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 Trust'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.

Darin Rayburn
Chief Executive Officer

Jonathan Chia, CA
Chief Financial Officer

Edmonton, Alberta
March 2, 2015

Auditors' Report to Unitholders

We have audited the accompanying consolidated financial statements of Melcor Real Estate Investment Trust and its subsidiaries, which comprise the consolidated statements of financial position as at December 31, 2014 and December 31, 2013 and the consolidated statements of income and comprehensive income, 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.

Auditors' responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Melcor Real Estate Investment Trust and its subsidiaries as at December 31, 2014 and December 31, 2013 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP

Chartered Accountants
Edmonton, Alberta
March 2, 2015

Consolidated Statements of Financial Position

As at December 31 ($000s)	2014	2013
ASSETS		
Current Assets		
Cash and cash equivalents	**6,712**	5,932
Accounts receivable	**2,877**	1,478
Other assets (note 9)	**943**	1,015
	10,532	8,425
Non-Current Assets		
Restricted cash	**2,945**	5,969
Investment properties (note 8 and 27)	**630,003**	429,117
Other assets (note 9)	**14,285**	11,232
	647,233	446,318
TOTAL ASSETS	**657,765**	454,743
LIABILITIES		
Current Liabilities		
Revolving credit facility (note 10)	**4,958**	23,748
Accounts payable	**1,297**	1,989
Distribution payable	**1,456**	1,050
Accrued liabilities and other payables (note 11)	**6,295**	3,690
Class C LP Units (note 13)	**25,825**	3,059
Mortgages payable (note 12)	**20,957**	19,911
	60,788	53,447
Non-Current Liabilities		
Accrued liabilities and other payables (note 11)	**1,360**	1,459
Class B LP Units (note 15 and 27)	**138,266**	99,120
Class C LP Units (note 13)	**64,923**	91,188
Mortgages payable (note 14)	**194,002**	78,911
Convertible debenture (note 14)	**31,780**	—
Derivative financial liability (note 14)	**185**	—
TOTAL LIABILITIES	**491,304**	324,125
UNITHOLDERS' EQUITY	**166,461**	130,618
TOTAL LIABILITIES AND UNITHOLDERS' EQUITY	**657,765**	454,743

See accompanying notes to the consolidated financial statements

On behalf of the REIT's Board of Trustees:

Audit Committee Chair

Andrew Melton
Chairman

Consolidated Statements of Income & Comprehensive Income

For the years ended December 31 ($000s)	2014	2013
Rental revenue (note 17 and 22)	**44,509**	39,325
Direct operating expenses (note 22)	**(17,860)**	(15,930)
Net rental income	**26,649**	23,395
General and administrative expenses (note 22)	**(2,134)**	(1,728)
Fair value adjustment on investment properties (note 8 and 27)	**93**	16,953
Fair value adjustment on Class B LP Units (note 15 and 27)	**9,880**	(3,812)
Income before finance costs and income taxes	**34,488**	34,808
Interest income	**72**	61
Finance costs (note 18 and 22)	**(16,212)**	(12,411)
Net finance costs	**(16,140)**	(12,350)
Net income before income taxes	**18,348**	22,458
Deferred income tax recovery (note 19)	**—**	40,261
Income tax recovery	**—**	40,261
Net income and comprehensive income	**18,348**	62,719

See note 21 for basic and diluted earnings per trust unit.

See accompanying notes to the consolidated financial statements

Consolidated Statements of Changes in Unitholders' Equity

($000s except unity amounts)	Number of Trust Units	Trust Units	Contributed Surplus	Divisional Surplus	Retained Earnings	Total Unitholders' Equity
Balance at December 31, 2012	—	—	—	168,331	—	168,331
Net income for the period January 1, 2013 to April 30, 2013 (note 20)	—	—	—	47,524	—	47,524
Net distributions to Melcor Developments Ltd.	—	—	—	(7,447)	—	(7,447)
Balance at April 30, 2013	—	—	—	208,408	—	208,408
Reorganization and recapitalization (note 6 and 16)	8,300,000	74,409	36,823	(208,408)	—	(97,176)
Conversion of Class B LP Units (note 6 and 15)	830,000	8,300	—	—	—	8,300
Net income for the period May 1, 2013 to December 31, 2013 (note 20)	—	—	—	—	15,195	15,195
Distributions to unitholders	—	—	—	—	(4,109)	(4,109)
Balance at December 31, 2013	9,130,000	82,709	36,823	—	11,086	130,618
Issuance of units (note 16)	**2,145,000**	**21,250**	**—**	**—**	**—**	**21,250**
Property purchase from Melcor Developments Ltd. (note 7 and 15)	**—**	**—**	**125**	**—**	**—**	**125**
Property purchase from Melcor Developments Ltd. (note 7 and 15)	**—**	**—**	**3,248**	**—**	**—**	**3,248**
Net income for the year	**—**	**—**	**—**	**—**	**18,348**	**18,348**
Distributions to unitholders	**—**	**—**	**—**	**—**	**(7,128)**	**(7,128)**
Balance at December 31, 2014	**11,275,000**	**103,959**	**40,196**	**—**	**22,306**	**166,461**

See accompanying notes to the consolidated financial statements

Consolidated Statements of Cash Flows

For the years ended December 31 ($000s)	2014	2013
CASH FLOWS FROM (USED IN)		
OPERATING ACTIVITIES		
Net income for the year	**18,348**	62,719
Non-cash items:		
Amortization of tenant incentives (note 9 and 17)	**2,539**	2,297
Straight-line rent adjustments (note 17)	**(607)**	(397)
Fair value adjustment on investment properties (note 8 and 27)	**(93)**	(16,953)
Fair value adjustment on Class B LP Units (note 15 and 27)	**(9,880)**	3,812
Amortization of fair value adjustment on Class C LP Units (note 18)	**(440)**	(293)
Non-cash finance costs (note 18)	**273**	108
Deferred income tax recovery (note 19)	**—**	(40,261)
	10,140	11,032
Changes in operating assets and liabilities (note 3o)	**(888)**	(530)
	9,252	10,502
INVESTING ACTIVITIES		
Additions to investment properties (note 7 and 8)	**(49,607)**	(25,851)
Payment of tenant incentives (note 9)	**(4,985)**	(2,052)
Investment property improvements, development and direct leasing costs (note 8)	**(4,440)**	(3,823)
Change in restricted cash	**2,037**	(3,141)
	(56,995)	(34,867)
FINANCING ACTIVITIES		
Proceeds from issuing units, net of costs (note 16)	**21,250**	74,409
Proceeds from issuing convertible debenture, net of costs (note 14)	**31,927**	—
Acquisition of Initial Properties (note 6)	**—**	(66,016)
Change in revolving credit facility	**(19,000)**	24,000
Proceeds from mortgages payable	**48,405**	67,000
Repayment of mortgages payable	**(25,265)**	(53,435)
Repayment on Class C LP Units	**(3,059)**	(1,966)
Change in restricted cash	**987**	(2,828)
Net distribution to Melcor Developments Ltd.	**—**	(7,447)
Distributions to unitholders	**(6,722)**	(4,109)
	48,523	29,608
INCREASE IN CASH & CASH EQUIVALENTS DURING THE YEAR	**780**	5,243
CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR	**5,932**	689
CASH AND CASH EQUIVALENTS, END OF THE YEAR	**6,712**	5,932

See accompanying notes to the consolidated financial statements

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

1. DESCRIPTION OF THE TRUST

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

The REIT began operations on May 1, 2013 when its trust units were issued for cash pursuant to the initial public offering (“IPO”).

The principal business of the REIT is to acquire, own and manage office, retail and industrial properties in select target markets in Western Canada. The REIT is externally managed, administered and operated by Melcor Developments Ltd. (“Melcor”) pursuant to the Property Management Agreement and Asset Management Agreement (see note 22).

As at March 2, 2015, Melcor, through an affiliate, holds an approximate 56.5% effective interest in the REIT through ownership of all Class B LP Units of the Partnership and is the ultimate controlling party.

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

2. BASIS OF PRESENTATION

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

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

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 2, 2015.

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 and Class B LP Units 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

I. 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.

II. 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 (2013 – three) with 50% interests. Refer to note 23 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 represents 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.

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 their fair value, which is determined by either a direct capitalization or discounted projected future cash flows approach based on property specific capitalization rates. Valuations are performed as of the period end date by independent, external professional valuators who hold recognized and relevant professional qualifications and have recent experience in the location and category of the investment property being valued. The fair value of investment property reflects, among other things, rental income from current leases and assumptions about rental income from future leases based on current market conditions. The value also reflects any cash outflows that could be expected in respect of the property. Changes in fair value are recognized in the consolidated statement of income.

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

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 22), 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 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 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, and non-cash financing costs. 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. 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 accounts receivable, cash and cash equivalents and restricted cash.

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, accrued liabilities and other payables, distributions payable, 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 a convertible debenture 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 debenture at a price equal to the principal amount thereof plus accrued and unpaid interest. We also have the ability to convert the debenture into trust units; however, the number of units to be issued at conversion varies with the market price of the units.

On initial recognition, the convertible debenture is 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 derivative is comprised of the conversion feature on our convertible debenture. 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 liabilities are recorded in the consolidated statement of financial position at their fair value. Changes in fair value of derivative liabilities that are not designated as hedges for accounting purposes are recognized in the income statement.

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

O. 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 and accrued liabilities and other payables. Investment property additions that are unpaid and included in accounts payable at year end are excluded from operating assets and liabilities.

4. SIGNIFICANT JUDGMENTS AND CRITICAL ACCOUNTING ESTIMATES

Estimates and judgments are continually evaluated and are based on historical experience and 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. BUSINESS COMBINATIONS UNDER COMMON CONTROL

Business combinations under common control ("BCUCC") are business combinations involving entities or businesses under common control, in which all of the combining entities or businesses are ultimately controlled by the same party both before and after the business combination. BCUCC are not within the scope of IFRS 3, Business combinations.

As the REIT was a newly formed entity in 2013 and Melcor retained control over the REIT, the IPO and acquisition of the Initial Properties was accounted for as a reorganization and recapitalization using the continuity of interests method. Under this method, the REIT records the assets acquired and liabilities assumed at their carrying amounts on the closing date of the transaction. The difference between the consideration given and the aggregate value of the net assets acquired is recorded as an adjustment to unitholders' equity. Refer to note 6 for details of the accounting treatment for the acquisition of the Initial Properties. Financial information for the pre-acquisition period, as included in the comparative period is presented based on historical combined financial information for the Initial Properties as previously reported by Melcor. Refer to note 20 for statement of income and comprehensive income and statement of cash flows for the period disaggregated by the activities of the REIT, and its predecessor, Melcor.

B. INVESTMENT PROPERTIES

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

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

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 is its 'highest and best use'.

C. 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.

D. 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 it continues 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:

VALUATION OF INVESTMENT PROPERTIES

Investment properties are valued using either a direct capitalization or discounted cash flow approach, as completed by qualified external professional valuators with key assumptions reviewed and updated quarterly. Key estimates and assumptions include expected occupancy rates and lease payments, expenditures for operating costs and capital expenditures as well as discount and capitalization rate. Refer to note 8 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, 2014.

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

The REIT is not subject to significant levies, other than with respect to property taxes. The adoption of IFRIC 21 did not result in a change in the recognition or timing of recognition of levies imposed on the REIT.

Other standards, amendments and interpretations that are effective for the year beginning January 1, 2014 are not material to the REIT.

NEW 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 retrospectively or through the recognition of the cumulative effect to opening retained earnings and is effective for accounting periods beginning on or after January 1, 2017, with earlier application permitted, subject to Canadian adoption.

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.

IFRS 8, Operating segments was amended to require disclosure of the judgements made by management in aggregating operating segments. This includes a description of the segments which have been aggregated and the economic indicators which have been assessed in determining that the aggregated segments share similar economic characteristics. The standard was further amended to require a reconciliation of segment assets to the entity's assets when segment assets are reported.

This amendment is effective for years beginning on or after July 1, 2014.

IAS 24, Related party transactions was amended to include, as a related party, an entity that provides key management personnel services to the reporting entity or to the parent of the reporting entity ('the management entity').

This amendment is effective for years beginning on or after July 1, 2014.

We are currently assessing the impact of adopting these standards on our consolidated financial statements.

6. ACQUISITION OF INITIAL PROPERTIES

On May 1, 2013, the REIT completed the purchase of 27 income-producing properties located in Western Canada, comprised primarily of retail, office and industrial properties (the "Initial Properties") from Melcor Developments Ltd. ("Melcor") with a carrying value of $397,896. As part of the acquisition of the Initial Properties, the REIT also assumed mortgages on certain properties totaling $92,360 at April 30, 2013. Deferred financing fees of $97 were netted against the assumed mortgages. In addition, the working capital, which is comprised of cash balances, accounts receivable, prepaid expenses, accounts payable and accrued liabilities, and other liabilities were transferred on closing. The purchase price was satisfied with cash consideration of $66,016 and issuance of 10,360,798 Class B LP Units of the Partnership. Melcor retained the debt on certain properties (the "Retained Debt") with a fair value of $96,506 at April 30, 2013. In consideration of the Retained Debt, Melcor received Class C LP Units of the Partnership on which it will receive priority distributions.

($000s except unit and per unit amounts)

The allocation of the purchase price to the assets acquired and liabilities assumed, based on their carrying values at the date of acquisition, is as follows:

Net assets acquired:	
Real estate properties	397,896
Working capital, net	(2,680)
Assumed mortgages	(92,263)
	302,953
Distributions to Melcor	
Class C LP Units	96,506
Class B LP Units	103,608
Cash paid out by the REIT	66,016
	266,130
Net contribution by Melcor	**36,823**

On May 10, 2013, the underwriters exercised, in full, their over-allotment option to purchase an additional 830,000 trust units from Melcor. The transaction resulted in an increase in unitholders' equity of $8,300 (underwriters' fee was paid by Melcor) and a decrease in Class B LP Units of $8,300.

Following closing of the over-allotment option, Melcor, through an affiliate, held an approximate 51.1% effective interest in the REIT through ownership of all remaining 9,530,798 Class B LP Units. As Melcor retained control over the REIT, the transaction constitutes a business combination under common control which is outside the scope of IFRS 3 – Business combinations. The IPO and acquisition of the Initial Properties by the REIT was accounted for as a reorganization and recapitalization using the continuity of interests method, where by the REIT recorded the assets acquired and liabilities assumed at their carrying amounts. The difference between the consideration given and the aggregate value of the net assets acquired was recorded as an adjustment to unitholders' equity.

Transaction costs directly related to the IPO and acquisition of the Initial Properties were $8,591 and were charged directly to unitholders' equity.

7. INVESTMENT PROPERTY ACQUISITIONS

ACQUIRED FROM MELCOR

On May 9, 2014, we completed the purchase of two multi-tenant retail properties from Melcor (the "May 2014 Melcor Acquisition") for a purchase price of $13,500 (an additional $75 in transaction costs were capitalized to the properties). The REIT satisfied approximately $7,400 of the purchase price of the May 2014 Melcor Acquisition by issuing 694,836 Class B LP Units at $10.65 per unit (note 15). The remainder of the purchase price was funded through the REIT's line of credit and available cash.

On December 18, 2014, we completed the purchase of six properties located in Western Canada, comprised of retail, office and industrial investment property (the "Melcor Acquisition Properties") for a purchase price of $138,250 (an additional $169 in transaction costs were capitalized to the properties). As part of the purchase of the Melcor Acquisition Properties, the REIT also assumed mortgages on certain properties totaling $78,444. The REIT satisfied approximately $45,000 of the purchase price of the Melcor Acquisition Properties by issuing 4,390,244 Class B LP Units at $10.25 per unit (note 15). The remainder of the purchase price was funded through the REIT's line of credit and available cash.

As part of the purchase, Melcor undertook, at its expense, to complete certain construction, capital improvements, landlords work, and payment of tenant incentives and commissions related to the properties. In addition, on closing of the Melcor Acquisition Properties, the REIT and Melcor entered Head and Bridge Lease Agreements which provides rental income to the REIT over a period of time on certain vacant spaces (note 22).

The purchase price approximates fair market value and the acquisitions of the May 2014 Melcor Acquisition and Melcor Acquisition Properties have been accounted for as asset purchases.

ACQUIRED FROM UNRELATED THIRD PARTIES

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

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

On December 8, 2014, the REIT acquired an office and retail complex, White Oaks, in Edmonton, Alberta for $31,829 (including transaction costs). As part of the purchase the REIT also assumed a mortgage on the property with a carrying value of $15,068. As a financial liability we recorded the assumed mortgage at its fair value on initial recognition. The fair value of the mortgage was calculated using a market interest rate for an equivalent mortgage and resulted in a fair value adjustment of $453 being recorded on the mortgage and the cost of the building.

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

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

ACQUISITIONS COMPLETED IN THE COMPARATIVE YEAR

On September 12, 2013, the REIT completed the purchase of Coast Home Centre ("Coast"), located in Edmonton, Alberta. We acquired 100% interest in the property for total consideration of $12,462 (including transaction costs).

On December 24, 2013, the REIT acquired Liberty Crossing ("Liberty"), located in Red Deer, Alberta. We acquired 100% interest in the property for total consideration of $13,389 (including transaction costs).

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

In accordance with our policy these acquisitions were accounted for as asset purchases.

($000s except unit and per unit amounts)

8. INVESTMENT PROPERTIES

	2014	2013
Balance - beginning of year	**429,117**	382,381
Additions		
Direct acquisition (note 7)	**195,972**	25,851
Property improvements	**2,743**	3,035
Property development activities	**640**	—
Direct leasing costs (note 22)	**1,057**	788
Fair value adjustment on investment properties (note 27)	**93**	16,953
Change in decommissioning obligation (note 11)	**381**	109
Balance - end of year	**630,003**	429,117

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

The cost of investment properties as at December 31, 2014 totalled $406,404 (December 31, 2013 - $205,992).

Presented separately from investment properties is $12,832 (December 31, 2013 - $10,386) in tenant incentives and $1,453 (December 31, 2013 - $846) in straight-line rent adjustments (note 9). 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. Rentals are receivable from tenants monthly. Minimum lease payments under non-cancellable operating leases of investment properties are receivable as follows:

	2014	2013
Within one year	**37,644**	23,683
Later than one year but not later than 5 years	**118,072**	67,490
Later than 5 years	**92,157**	40,386
	247,873	131,559

9. OTHER ASSETS

	2014	2013
Current Assets		
Prepaid expense, and other	**943**	1,015
Non-Current Assets		
Straight-line rent adjustments	**1,453**	846
Tenant incentives	**12,832**	10,386
	14,285	11,232

During the year we provided tenant incentives of $4,985 (December 31, 2013 - $2,052) and recorded $2,539 (December 31, 2013 - $2,297) 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.

10. REVOLVING CREDIT FACILITY

On April 20, 2013, we entered into a revolving term facility credit agreement with two major Canadian chartered banks. Under the terms of the agreement the REIT has an available credit limit based upon the carrying values of specific investment properties, as calculated quarterly, up to a maximum of $25,000 for general purposes, including a $3,000 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, 2015, with a one year extension period at the discretion of the lenders. Depending on the form under which the credit facility is accessed, rates of interest will vary between prime plus 1.25% 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 0.50% for the unused portion of the revolving 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 facility. During the year ended December 31, 2014 we amended our revolving credit facility agreement, pledging two additional recently acquired and unencumbered properties as collateral for the facility.

As at December 31, 2014, the carrying value of pledged properties was $80,500 (December 31, 2013 - $66,700). We initially capitalized $252 in transaction costs associated with the facility, of which $39 was unamortized at December 31, 2014 and is presented net of the outstanding balance (December 31, 2013 - $170).

As at December 31, 2014 we had $5,000 (December 31, 2013 - $24,000) drawn from the facility; and posted letters of credit of $nil (December 31, 2013 - $nil). The weighted average effective interest rate on borrowings, based on period end balances, is 3.52% (December 31, 2013 - 3.72%). The following table summarizes the components of the balance:

	2014	2013
Amount drawn on facility	**5,000**	24,000
Unamortized transaction fees	**(39)**	(170)
Unamortized discount on bankers acceptance	**(3)**	(82)
	4,958	23,748

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

11. ACCRUED LIABILITIES AND OTHER PAYABLES

	2014	2013
Current Liabilities		
Accrued liabilities and other payables	**6,245**	3,508
Decommissioning obligation	**50**	182
	6,295	3,690
Non-Current Liabilities		
Decommissioning obligation	**1,360**	1,459

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 $2,064 (December 31, 2013 - $2,298). At December 31, 2014, a discount rate of 4.00% (December 31, 2013 - 4.00%) and an inflation rate of 2.00% (December 31, 2013 - 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.

12. MORTGAGES PAYABLE

	2014	2013
Mortgages amortized over 15-25 years at fixed interest rates	**215,675**	99,023
Unamortized fair value adjustment	**432**	—
Unamortized deferred financing fees	**(1,148)**	(201)
	214,959	98,822
Current portion of mortgages payable	**(20,957)**	(19,911)
	194,002	78,911
Interest rate ranges	**(3.01%-5.70%)**	(3.01%-5.86%)

Specific investment properties with a carrying value of $403,330 (December 31, 2013 - $197,866) and assignment of applicable rents and insurance proceeds have been pledged as collateral for the above mortgages. The weighted average effective interest rate for the above mortgages, based on period end balances, is 3.80% (December 31, 2013 – 4.20%).

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

	Principal Instalment Repayments	Balance Maturing	Total
2015	6,059	14,898	**20,957**
2016	5,430	26,444	**31,874**
2017	5,011	—	**5,011**
2018	5,191	32,592	**37,783**
2019	4,032	65,828	**69,860**
Thereafter	8,854	41,336	**50,190**
	34,577	181,098	**215,675**

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 interest expense.

As at December 31, 2014 the carrying value of the Class C LP Units, included in the consolidated statement of financial position, were as follows:

	2014	2013
Class C LP Units amortized over 2-6 years at fixed interest rates	**89,519**	92,578
Unamortized fair value adjustment	**1,229**	1,669
	90,748	94,247
Current portion of Class C LP Units	**(25,825)**	(3,059)
	64,923	91,188
Effective interest rate	**3.84%**	3.84%

	Principal Instalment Repayments	Balance Maturing	Total
2015	2,780	23,045	**25,825**
2016	2,150	9,030	**11,180**
2017	2,006	2,578	**4,584**
2018	1,687	11,421	**13,108**
2019	1,488	6,576	**8,064**
Thereafter	2,725	24,033	**26,758**
	12,836	76,683	**89,519**

During the year $3,531 (2013 - $2,428) was recognized in finance costs (note 18) and $3,499 (2013 - $2,259) was recognized as a reduction in the Class C LP Units liability related to these distributions.

14. CONVERTIBLE DEBENTURE

On December 3, 2014, we issued a 5.50% extendible convertible unsecured subordinated debenture (the "convertible debenture") to the public for gross proceeds of $34,500, including $4,500 issued pursuant to the exercise of an over-allotment option. The convertible debenture bears 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 Melcor Acquisition Properties (note 7), the maturity date of the convertible debenture was extended to December 31, 2019. The convertible debenture 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 convertible debenture 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 convertible debenture 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 convertible debenture being repaid by 95% of the Current Market Price on the date of redemption or maturity.

($000s except unit and per unit amounts)

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

A reconciliation of the convertible debenture is as follows:

	Host Instrument	Conversion Feature	Total
Convertible debenture issued	**34,315**	**185**	**34,500**
Transaction costs	**(2,573)**	**—**	**(2,573)**
	31,742	**185**	**31,927**
Amortization of discount and transaction costs	**38**	**—**	**38**
Balance, end of year	**31,780**	**185**	**31,965**

During the year ended December 31, 2014, we recognized $151 of interest expense which is included in finance costs (note 18).

At December 31, 2014 we remeasured the conversion feature to fair value resulting in a fair value adjustment of $nil for the year. Supplemental information on fair value measurement, including valuation techniques and key inputs, is included in note 27.

15. CLASS B LP UNITS

On closing of the IPO, Melcor received 10,360,798 Class B LP Units of the Partnership as partial consideration for the Initial Properties. 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 16b). Distributions on Class B LP Units are recorded and paid to holders equal to those declared on trust units. On May 10, 2013, Melcor exchanged 830,000 Class B LP Units for an equal number of trust units, which were then used to fulfill the over-allotment option held by the underwriters pursuant to the IPO.

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

On December 18, 2014 the REIT issued 4,390,244 Class B LP Units at $10.25 per unit to Melcor as partial consideration for the Melcor Acquisition Properties (note 7). As at the adjustment date the fair value of the units issued was $9.51 per unit, or $41,752; the $3,248 difference between book value and fair value was recorded to contributed surplus.

Distributions on Class B LP Units for the year were $6,993 (2013 - $4,289), and are included in finance costs (note 18).

In accordance with our policy, as detailed in note 3h, we record Class B LP Units at fair value. We remeasured the Class B LP Units at December 31, 2014 and recognized a fair value gain of $9,880 during the year (2013 - fair value loss of $3,812). Supplemental information on fair value measurement, including valuation technique and the key input, is included in note 27.

At December 31, 2014 there were 14,615,878 Class B LP Units issued and outstanding at a fair value of $9.46 per unit or $138,266 (December 31, 2013 - 9,530,798 Class B LP Units issued and outstanding at a fair value of $10.40 per unit or $99,120).

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

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

The following table summarizes the change in trust units for the year.

	2014	
	Units	Amount
Balance, beginning of year	**9,130,000**	**82,709**
Issuance of Units - net of $1,594 in costs	**2,145,000**	**21,250**
Balance, end of year	**11,275,000**	**103,959**

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

	2013	
	Units	Amount
Balance, beginning of year	—	—
Issuance of Units - IPO, net of $8,591 in costs	8,300,000	74,409
Conversion of Class B LP Units	830,000	8,300
Balance, end of year	9,130,000	82,709

17. RENTAL REVENUE

The components of rental revenue are as follows:

	2014	2013
Rental revenue	**46,441**	41,225
Amortization of tenant incentives (note 9)	**(2,539)**	(2,297)
Straight-line adjustments	**607**	397
	44,509	39,325

18. FINANCE COSTS

The components of finance costs are as follows:

	2014	2013
Interest on mortgages payable and revolving credit facility	**5,264**	5,586
Interest on Class C LP Units	**3,971**	2,721
Amortization of fair value adjustments on Class C LP Units	**(440)**	(293)
Distributions on Class B LP Units	**6,993**	4,289
Interest on convertible debenture	**151**	—
Non-cash finance costs	**273**	108
	16,212	12,411

Total finance costs paid during the year were $15,174 (2013 - $12,060).

19. INCOME TAXES

As at December 31, 2014 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. In addition, we recorded a deferred income tax recovery of $40,585 on May 1, 2013 related to the de-recognition of a deferred income tax liability as a result of qualifying for the REIT Exception at the time of the IPO.

The components of income tax recovery are as follows:

	2014	2013
Deferred tax expense		
Origination and reversal of temporary differences	**—**	324
Reversal of deferred taxes upon reorganization and recapitalization and allocation of taxable income to unitholders (note 3m and 6)	**—**	(40,585)
	—	(40,261)

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

	2014	2013
Net income before income taxes	**18,348**	22,458
Statutory rate	**25%**	25%
	4,587	5,615
Non-deductible expenses	**5**	79
Non-taxable portion of capital gains and fair value adjustments	**(12)**	(2,119)
Allocation of taxable income to unitholders (note 3m)	**(4,580)**	(3,251)
Reversal of current and deferred taxes upon reorganization and recapitalization (note 3m)	**—**	(40,585)
	—	(40,261)

The movement of deferred tax balances for the year are as follows:

	December 31, 2014		
	Opening	Recognized in net income	Closing
Investment properties	—	—	—
Tenant incentives	—	—	—
Straight-line rent adjustment	—	—	—
Provision for decommissioning obligation	—	—	—
	—	—	—

	December 31, 2013		
	Opening	Recognized in net income	Closing
Investment properties	37,993	(37,993)	—
Tenant incentives	2,658	(2,658)	—
Straight-line rent adjustment	60	(60)	—
Provision for decommissioning obligation	(450)	450	—
	40,261	(40,261)	—

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

20. RESULTS OF THE REIT AND ITS PREDECESSOR

The following consolidated statement of income and comprehensive income and consolidated statement of cash flows disaggregate the financial results of the REIT for the year ended December 31, 2013 between the activities of the REIT, subsequent to April 30, 2013, and those of Melcor, prior to May 1, 2013.

	Melcor 1–Jan to 30–Apr	REIT 1–May to 31–Dec	Year ended 2013
Rental revenue (note 17 and 22)	12,942	26,383	39,325
Direct operating expenses (note 22)	(5,037)	(10,893)	(15,930)
Net rental income	7,905	15,490	23,395
General and administrative expenses (note 22)	(507)	(1,221)	(1,728)
Fair value adjustment on investment properties (note 8 and 27)	2,594	14,359	16,953
Fair value adjustment on Class B LP Units (note 15 and 27)	—	(3,812)	(3,812)
Income before finance costs and income taxes	9,992	24,816	34,808
Interest income	8	53	61
Finance costs (note 18 and 22)	(2,737)	(9,674)	(12,411)
Net finance costs	(2,729)	(9,621)	(12,350)
Net income before income taxes	7,263	15,195	22,458
Deferred income tax recovery (note 19)	40,261	—	40,261
Income tax recovery	40,261	—	40,261
Net income and comprehensive income	47,524	15,195	62,719

	Melcor 1–Jan to 30–Apr	REIT 1–May to 31–Dec	Year ended 2013
CASH FLOWS FROM (USED IN)			
OPERATING ACTIVITIES			
Net income for the year	47,524	15,195	62,719
Noncash items:			
Amortization of tenant incentives (note 9 and 17)	773	1,524	2,297
Straight-line rent adjustments (note 17)	(125)	(272)	(397)
Fair value adjustment on investment properties (note 8 and 27)	(2,594)	(14,359)	(16,953)
Fair value adjustment on Class B LP Units (note 15 and 27)	—	3,812	3,812
Amortization of fair value adjustment on Class C LP Units (note 18)	—	(293)	(293)
Non-cash finance costs (note 18)	20	88	108
Deferred income tax recovery (note 19)	(40,261)	—	(40,261)
	5,337	5,695	11,032
Changes in operating assets and liabilities (note 3o)	(1,975)	1,445	(530)
	3,362	7,140	10,502
INVESTING ACTIVITIES			
Additions to investment properties (note 7 and 8)	—	(25,851)	(25,851)
Payment of tenant incentives (note 9)	(743)	(1,309)	(2,052)
Investment property improvements, development and direct leasing costs (note 8)	(1,746)	(2,077)	(3,823)
Change in restricted cash	—	(3,141)	(3,141)
	(2,489)	(32,378)	(34,867)
FINANCING ACTIVITIES			
Proceeds from issuing units, net of costs (note 16)	—	74,409	74,409
Proceeds from issuing convertible debenture, net of costs (note 14)	—	—	—
Acquisition of Initial Properties (note 6)	—	(66,016)	(66,016)
Change in revolving credit facility	—	24,000	24,000
Proceeds from mortgages payable	55,000	12,000	67,000
Repayment of mortgages payable	(48,195)	(5,240)	(53,435)
Repayment on Class C LP Units	—	(1,966)	(1,966)
Change in restricted cash	—	(2,828)	(2,828)
Net distribution to Melcor Developments Ltd.	(7,447)	—	(7,447)
Distributions to unitholders	—	(4,109)	(4,109)
	(642)	30,250	29,608
INCREASE IN CASH & CASH EQUIVALENTS DURING THE YEAR	231	5,012	5,243
CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR	689	920	689
CASH AND CASH EQUIVALENTS, END OF THE YEAR	920	5,932	5,932

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

21. INCOME PER UNIT

Basic and diluted earnings per trust unit for the year ended December 31, 2014 and the comparative post-formation period of May 1, 2013 to December 31, 2013 are calculated as follows:

	2014	1-May-13 to 31-Dec-13
Net income - basic ($000s) (note 20)	**18,348**	15,195
Impact of Class B LP Unit fair value adjustment and distributions ($000s)	**(2,887)**	8,101
Impact of convertible debenture interest and amortization ($000s)	**189**	—
Net income - diluted ($000s)	**15,650**	23,296
Basic weighted average trust units outstanding during the year	**10,522,616**	9,099,385
Impact of conversion of Class B LP Units	**10,136,427**	9,530,798
Impact of conversion of convertible debenture	**209,215**	—
Diluted weighted average trust units outstanding during the year	**20,868,258**	18,630,183
Basic earnings per trust unit	**$1.74**	$1.67
Diluted earnings per trust unit	**$0.75**	$1.25

22. RELATED PARTY TRANSACTIONS

Pursuant to the transaction detailed in note 6, 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

Effective May 1, 2013, the REIT and Melcor entered into a Property Management Agreement and an Asset Management Agreement which set forth the terms and conditions under which the REIT is managed, administered and operated.

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 (2013 - May 1, 2013 to December 31, 2013):

	2014	2013
Asset Management Agreement		
Base Annual Management Fee	**1,123**	676
Capital Expenditure Fee	**—**	—
Acquisition Fee	**428**	256
Financing Fee	**—**	—
Property Management Agreement		
Monthly Fee	**1,333**	746
Lease Fee	**1,057**	511
	3,941	2,189

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 (3e), Acquisition Fees and Lease Fees are capitalized to investment properties. As at December 31, 2014 there was $271 payable to Melcor related to these fees (2013 - December 31, 2013 - $447).

B. DISTRIBUTIONS ON CLASS B LP UNITS AND REDEMPTIONS OF CLASS C LP UNITS

During the year $6,993 in distributions were recorded on Class B LP Units held by Melcor (May 1, 2013 to December 31, 2013 - $4,289). These distributions were recorded as finance costs (note 18). As at December 31, 2014 there was $822 payable to Melcor for the December distribution (December 31, 2013 - $536).

Also during the same period, Melcor, as holder of all Class C LP Units, was paid $7,030 to fund principal and interest payments on the Retained Debt (2013 - $4,687). These redemptions were recorded as a reduction of the Class C LP Unit liability and as finance costs (note 18).

C. RENTAL REVENUE

During the year the REIT collected $698 in rental revenue from Melcor and an affiliate for use of office space (May 1, 2013 to December 31, 2013 - $470). In addition, pursuant to the Head and Bridge Lease Agreements entered into upon closing of the Melcor Acquisition Properties (note 7), the REIT collected $45 in rental revenue from Melcor as compensation for certain vacant spaces at the properties acquired.

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.

Notes to the Consolidated Financial Statements

($000s except unit and per unit amounts)

E. PURCHASE OF INVESTMENT PROPERTIES

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

On December 18, 2014, the REIT purchased six properties from Melcor pursuant to the Development and Opportunities Agreement with Melcor for a purchase price of $138,250. As part of the purchase, the REIT also assumed mortgages on certain properties totaling $78,444. The REIT satisfied approximately $45,000 of the purchase price by issuing 4,390,244 Class B LP Units at $10.25 per unit. The remainder of the purchase price was funded through the REIT's line of credit and available cash (note 7).

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

23. JOINT ARRANGEMENTS

The table below discloses our rights to and share of the assets, liabilities, revenues, and earnings of three joint arrangements (2013 – 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%

For the year ended and as at December 31	Assets	Liabilities	Revenue	Earnings
2014	**52,389**	**24,612**	**3,867**	**1,586**
2013	48,712	22,472	3,741	4,138

24. 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.

25. MANAGEMENT OF CAPITAL RESOURCES

We define capital as unitholders' equity, Class B LP Units, Class C LP Units, mortgages payables, convertible debenture 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, 2014, and throughout the period, we were in compliance with the Degree of Leverage Ratio and had a ratio of 56% (50% excluding convertible debenture) as at December 31, 2014.

We are also subject to financial covenants on our $25,000 revolving credit facility. The covenants include a maximum debt to total capital ratio of 60%, a minimum interest coverage ratio of 1.50, and a minimum net book value of unitholders' equity of $140,000. As at December 31, 2014, we were in compliance with our financial covenants with a debt to total capital ratio of 56% (50% excluding convertible debenture), interest coverage ratio of 1.67, and a net book value of unitholders equity, based on the definition of unitholders equity in our revolving credit facility agreement, of $288,270. We also have financial covenants on certain mortgages for investment properties. At December 31, 2014, and throughout the period, we were in compliance with our financial covenants on our mortgages. We prepare financial forecasts to monitor the changes in our debt and capital levels and our ability to meet our financial covenants.

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 and accounts 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, 2014 and made a provision of $61 related to accounts where collectability is doubtful. 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 ongoing 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.

Refer to notes 12, 13 and 14 for the maturity analysis of mortgages payable, Class C LP Units and Convertible Debenture. Amounts drawn under the revolving credit facility are due upon the maturity of the facility, on or before May 1, 2015. 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.

($000s except unit and per unit amounts)

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 $50 (December 31, 2013 - $240) 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, revolving credit facility, accounts payable and distribution payable approximate their fair values based on the short term maturities of these financial instruments.
- fair values of mortgages payable and Class C LP Units are estimated by discounting the future cash flows associated with the debt at market interest rates (Level 2).
- fair value of derivative financial liability, the conversion feature 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 (Level 1).

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

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

	December 31, 2014			
	Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value
Non-financial assets				
Investment properties	**630,003**	**—**	**630,003**	**630,003**
Financial liabilities				
Mortgages payable	**—**	**215,675**	**215,675**	**219,492**
Class B LP Units	**138,266**	**—**	**138,266**	**138,266**
Class C LP Units	**—**	**90,748**	**90,748**	**90,748**
Convertible debenture	**—**	**31,780**	**31,780**	**31,780**
Derivative financial liability	**185**	**—**	**185**	**185**

	December 31, 2013			
	Fair Value	Amortized Cost	Total Carrying Value	Total Fair Value
Non-financial assets				
Investment properties	429,117	—	429,117	429,117
Financial liabilities				
Mortgages payable	—	99,023	99,023	105,165
Class B LP Units	99,120	—	99,120	99,120
Class C LP Units	—	94,247	94,247	94,247
Convertible debenture	—	—	—	—
Derivative financial liability	—	—	—	—

The table below analyzes assets and liabilities carried at fair value in the consolidated statement of financial position, by the levels in the fair value hierarchy. The fair value hierarchy categorizes fair value measurement into three levels based upon the inputs to valuation technique, which are defined as follows:

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

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

	Level 1	Level 2	Level 3	Total
Non-financial assets				
Investment properties	—	—	630,003	630,003
Financial liabilities				
Derivative financial liability	—	—	185	185
Class B LP Units	138,266	—	—	138,266

($000s except unit and per unit amounts)

INVESTMENT PROPERTIES

Investment properties are remeasured to fair value on a recurring basis and categorized as Level 3 in the fair value hierarchy. Investment properties were valued by qualified independent external valuation professionals as at December 31, 2014 and 2013 which resulted in fair value gains of $93 (2013 - $16,953) recorded as fair value adjustment on investment properties in income during the year. Fair values are primarily determined by discounting the expected future cash flows over ten years plus a terminal value determined by applying a terminal capitalization rate to estimated year eleven cash flows, or by applying a capitalization rate to the estimated future net operating income under the direct capitalization approach. The significant unobservable inputs in the Level 3 valuations are as follows:

- Capitalization rate - based on actual location, size and quality of the property and taking into consideration available market data as at the valuation date;
- Stabilized net operating income - revenue less direct operating expenses adjusted for items such as average lease up costs, vacancies, non-recoverable capital expenditures, management fees, straight-line rents and other non-recurring items;
- Discount rate - reflecting current market assessments of the uncertainty in the amount and timing of cash flows;
- Terminal 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 including verifying all major inputs included in the valuation and reviewing the results with the independent valuator. Melcor's management, along with the REIT's Audit Committee, discuss the valuation process and key inputs on a quarterly basis.

Weighted average stabilized net operating income for investment properties is $1,414 (2013 - $1,176). Other significant valuation metrics and unobservable inputs are set out in the following table. Fair values are most sensitive to changes in capitalization rates.

	December 31, 2014		
	Min	Max	Weighted Average
Capitalization rate	5.50%	9.00%	6.49%
Terminal capitalization rate	5.75%	9.25%	6.77%
Discount rate	6.50%	10.00%	7.69%

	December 31, 2013		
	Min	Max	Weighted Average
Capitalization rate	5.50%	9.00%	6.41%
Terminal capitalization rate	5.75%	9.25%	6.69%
Discount rate	6.50%	10.00%	7.57%

An increase in the capitalization rates by 50 basis points would decrease the carrying amount of investment properties by $43,828 (2013 - $31,881). A decrease in the capitalization rates by 50 basis points would increase the carrying amount of investment properties by $51,148 (2013 - $37,278).

DERIVATIVE FINANCIAL LIABILITY

Our financial derivative liability is comprised of the conversion feature on our convertible debenture.

The significant unobservable inputs used in the fair value measurement of the conversion feature on the convertible debenture as at December 31, 2014 are as follows:

- Volatility - expected volatility as at December 31, 2014 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, 2014. Volatility was 15.17%.
- Credit spread - the credit spread of the convertible debenture was imputed from the traded price of the convertible debenture as at December 31, 2014. The credit spread used was 3.76%.

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, 2014 the fair value of the Class B LP Units was $138,266, resulting in a fair value gain of $9,880 in income for the year (2013 - fair value loss of $3,812).

28. SUBSEQUENT EVENTS

DISTRIBUTION DECLARED

On January 15, 2015 we declared a distribution of $0.05625 per unit for the months of January, February and March 2015. The distributions will be payable as follows:

Month	Record Date	Distribution Date	Distribution Amount (per unit)
January 2015	January 30, 2015	February 16, 2015	$0.05625
February 2015	February 27, 2015	March 16, 2015	$0.05625
March 2015	March 31, 2015	April 15, 2015	$0.05625