Management's Responsibility for Financial Reporting

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

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

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

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

Andrew Melton
Chief Executive Officer

Naomi Stefura, CA
Chief Financial Officer

Edmonton, Alberta
March 1, 2018

March 1, 2018

Independent Auditor's Report

To the Unitholders of
Melcor Real Estate Investment Trust

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

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

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

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

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

PricewaterhouseCoopers LLP
TD Tower, 10088 102 Avenue NW, Suite 1501, Edmonton, Alberta, Canada T5J 3N5
T: +1 780 441 6700, F: +1 780 441 6776

Opinion

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

PricewaterhouseCoopers LLP

Chartered Professional Accountants

MELCOR REAL ESTATE INVESTMENT TRUST

Consolidated Financial Statements

December 31, 2017

Consolidated Statements of Financial Position

As at December 31

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

See accompanying notes to the consolidated financial statements.

By order of the REIT's Board of Trustees:

Ralph Y-g

Larry Pollock - Trustee

Ralph Young - Chairman

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

For the years ended December 31

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

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Changes in Unitholders' Equity

As at December 31

($000s except unit amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2015	**11,151,297**	**102,707**	**40,448**	**55,794**	**198,949**
Net loss for the year	—	—	—	(11,176)	(11,176)
Distributions to unitholders	—	—	—	(7,527)	(7,527)
Balance at December 31, 2016	**11,151,297**	**102,707**	**40,448**	**37,091**	**180,246**
Net income for the year	**—**	**—**	**—**	**732**	**732**
Distributions to unitholders	**—**	**—**	**—**	**(7,527)**	**(7,527)**
Balance at December 31, 2017	**11,151,297**	**102,707**	**40,448**	**30,296**	**173,451**

See accompanying notes to the consolidated financial statements.

Consolidated Statements of Cash Flows

For the years ended December 31

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

See accompanying notes to the consolidated financial statements.

1. DESCRIPTION OF THE TRUST

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

The principal business of the REIT is to acquire, own and manage office, retail and industrial properties in select markets across Western Canada. The REIT is externally managed, administered and operated by Melcor Developments Ltd. ("Melcor") pursuant to the Property Management Agreement and Asset Management Agreement (see note 21).

As at March 1, 2018, Melcor, through an affiliate, holds an approximate 53.0% effective interest in the REIT through ownership of all Class B LP Units of Melcor REIT Limited Partnership (the "Partnership") and is the ultimate controlling party.

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

2. BASIS OF PRESENTATION

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standard Board (“IASB”).

These consolidated financial statements are presented in Canadian dollars, which is the presentation and functional currency of the REIT; and were authorized for issue by the Board of Trustees on March 1, 2018.

3. SIGNIFICANT ACCOUNTING POLICIES

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

a) Basis of measurement

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

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

b) Basis of consolidation

Subsidiaries
Subsidiaries are entities controlled by the REIT. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. These consolidated financial statements include the accounts of the REIT and its subsidiaries, its controlled partnership Melcor REIT Limited Partnership (the “Partnership”), and its general partner, Melcor REIT GP Inc.

Joint arrangements
These arrangements are undivided interests in the assets, liabilities, revenues and expenses under arrangement and we record our proportionate share in accordance with the agreements as joint operations. These consolidated financial statements include investments in three joint arrangements (2016 – three) with 50% interests. Refer to note 22 for additional details on our joint arrangements.

All intercompany transactions and balances are eliminated on consolidation.

c) Cash and cash equivalents

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

d) Restricted cash

Restricted cash can only be used for specified purposes. The REIT’s restricted cash as at December 31, 2017 represents amounts held in escrow pending the closing of the Melcor Acquisition (note 11 and 28). During 2016 the REIT's restricted cash represented subsidies funded by Melcor as part of the IPO to subsidize finance costs on assumed debt and Class C LP Units, and to fund capital expenditures, environmental expenditures, tenant incentives and lease costs. On May 1, 2016 the term of the covenant elapsed, at which point the remaining restricted cash was re-classified to cash and cash equivalents.

e) Investment properties

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

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

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

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

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

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

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

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

Initial direct leasing costs incurred in negotiating and arranging tenant leases are added to the carrying amount of investment properties. All direct leasing costs are external expenditures, including those charged under the Property Management Agreement with Melcor (note 21), and no amounts for internal allocations are capitalized with respect to the negotiation or arranging of tenant leases.

f) Other assets

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

g) Provision for decommissioning obligation

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

h) Class B LP Units

The Class B LP Units are exchangeable into trust units at the option of the holder and, therefore, are considered a puttable instrument in accordance with International Accounting Standard (''IAS'') 32, Financial instruments — presentation (''IAS 32''). The Class B LP Units, as puttable instruments, are required to be accounted for as financial liabilities. The Class B LP Units are designated as fair value through profit or loss financial liabilities and are remeasured to fair value at each period end date based on the trading price of the trust units at the period end date with any changes in fair value recognized in the consolidated statements of income and comprehensive income. Distributions declared on Class B LP Units are recorded as finance costs in the consolidated statement of income and comprehensive income.

i) Unit capital

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

j) Distributions

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

k) Recognition of revenue

Tenant leases are accounted for as operating leases given that we have retained substantially all of the risks and benefits of the ownership of our investment properties. Revenue from investment properties includes base rents, recoveries of operating expenses including property taxes, parking revenue and incidental income. Revenue recognition under a lease commences when the tenant has a right to use the leased asset. The total amount of contractual rent to be received from operating leases is recognized on a straight-line basis over the term of the lease; a straight-line rent receivable, which is included in other assets, is recorded for the difference between the rental revenue recognized and the contractual amount received. When incentives are provided to our tenants, the cost of these incentives is recognized over the lease term, on a straight-line basis, as a reduction to rental revenue. Recoveries from tenants are recognized as revenues in the period in which the corresponding costs are incurred. Other revenues are recorded as earned.

l) Finance costs

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

m) Income taxes

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

n) Assets held for sale

Investment property held for sale are assets that the REIT intends to sell rather than hold for the long term and meet the criteria established in IFRS 5, "Non-Current Assets Held For Sale and Discontinued Operations", for separate classification.

Non-current assets and groups of assets and liabilities are categorized as assets held for sale where the asset is available for immediate sale in its present condition and the sale is highly probable.

o) Financial instruments

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

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

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

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

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

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

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

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

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

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

p) Statements of cash flows

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

4. SIGNIFICANT JUDGEMENTS AND CRITICAL ACCOUNTING ESTIMATES

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

Significant judgments

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

a) Investment properties

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

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

b) Classification of tenant incentives

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

c) Compliance with REIT exemption under ITA

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

Critical accounting estimates

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

a) Valuation of investment properties

The fair value of investment properties is dependent on stabilized net operating income or forecasted future cash flows and property specific capitalization or discount rates. The stabilized net operating income or forecasted future cash flows involve assumptions of future rental income, including estimated market rental rates and vacancy rates, estimated direct operating costs and estimated capital expenditures. Capitalization and discount rates take into account the location, size and quality of the property, as well as market data at the valuation date. Refer to note 7 and 27 for further information about methods and assumptions used in determining fair value.

5. NEW STANDARDS

NEW STANDARDS ADOPTED

We have adopted the following new standard interpretation effective January 1, 2017.

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

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

NEW AND AMENDED STANDARDS NOT YET ADOPTED

IFRS 15, Revenue from Contracts with Customers was issued in May 2014 by the IASB and supersedes IAS 18, 'Revenue', IAS 11,'Construction Contracts' and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single model to determine how and when an entity should recognize revenue, as well as requiring entities to provide more informative, relevant disclosures in respect of its revenue recognition criteria.

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

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

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

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

This final version introduces a third measurement category, 'fair value through other comprehensive income', for financial assets, as well as an expected loss impairment model that requires more timely recognition of expected credit losses. Additional disclosures on transition from IAS 39 to IFRS 9 will be required under IFRS 7, the application of which is effective on adoption of IFRS 9.

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

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

i. All leases will be on the balance sheet of lessees, except those that meet the limited exception criteria;

ii. Rent expense for leases on the balance sheet will be recorded as depreciation and finance expenses;

iii. Timing of expenses will change as the finance lease model results in an accelerated recognition of expenses compared to a straight-line operating lease model.

IFRS 16 is required to be applied for annual periods beginning on or after January 1, 2019. We are currently in the process of evaluating the impact this standard will have on our financial statements.

6. ASSETS HELD FOR SALE

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

7. INVESTMENT PROPERTIES

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

In accordance with our policy, as detailed in note 3(e), we record our investment properties at fair value. Fair value adjustments on investment properties are primarily driven by changes in capitalization rates and stabilized net operating income ("NOI"). Supplemental information on fair value measurement, including valuation techniques and key inputs, is included in note 27.

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

Presented separately from investment properties is $13,478 (December 31, 2016 - $14,021) in tenant incentives and $5,275 (December 31, 2016 - $4,225) in straight-line rent adjustments (note 8). The fair value of investment properties has been reduced by these amounts.

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

($000s)	**2017**	**2016**
Within one year	**36,682**	38,626
Later than one year but not later than 5 years	**112,109**	113,324
Later than 5 years	**55,611**	68,764
	204,402	220,714

8. OTHER ASSETS

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

During the year we recorded tenant incentives of $2,585 (December 31, 2016 - $2,789) and $3,062 (December 31, 2016 - $3,216) of amortization expense respectively. During the year we also reclassified $66 in tenant incentives and $24 in straight line rent adjustments to asset held for sale (note 6).

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

9. REVOLVING CREDIT FACILITY

The REIT has an available credit limit based upon the carrying values of specific investment properties up to a maximum of $35,000 for general purposes, including a $5,000 swingline sub-facility. The agreement also provides the REIT with $5,000 in available letters of credit which bear interest at 2.25%. The facility matures on May 1, 2018, with an extension option of up to three years at the discretion of the lenders. Depending on the form under which the new facility is accessed, rates of interest will vary between prime plus 1.15% or bankers' acceptance plus 2.25% stamping fee. Interest payments are due and payable based upon the form of the facility drawn upon, and principal is due and payable upon maturity. The agreement also bears a standby fee of 0.45% for the unused portion of the new facility. The lenders hold demand debentures, a first priority general security and a general assignment of leases and rents over specific investment properties as security for the new facility.

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

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

The following table summarizes the components of the balance:

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

10. ACCRUED LIABILITIES AND OTHER PAYABLES

($000s)	2017	2016
Current Liabilities		
Tenant security deposits and pre-payments	2,488	2,404
Accrued finance costs	533	488
Other accrued liabilities and payables	4,174	2,928
	7,195	5,820
Non-Current Liabilities		
Decommissioning obligation	1,524	1,475

The REIT's decommissioning obligation relates to one of our commercial properties. The total decommissioning obligation is estimated based on the future obligation and timing of these expenditures to be incurred. We estimate the net present value of the obligation based on an undiscounted total future provision of $2,014 (December 31, 2016 - $2,014). At December 31, 2017, a discount rate of 4.00% (December 31, 2016 - 4.00%) and an inflation rate of 2.00% (December 31, 2016 - 2.00%) were used to calculate the net present value of the obligation. Due to uncertainty surrounding the nature and timing of this obligation amounts are subject to change.

11. SUBSCRIPTION RECEIPTS

On December 21, 2017 the REIT issued 2,035,500 subscription receipts to the public at a price of $8.50 per subscription receipt for gross proceeds of $17,302, including $2,257 issued pursuant to the exercise of an over-allotment option. Subscription receipts entitle the holder to receive one trust unit of the REIT upon closing of the Melcor Acquisition from Melcor Developments Ltd. ("Melcor Acquisition") (note 28). While the subscription receipts remain outstanding, holders are entitled to receive cash payments per subscription receipt that are equivalent to distributions declared by the REIT on trust units. The gross proceeds, less 50% of the underwriter's fees, representing $16,956 are held in escrow pending the closing of the Melcor Acquisition and have been recorded as Restricted Cash. The remaining 50% of the underwriter's fee, representing $346, is payable upon closing of the Melcor Acquisition and has been disclosed as a contingent liability (note 24).

A reconciliation of the subscription receipts are as follows:

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

12. MORTGAGES PAYABLE

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

Specific investment properties with a carrying value of $425,173 (December 31, 2016 - $428,272) and assignment of applicable rents and insurance proceeds have been pledged as collateral for the above mortgages. The weighted average effective interest rate for the above mortgages, based on period end balances, is 3.40% (December 31, 2016 – 3.45%).

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

($000s)	Principal Installment Repayments	Balance Maturing	Total
2018	6,973	17,375	**24,348**
2019	6,320	60,653	**66,973**
2020	4,260	5,318	**9,578**
2021	4,180	30,513	**34,693**
2022	3,068	26,096	**29,164**
Thereafter	5,282	48,294	**53,576**
	30,083	188,249	**218,332**

We have a floating for fixed interest rate swap which fixes the interest rate on our variable rate mortgage at 2.97% for the term of the mortgage. As at December 31, 2017 the fair value of the interest rate swap contract is $504. This financial instrument has not been designated as a hedge for accounting purposes. Supplemental information on fair value measurement, including valuation technique and key inputs, is included in note 27.

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

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

13. CLASS C LP UNITS

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

As at December 31, 2017 the carrying value of the Class C LP Units, included in the consolidated statement of financial position, were as follows:

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

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

Specific investment properties with a carrying value of $140,242 (December 31, 2016 - $153,868) and assignment of applicable rents and insurance proceeds have been pledged as collateral for the above Class C LP Units, along with a guarantee by the Partnership.

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

($000s)	Principal Installment Repayments	Balance Maturing	Total
2018	3,216	11,421	**14,637**
2019	3,058	6,576	**9,634**
2020	2,436	23,863	**26,299**
2021	907	7,181	**8,088**
2022	673	—	**673**
Thereafter	242	14,265	**14,507**
	10,532	63,306	**73,838**

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

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

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

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

14. CONVERTIBLE DEBENTURES

a) 2014 Debentures

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

b) 2017 Debentures

On December 21, 2017, the REIT issued a 5.25% extendible convertible unsecured subordinated debentures (the "2017 Debentures") to the public for gross proceeds of $23,000, including $3,000 issued pursuant to the exercise of an over-allotment option. Transaction costs related to the issuance were $1,457 for net proceeds of $21,543. The 2017 Debentures bear interest at an annual rate of 5.25% payable semi-annually in arrears on June 30 and December 31 in each year commencing June 30, 2018. Upon completion of the Melcor Acquisition (note 28), the maturity date of the 2017 Debentures were extended to December 31, 2022. The 2017 Debentures can be converted into trust units at the holders' option at any point prior to the maturity date at a conversion rate of 86.9565 trust units per one thousand principal amount of convertible debentures (the "Conversion Price"). On and from December 31, 2020, and prior to December 31, 2021, the 2017 Debentures may be redeemed by the REIT, in whole at any time, or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest, provided that the volume weighted-average trading price of the trust units for a specified period (the "Current Market Price") preceding the date on which notice of redemption is given is not less than 125% of the Conversion Price. On and from December 31, 2021, and prior to the maturity date, the 2017 Debentures may be redeemed by the REIT, in whole at any time or in part from time to time, at a price equal to the principal amount thereof plus accrued and unpaid interest. Subject to regulatory approval and other conditions, the REIT may, at its option, elect to satisfy its obligation to pay the principal amount of the convertible debenture on redemption or at maturity, in whole or in part, by delivering that number of freely tradeable trust units obtained by dividing the principal amount of the 2017 Debentures being repaid by 95% of the Current Market Price on the date of redemption or maturity.

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

($000s)				December 31, 2017		December 31, 2016
Convertible Debentures	**Date Issued**	**Maturity Date**	**Interest Rate**	**Outstanding Principal**	**Carrying Value**	Carrying Value
2014 Debentures	Dec 3, 2014	Dec 31, 2019	5.50%	**34,500**	**33,291**	32,749
2017 Debentures	Dec 21, 2017	Dec 31, 2022	5.25%	**23,000**	**20,755**	—
				57,500	**54,046**	32,749

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

A reconciliation of the convertible debentures are as follows:

($000s)	**Host Instruments**	**Conversion Features**	**Total**
Balance at December 31, 2015	32,246	5	32,251
Amortization of discount and transaction costs	503	—	503
Fair value adjustment on conversion feature (note 27)	—	56	56
Balance at December 31, 2016	32,749	61	32,810
Convertible debenture issued	**22,205**	**795**	**23,000**
Transaction costs	**(1,457)**	**—**	**(1,457)**
Amortization of discount and transaction costs	**549**	**—**	**549**
Fair value adjustment on conversion features (note 27)	**—**	**(127)**	**(127)**
Balance at December 31, 2017	**54,046**	**729**	**54,775**

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

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

15. CLASS B LP UNITS

Melcor, through an affiliate, holds an approximate 56.7% effective interest in the REIT through ownership of all Class B LP Units of the Partnership and is the ultimate controlling party. The Class B LP Units are exchangeable at the option of the holder for one trust unit of the REIT and accompanied by one special voting unit (note 16(b)). Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units.

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

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

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

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

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

16. UNITHOLDERS' EQUITY

a) Trust Units

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

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

b) Special Voting Units

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

c) Units Outstanding

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

17. RENTAL REVENUE

The components of rental revenue are as follows:

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

18. FINANCE COSTS

The components of finance costs are as follows:

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

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

19. INCOME TAXES

As at December 31, 2017 the REIT qualifies as a mutual fund trust within the meaning of the Tax Act and as a real estate investment trust eligible for the 'REIT Exception' under the Specified Investment Flow-Through ("SIFT"); accordingly, no current or deferred income tax expense has been recognized on income earned or capital gains recognized subsequent to the formation of the REIT.

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

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

20. INCOME PER UNIT

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

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

21. RELATED PARTY TRANSACTIONS

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

a) Property and Asset Management Agreements

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

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

Property Management Agreement – we pay a monthly fee which is comprised of the following: (a) a base fee of 1/12 of 3% of gross property revenue; (b) a leasing fee equal to 5% of aggregate base rent for new leases for the first 5 years and 2.5% thereafter, and 2.5% of aggregate base rent for lease renewals and expansions for the first 5 years.

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

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

The Base Annual Management Fee is included in general and administrative expenses. Monthly Fees are included in direct operating expenses. In accordance with our policy (3(e)), Acquisition Fees and Lease Fees are capitalized to investment properties. As at December 31, 2017 there was $579 payable to Melcor related to these fees (December 31, 2016 - $583) which is included in accrued liabilities and other payables.

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

During the year $9,866 in distributions were recorded on Class B LP Units held by Melcor (2016 - $9,866). These distributions were recorded as finance costs (note 18). As at December 31, 2017 there was $822 payable to Melcor for the December distribution (December 31, 2016 - $822) which is included in distribution payable.

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

c) Rental Revenue

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

d) Key Management Remuneration

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

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

22. JOINT ARRANGEMENTS

The table below discloses our rights to and share of the assets, liabilities, revenues, and earnings of three joint arrangements (2016 – three) that are recorded in these consolidated financial statements:

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

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

23. SEGMENTED INFORMATION

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

24. COMMITMENTS AND CONTINGENCIES

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

In the normal course of operations we enter into lease agreements with tenants which specify tenant incentive payments upon completion of the related tenant improvements. The REIT has entered into lease agreements that may require tenant incentive payments of approximately $440 (2016 - $1,111).

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

25. MANAGEMENT OF CAPITAL RESOURCES

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

Pursuant to the DOT, the REIT may not incur or assume any indebtedness if, after incurring or assuming such indebtedness, the total indebtedness of the REIT would be more than 60% of Gross Book Value ("GBV") ("Degree of Leverage Ratio") (65% including any convertible debenture). At December 31, 2017, and throughout the period, we were in compliance with the Degree of Leverage Ratio.

We are also subject to financial covenants on our $35,000 revolving credit facility. The covenants include a maximum debt to gross book value ratio of 60% (excluding convertible debentures), a minimum debt service coverage ratio of 1.50, and a minimum adjusted unitholders' equity of $140,000. As at December 31, 2017, and throughout the period, we were in compliance with our financial covenants. We also have financial covenants on certain mortgages for investment properties. At December 31, 2017, and throughout the period, we were in compliance with our financial covenants on our mortgages. We prepare financial forecasts to monitor the changes in our debt and capital levels and our ability to meet our financial covenants.

26. FINANCIAL RISK MANAGEMENT

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

a) Credit Risk

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

We invest our cash and cash equivalents and restricted cash in bank accounts with major Canadian chartered banks. Accounts receivable balances include amounts due from tenants and various smaller amounts due from vendors.

We manage our credit risk through careful selection of tenants and look to obtain national tenants or tenants in businesses with a long standing history, or perform financial background checks including business plan review for smaller tenants. We manage our concentration risk by renting to an expansive tenant base, with no dependency on rents from any one specific tenant. Management has reviewed outstanding receivable balances at December 31, 2017 and has provided for $133 of outstanding receivables related to accounts where collectability is doubtful (2016 - $76). We expect full payment of remaining balances outstanding, and accordingly, no additional allowance for doubtful accounts has been recorded.

b) Liquidity Risk

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

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

Refer to notes 12, 13 and 14 for the maturity analysis of mortgages payable, Class C LP Units and Convertible Debentures. Amounts drawn under the revolving credit facility are due upon the maturity of the facility, on or before May 1, 2018. We expect to be able to renew our facility on maturity, no amounts were drawn at year end. Accounts payable are expected to be repaid in the next twelve months. Distributions declared on trust units and Class B LP Units are paid one month following the date of declaration. Subscription receipts were converted to trust units subsequent to year-end.

c) Market Risk

We are subject to interest rate cash flow risk as our revolving credit facility bears interest at rates that vary in accordance with borrowing rates in Canada. For each 1% change in the rate of interest on our revolving credit facility, the change in annual finance costs is approximately $nil (December 31, 2016 - $175) based upon applicable period end debt balances. We are also subject to interest rate risk on refinancing of our fixed rate debts in the year of maturity. We are not subject to other significant market risks pertaining to our financial instruments.

27. FAIR VALUE MEASUREMENT

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

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

- the carrying amounts of cash and cash equivalents, restricted cash, accounts receivables, loan receivable, revolving credit facility, accounts payable, distribution payable and subscription receipts approximate their fair values based on the short term maturities of these financial instruments.
- fair values of mortgages payable, liability held for sale, Class C LP Units and derivative financial asset - interest rate swap are estimated by discounting the future cash flows associated with the debt at market interest rates (Level 3).
- fair value of derivative financial liabilities, the conversion features on our convertible debenture, is estimated based upon unobservable inputs, including volatility and credit spread (Level 3).
- fair value of Class B LP Units are estimated based on the closing trading price of the REIT's trust units and the fair value of convertible debenture are estimated based on the closing trading price of the REIT's debentures (Level 1).

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

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

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

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

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

		December 31, 2017				December 31, 2016	
($000s)	Fair Value Hierarchy	**Fair Value**	**Amortized Cost**	**Total Carrying Value**	**Total Fair Value**	Total Carrying Value	Total Fair Value
Non-financial assets							
Investment properties	Level 3	617,278	—	617,278	617,278	641,365	641,365
Assets held for sale	Level 3	6,732	—	6,732	6,732	—	—
Financial liabilities							
Mortgages payable	Level 3	—	217,240	217,240	219,700	218,866	222,116
Class B LP Units	Level 1	124,381	—	124,381	124,381	123,650	123,650
Class C LP Units	Level 3	—	74,276	74,276	74,276	80,568	80,568
Convertible debentures	Level 1	—	54,046	54,046	58,018	32,749	35,018
Liability held for sale	Level 3	—	3,670	3,670	3,670	—	—
Derivative financial instruments							
Interest rate swap	Level 3	504	—	504	504	110	110
Conversion features on convertible debentures	Level 3	729	—	729	729	61	61

Investment properties

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

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

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

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

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

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

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

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

(In $000s except unit and per unit amounts)

Investment properties were valued by Melcor's internal valuation team as at December 31, 2017 of which 27 investment properties (of 46 legal phases valued) with a fair value of $392,700 were valued by qualified independent external valuation professionals during the year. Valuations performed during the year resulted in fair value losses of $12,800. During the year ended December 31, 2016 Melcor's internal valuation team valued investment properties of which 22 invest properties (of 47 legal phases valued) with a fair value of $287,000 were valued by qualified independent external valuation professionals during the year. Valuations performed during the year ended December 31, 2016 resulted in fair value losses of $6,546.

Weighted average stabilized net operating income for investment properties is $1,534 (2016 - $1,503). Other significant valuation metrics and unobservable inputs are set out in the following table. Fair values are most sensitive to changes in capitalization rates.

	December 31, 2017			**December 31, 2016**		
	Min	**Max**	**Weighted Average**	Min	Max	Weighted Average
Capitalization rate	**5.50%**	**8.75%**	**6.68%**	5.50%	8.75%	6.63%
Terminal capitalization rate	**5.75%**	**9.00%**	**6.79%**	5.75%	9.00%	6.83%
Discount rate	**6.50%**	**9.75%**	**7.75%**	6.50%	9.75%	7.70%

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

Non-derivative financial liabilities

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

Derivative financial instruments

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

The fair value of the interest rate swap is calculated as the net present value of the future cash flows expected to arise on the variable and fixed portion, determined using applicable yield curves at the measurement date. As at December 31, 2017 the fair value of the interest rate swap contract is $504 (2016 - $110).

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

- Volatility - expected volatility as at December 31, 2017 was derived from the historical prices of the REIT's trust units. As the REIT was formed on May 1, 2013, price history is limited and we have used the entire historical data up until December 31, 2017. Volatility was 21.70% (2016 - 16.73%).
- Credit spread - the credit spread of the convertible debenture was imputed from the traded price of the convertible debenture as at December 31, 2017. The credit spread used was 2.81% (2016 - 3.71%).

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

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

Class B LP Units

Class B LP Units are remeasured to fair value on a recurring basis and categorized as Level 1 in the fair value hierarchy. The units are fair valued based on the trading price of the trust units at the period end date. At December 31, 2017 the fair value of the Class B LP Units was $124,381, resulting in a fair value loss of $731 in income for the year (2016 - fair value loss of $18,270).

(In $000s except unit and per unit amounts)

28. SUBSEQUENT EVENTS

Closing of the Melcor Acquisition

On January 12, 2018 the REIT closed on the previously announced acquisition of five commercial properties from Melcor Developments Ltd. ("Melcor Acquisition") for a total purchase price of $80,875. The purchase price was settled through assumption of $31,038 in mortgages payable; issuance of 1,331,202 Class C LP Units, representing $13,312 in Retained Debt by Melcor; issuance of 283,447 Class B LP Units at a price of $8.82, representing $2,500; and cash of $34,025.

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

Distribution declared

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

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

Asset Disposition

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

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