unit: FFO per unit is defined as FFO divided by weighted average trust units and weighted average Class B LP Units outstanding. Dilutive FFO includes the effect of the convertible debentures.

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

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

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

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

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

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

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



MELCOR REAL ESTATE INVESTMENT TRUST

Condensed Interim Consolidated Financial Statements

For the three-months ended March 31, 2019

(Unaudited)

Condensed Interim Consolidated Statements of Financial Position

As at March 31, 2019

(Unaudited)

(\$000s)	March 31, 2019	December 31, 2018
ASSETS		
Current Assets		
Cash and cash equivalents	1,547	1,581
Accounts receivable	1,669	1,330
Other assets (note 5)	1,247	1,070
	4,463	3,981
Non-Current Assets		
Investment properties (note 4 and 14)	685,924	683,768
Other assets (note 5)	20,851	20,571
Loan receivable	900	900
Derivative financial asset (note 14)	238	383
	707,913	705,622
TOTAL ASSETS	712,376	709,603
LIABILITIES		
Current Liabilities		
Revolving credit facility	9,952	—
Accounts payable	1,434	1,692
Distribution payable	1,580	1,580
Accrued liabilities and other payables (note 6)	8,228	7,873
Class C LP Units (note 8)	3,659	3,628
Mortgages payable (note 7)	35,391	44,177
Convertible debenture	34,027	33,873
	94,271	92,823
Non-Current Liabilities		
Accrued liabilities and other payables (note 6)	1,595	1,579
Class B LP Units (note 9 and 14)	112,937	111,149
Class C LP Units (note 8)	67,992	68,952
Mortgages payable (note 7)	215,536	215,409
Convertible debentures	21,245	21,144
Derivative financial liabilities (note 14)	187	187
TOTAL LIABILITIES	513,763	511,243
UNITHOLDERS' EQUITY	198,613	198,360
TOTAL LIABILITIES AND UNITHOLDERS' EQUITY	712,376	709,603

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Income and Comprehensive Income

For the three-months ended March 31

(Unaudited)

(\$000s)	2019	2018
Rental revenue (note 11 and 13)	17,944	18,017
Direct operating expenses (note 13)	(7,400)	(7,338)
Net rental income	10,544	10,679
General and administrative expenses (note 13)	(722)	(746)
Fair value adjustment on investment properties (note 4 and 14)	1,159	(1)
Fair value adjustment on Class B LP Units (note 9 and 14)	(1,788)	6,108
Income before finance costs	9,193	16,040
Interest income	28	36
Finance costs (note 12 and 13)	(6,743)	(6,532)
Net finance costs	(6,715)	(6,496)
Net income and comprehensive income	2,478	9,544
Basic income per trust unit (note 10)	\$0.19	\$0.74
Diluted income per trust unit (note 10)	\$0.19	\$0.21

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Changes in Unitholders' Equity

As at March 31, 2019

(Unaudited)

(\$000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2018	13,186,797	118,819	40,536	39,005	198,360
Net income for the period	—	—	—	2,478	2,478
Distributions to unitholders	—	—	—	(2,225)	(2,225)
Balance at March 31, 2019	13,186,797	118,819	40,536	39,258	198,613

(\$000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2017	11,151,297	102,707	40,448	30,296	173,451
Issuance of trust units	2,035,500	16,112	—	—	16,112
Property purchase from Melcor Developments Ltd.	—	—	88	—	88
Net income for the period	—	—	—	9,544	9,544
Distributions to unitholders	—	—	—	(2,225)	(2,225)
Balance at March 31, 2018	13,186,797	118,819	40,536	37,615	196,970

See accompanying notes to the condensed interim consolidated financial statements.

Condensed Interim Consolidated Statements of Cash Flows

For the three-months ended March 31

(Unaudited)

(\$000s)	2019	2018
CASH FLOWS FROM (USED IN)		
OPERATING ACTIVITIES		
Net income for the period	2,478	9,544
Non cash items:		
Amortization of tenant incentives (note 5 and 11)	765	768
Straight-line rent adjustments (note 11)	(297)	(372)
Fair value adjustment on investment properties (note 4 and 14)	(1,159)	1
Fair value adjustment on Class B LP Units (note 9 and 14)	1,788	(6,108)
Amortization of fair value adjustment on Class C LP Units (note 12)	(33)	(56)
Fair value adjustment on derivative instruments (note 12 and 14)	145	(17)
Amortization of deferred financing fees (note 12)	388	388
	4,075	4,148
Payment of tenant incentives and direct leasing costs	(1,073)	(583)
Changes in operating assets and liabilities	(251)	132
	2,751	3,697
INVESTING ACTIVITIES		
Additions to investment properties	—	(34,175)
Net proceeds from disposal of investment property	—	3,070
Investment in property improvements (note 4)	(882)	(183)
	(882)	(31,288)
FINANCING ACTIVITIES		
Proceeds from issuing trust units net of costs	—	16,112
Change in revolving credit facility	9,952	5,481
Repayment of mortgages payable (note 7)	(8,734)	(1,881)
Repayment on Class C LP Units (note 8)	(896)	(939)
Distributions to unitholders	(2,225)	(2,113)
	(1,903)	16,660
DECREASE IN CASH & CASH EQUIVALENTS DURING THE PERIOD	(34)	(10,931)
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD	1,581	12,189
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	1,547	1,258

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. We began operations on May 1, 2013.

Our principal business is to acquire, own and manage office, retail and industrial properties in select markets across Western Canada. The properties are externally managed, administered and operated by Melcor Developments Ltd. (“Melcor”) pursuant to the Property Management Agreement and Asset Management Agreement (note 13).

As at May 2, 2019, Melcor, through an affiliate, holds an approximate 53.0% effective interest in the REIT through ownership of all Class B LP Units of Melcor REIT Limited Partnership (the “Partnership”) and is the ultimate controlling party.

We are governed under the laws of the Province of Alberta. Our registered office 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*.

These condensed interim consolidated financial statements should be read in conjunction with our annual consolidated financial statements for the year ended December 31, 2018, 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 May 2, 2019.

The condensed interim consolidated financial statements have been prepared using the same significant accounting policies and methods as those used in our annual consolidated financial statements for the year ended December 31, 2017. We have adopted new standard IFRS 16, Leases. Adoption of this amended standards requires additional disclosure within these condensed interim consolidated financial statements (note 3).

3. SIGNIFICANT ACCOUNTING POLICIES AND NEW STANDARDS 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.

We have adopted the following new IFRS standard effective January 1, 2019:

- a) **IFRS 16, Leases** was issued in January 2016 by the IASB to replace IAS 17. IFRS 16 includes several changes in the method of accounting for operating leases, including:
- i. All leases will be on the balance sheet of lessees, except those that meet the limited exception criteria;
 - ii. Rent expenses for leases on the balance sheet will be recorded as depreciation and finance expenses;
 - iii. Timing of expenses will change as the finance lease model results in an accelerated recognition of expenses compared to straight-line operating lease model.

Impact of Adoption

As the changes implemented through IFRS 16 are directed mainly towards lessees, the adoption of IFRS 16 did not result in any adjustments upon transition, change in recognition, or changes to our accounting policy as the REIT is a lessor. Adoption does require additional disclosures to show variable lease revenues earned during the year (note 11), as well as additional disclosures to the year end financial statements to show minimum lease payments under non-cancellable operating leases of investment properties for each year for up to 5 years. This standard was adopted through the modified retrospective approach.

4. INVESTMENT PROPERTIES

(\$000s)	Three months ended March 31, 2019	Year ended December 31, 2018
Balance - beginning of period	683,768	617,278
Additions		
Direct acquisition	—	87,346
Property improvements	882	2,592
Direct leasing costs	115	742
Fair value adjustment on investment properties (note 14)	1,159	(11,385)
Investment property disposed of during the period	—	(12,805)
Balance - end of period	685,924	683,768

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 14.

Presented separately from investment properties is \$14,169 (December 31, 2018 - \$14,186) in tenant incentives and \$6,682 (December 31, 2018 - \$6,385) in straight-line rent adjustments (note 5). The fair value of investment properties has been reduced by these amounts.

5. OTHER ASSETS

(\$000s)	March 31, 2019	December 31, 2018
Current Assets		
Prepaid expense, and other	1,247	1,070
Non-Current Assets		
Straight-line rent adjustments	6,682	6,385
Tenant incentives	14,169	14,186
	20,851	20,571

During the three-month period, we recorded tenant incentives of \$748 (2018 - \$1,242) and recorded \$765 (2018 - \$768) 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.

6. ACCRUED LIABILITIES AND OTHER PAYABLES

(\$000s)	March 31, 2019	December 31, 2018
Current Liabilities		
Tenant security deposits and pre-payments	2,620	3,090
Accrued finance costs	1,379	591
Other accrued liabilities and payables	4,229	4,192
	8,228	7,873
Non-Current Liabilities		
Decommissioning obligation	1,595	1,579

7. MORTGAGES PAYABLE

(\$000s)	March 31, 2019	December 31, 2018
Mortgages amortized over 15-25 years at fixed interest rates	235,398	244,007
Mortgage amortized over 25 years at a variable interest rate (via a fixed for floating interest rate swap)	16,935	17,060
Unamortized deferred financing fees	(1,406)	(1,481)
	250,927	259,586
Current portion of mortgages payable	(35,391)	(44,177)
	215,536	215,409
Interest rate ranges	(2.58%-4.91%)	(2.58%-4.91%)

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

(\$000s)	March 31, 2019	December 31, 2018
Balance - beginning of period	259,586	217,240
Principal repayments:		
Scheduled amortization on mortgages	(1,924)	(7,654)
Mortgage repayments	(6,810)	(40,888)
New mortgages	—	60,240
Mortgages assumed	—	31,037
Deferred financing fees capitalized	(41)	(850)
Amortization of deferred financing fees	116	461
Balance - end of period	250,927	259,586

8. 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)	March 31, 2019	December 31, 2018
Class C LP Units amortized over 15-25 years at fixed interest rates	71,455	72,351
Unamortized fair value adjustment	196	229
	71,651	72,580
Current portion of Class C LP Units	(3,659)	(3,628)
	67,992	68,952
Effective interest rate	3.40%	3.40%

As at March 31, 2019 we had 10,785,613 Class C LP Units issued and outstanding (December 31, 2018 - 10,785,613).

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

(\$000s)	March 31, 2019	December 31, 2018
Balance - beginning of period	72,580	74,276
Principal repayments:		
Scheduled amortization on Class C LP Units	(896)	(3,705)
Class C LP Units repayments	—	(11,094)
Class C LP units issued	—	13,312
Amortization of fair value adjustment on Class C LP Units (note 12)	(33)	(209)
Balance - end of period	71,651	72,580

9. CLASS B LP UNITS

Class B LP Units are held by Melcor as partial consideration for certain properties sold to the REIT. The Class B LP Units are exchangeable at the option of the holder for one trust unit 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 entitles 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 March 31, 2019 and recognized a fair value loss of \$1,788 during the three-month period (2018 - fair value gain of \$6,108). Supplemental information on fair value measurement, including valuation technique and the key input, is included in note 14.

At March 31, 2019 there were 14,899,325 Class B LP Units issued and outstanding at a fair value of \$7.58 per unit or \$112,937 (December 31, 2018 - 14,899,325 at \$7.46 per unit or \$111,149).

The following table summarizes the change in Class B LP Units for the period:

(\$000s except unit amounts)	March 31, 2019		December 31, 2018	
Balance - beginning of period	14,899,325	111,149	14,615,878	124,381
Issuance of Class B LP Units	—	—	283,447	2,412
Fair value adjustment on Class B LP Units (note 14)	—	1,788	—	(15,644)
Balance - end of period	14,899,325	112,937	14,899,325	111,149

10. UNITHOLDERS' EQUITY

At March 31, 2019, our issued and outstanding trust units were 13,186,797 (December 31, 2018 - 13,186,797).

<i>(\$000's except unit amounts)</i>	March 31, 2019	March 31, 2018
Net income - basic	2,478	9,544
Impact of Class B LP Units fair value adjustment and distributions	—	(3,594)
Impact of convertible debentures interest, fair value adjustment and amortization	—	—
Net income - diluted	2,478	5,950
Basic weighted average trust units outstanding	13,186,797	12,915,397
Impact of conversion of Class B LP Units	—	14,861,532
Impact of conversion of convertible debentures	—	—
Diluted weighted average trust units outstanding	13,186,797	27,776,929
Basic earnings per trust unit	0.19	0.74
Diluted earnings per trust unit*	0.19	0.21

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

11. RENTAL REVENUE

The components of rental revenue are as follows:

For the three-months ended March 31 (\$000s)	2019	2018
Lease revenue	11,618	11,601
Variable lease revenue	3,292	3,280
Service revenue	3,502	3,532
Amortization of tenant incentives (note 5)	(765)	(768)
Straight-line adjustments	297	372
	17,944	18,017

12. FINANCE COSTS

The components of finance costs are as follows:

For the three-months ended March 31 (\$000s)	2019	2018
Interest on mortgages payable and revolving credit facility	2,314	2,152
Interest on Class C LP Units	639	775
Amortization of fair value adjustment on Class C LP Units	(33)	(56)
Distributions on Class B LP Units	2,514	2,514
Interest on convertible debenture	776	776
Fair value adjustment on derivative instruments	145	(17)
Amortization of deferred financing fees	388	388
	6,743	6,532

Total finance costs paid during the three-month period were \$5,422 (2018 - \$5,306).

13. RELATED PARTY TRANSACTIONS

Our condensed interim consolidated financial statements include the following related party transactions with Melcor, and its affiliates, as our controlling unitholder:

a) *Property and Asset Management Agreements*

Pursuant to the terms of the Property and Asset Management Agreements, we incurred the following fees during the period:

For the three-months ended March 31 (\$000s)	2019	2018
Asset Management Agreement		
Base Annual Management Fee	437	437
Property Management Agreement		
Monthly Fee	497	512
Lease Fee	115	95
	1,049	1,044

The Base Annual Management Fee is included in general and administrative expenses. Monthly Fees are included in direct operating expenses. Acquisition Fees, Capital Expenditure Fees and Lease Fees are capitalized to investment properties. As at March 31, 2019 there was \$459 (December 31, 2018 - \$583) payable to Melcor related to these fees.

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

During the three month period ended March 31, 2019, \$2,514 in distributions were recorded on Class B LP Units held by Melcor (2018 - \$2,514). These distributions were recorded as finance costs (note 12). As at March 31, 2019 there was \$838 payable to Melcor for the March distribution (December 31, 2018 - \$838 for the December distribution).

Also during the three month period ended March 31, 2019, Melcor, as holder of all Class C LP Units, was paid \$1,535 to fund principal and interest payments on the retained debt (2018 - \$1,747).

c) *Rental Revenue*

For the three month period ended March 31, 2019 we collected \$140 in rental revenue from Melcor and an affiliate for use of office space (2018 - \$235). In addition, pursuant to certain Head and Bridge Lease Agreements, we collected \$24 in rental revenue from Melcor as compensation for certain vacant spaces at properties acquired from Melcor in 2014 (2018 - \$46). These amounts are included in rental revenue.

d) *Key Management Remuneration*

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

14. 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, accounts receivable, loan receivable, 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, Class C LP Units and derivative financial asset - interest rate swap are estimated by discounting the future cash flows associated with the debt at market interest rates (Level 3).
- fair value of derivative financial liabilities, the conversion features on our convertible debentures, are estimated based upon unobservable inputs, including volatility and credit spread (Level 3).

- fair value of Class B LP Units are estimated based on the closing trading price of the REIT's trust units and the fair value of convertible debenture is estimated based on the closing trading price of the REIT's debenture (Level 2).

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

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

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

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

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

		March 31, 2019				December 31, 2018	
(\$000s)		Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value	Total Carrying Value	Total Fair Value
Non-financial assets							
Investment properties	Level 3	685,924	—	685,924	685,924	683,768	683,768
Financial liabilities							
Mortgages payable	Level 3	—	250,927	250,927	245,619	259,586	258,858
Class B LP Units	Level 2	112,937	—	112,937	112,937	111,149	111,149
Class C LP Units	Level 3	—	71,651	71,651	71,651	72,580	72,580
Convertible debentures	Level 2	—	55,272	55,272	57,960	55,017	56,738
Derivative financial instruments							
Interest rate swap	Level 3	238	—	238	238	383	383
Conversion feature on convertible debentures	Level 3	187	—	187	187	187	187

Investment properties

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

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

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

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

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

- Cash flows - based on the physical location, type and quality of the property and supported by the terms of existing leases, other contracts or external evidence such as current market rents for similar properties.

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

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

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

Investment properties were valued by Melcor's internal valuation team as at March 31, 2019 of which 6 investment properties (of 51 legal phases) with a fair value of \$57,000 were valued by qualified independent external valuation professionals during the period. Valuations performed during the three-month period resulted in fair value gains of \$1,159. During the year ended December 31, 2018 Melcor's internal valuation team valued investment properties of which 24 investment properties (of 51 legal phases valued) with a fair value of \$367,550 were valued by qualified independent external valuation professionals during the year. Valuations performed during the year ended December 31, 2018 resulted in fair value losses of \$11,385.

Weighted average stabilized net operating income for investment properties is \$1,503 (December 31, 2018 - \$1,500) per property. Other significant valuation metrics and unobservable inputs are set out in the following table. Fair values are most sensitive to changes in capitalization rates.

	March 31, 2019			December 31, 2018		
	Min	Max	Weighted Average	Min	Max	Weighted Average
Capitalization rate	5.50%	10.50%	6.70%	5.50%	10.50%	6.69%
Terminal capitalization rate	5.75%	9.00%	6.75%	5.75%	9.00%	6.75%
Discount rate	6.50%	9.75%	7.70%	6.50%	9.75%	7.70%

An increase in the capitalization rates by 50 basis points would decrease the carrying amount of investment properties by \$48,802 (December 31, 2018 - \$48,645). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by \$56,677 (December 31, 2018 - \$56,502).

Non-derivative financial instruments

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

Derivative financial instruments

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

The fair value of the interest rate swap is calculated as the net present value of the future cash flows expected to arise on the variable and fixed portion, determined using applicable yield curves at the measurement date. As at March 31, 2019 the fair value of the interest rate swap contract is \$238 (December 31, 2018 - \$383).

The significant unobservable inputs used in the fair value measurement of the conversion feature on the convertible debenture as at March 31, 2019 are as follows:

- Volatility - expected volatility as at March 31, 2019 was derived from the historical prices of our trust units. As the REIT was formed on May 1, 2013, price history is limited and we use the entire historical data up until March 31, 2019. Volatility was 17.80% (December 31, 2018 - 17.80%).

- Credit spread - the credit spread of the convertible debenture was imputed from the traded price of the convertible debenture as at March 31, 2019. The credit spread used was 3.92% (December 31, 2018 - 3.92%).
- As at March 31, 2019, the fair value of the conversion feature on our convertible debentures was \$187 (December 31, 2018 - \$187).

Valuations performed during the three-month period resulted in fair value losses of \$145 (2018 - fair value gains of \$17).

Class B LP Units

Class B LP Units are remeasured to fair value on a recurring basis and categorized as Level 2 in the fair value hierarchy. The units are fair valued based on the trading price of the trust units at the period end date. At March 31, 2019 the fair value of the Class B LP Units was \$112,937, resulting in a fair value loss of \$1,788 for the three-month period (December 31, 2018 - fair value gain of \$15,644).

15. SUBSEQUENT EVENTS

Normal Course Issuer Bid

On April 1, 2019 we commenced a normal course issuer bid ("NCIB") which allows the REIT to purchase up to 659,339 trust units for cancellation, representing approximately 5% of the REIT's issued and outstanding trust units. The trust units may be repurchased up to a maximum daily limit of 2,908. The price which the REIT will pay for trust units repurchased under the plan will be the market price at the time of acquisition. The NCIB ends one year from commencement, on March 31, 2020.

In connection with the commencement of the NCIB, the REIT also entered into an automatic purchase plan agreement with a broker to allow for the purchase of trust units under the NCIB at times when the REIT ordinarily would not be active in the market due to regulatory restrictions or self-imposed trading blackout periods.

As of May 2, 2019, there were 13,432 trust units purchased for cancellation by the REIT pursuant to the NCIB at a cost of \$102.

Distributions

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

Month	Record Date	Distribution Date	Distribution Amount
April 2019	April 30, 2019	May 15, 2019	\$0.05625 per unit
May 2019	May 31, 2019	June 17, 2019	\$0.05625 per unit
June 2019	June 28, 2019	July 15, 2019	\$0.05625 per unit

Asset Acquisition

On April 24, 2018 we purchased a retail investment property in Calgary, Alberta from a third party for a purchase price of \$12,450. This purchase was accounted for as an asset purchase in accordance with our policy.