Condensed Consolidated Financial Statements of

PARTNERS REAL ESTATE INVESTMENT TRUST

For the three and six months ended June 30, 2014 and 2013

(Unaudited)

PARTNERS REAL ESTATE INVESTMENT TRUST
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For the three and six months ended June 30, 2014 and 2013

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PARTNERS REAL ESTATE INVESTMENT TRUST
Condensed Consolidated Statements of Financial Position
unaudited (Cdn $)

As at		June 30, 2014		December 31, 2013
ASSETS				
Non-current assets				
Income producing properties (Note 4)	$	**664,204,898**	$	588,391,005
		664,204,898		588,391,005
Current assets				
Other assets (Note 5)		**6,228,409**		4,514,391
Notes receivable (Note 6)		**7,484,161**		-
Accounts receivable (Note 7)		**6,468,230**		2,722,641
Cash		**1,746,350**		-
		21,927,150		7,237,032
	$	**686,132,048**	$	595,628,037
LIABILITIES				
Non-current liabilities				
Mortgages payable (Note 8)	$	**242,223,088**	$	250,046,544
Convertible debentures (Note 9)		**82,889,239**		82,352,601
Credit facilities (Note 10)		-		30,795,803
		325,112,327		363,194,948
Current liabilities				
Mortgages payable (Note 8)		**107,271,247**		34,104,016
Credit facilities (Note 10)		**32,869,629**		-
Accounts payable and other liabilities		**15,192,259**		11,378,767
Distributions payable		**1,147,529**		1,094,156
Bank indebtedness		**-**		134,868
		156,480,664		46,711,807
		481,592,991		409,906,755
Exchangeable LP units (Note 11)		**24,019,448**		842,625
		505,612,439		410,749,380
UNITHOLDERS' EQUITY		**180,519,609**		184,878,657
	$	**686,132,048**	$	595,628,037

Subsequent Events (Note 24)

The accompanying notes are an integral part of these condensed consolidated financial statements.

PARTNERS REAL ESTATE INVESTMENT TRUST
Condensed Consolidated Statements of Comprehensive Income (Loss)
unaudited (Cdn $)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	**2014**	2013
Revenues from income producing properties (Note 12)	**$ 16,432,960**	$ 14,078,122	**$ 31,600,856**	$ 27,259,686
Property operating expenses	**(2,718,497)**	(1,684,535)	**(4,989,282)**	(3,938,843)
Realty taxes	**(3,500,520)**	(2,976,432)	**(6,737,924)**	(5,636,010)
Property management fees	**(275,854)**	(262,280)	**(541,178)**	(484,449)
	9,938,089	9,154,875	**19,332,472**	17,200,384
Other expenses:				
Financing costs	**$ 6,353,427**	4,516,360	**11,484,958**	8,225,041
General and administrative expenses	**1,823,622**	892,248	**2,757,128**	1,597,958
Other transaction costs (Note 13)	**2,542,934**	1,787,634	**5,263,003**	1,787,634
	10,719,983	7,196,242	**19,505,089**	11,610,633
Income before fair value gains (losses)	**(781,894)**	1,958,633	**(172,617)**	5,589,751
Fair value gains (losses) (Note 14)	**(3,717,277)**	443,938	**(5,638,740)**	4,910,485
Net income (loss) and comprehensive income (loss)	**$ (4,499,171)**	$ 2,402,571	**$ (5,811,357)**	$ 10,500,236
EARNINGS (LOSS) PER UNIT (Note 15)				
Basic and diluted	**$ (0.17)**	$ 0.09	**$ (0.22)**	$ 0.41

The accompanying notes are an integral part of these condensed consolidated financial statements.

PARTNERS REAL ESTATE INVESTMENT TRUST
Condensed Consolidated Statements of Changes in Unitholders' Equity
unaudited (Cdn $)

	Three months ended June 30, **2014**	Three months ended June 30, 2013	Six months ended June 30, **2014**	Six months ended June 30, 2013
Trust Units (Note 16)				
BALANCE, BEGINNING OF PERIOD	**$ 195,323,673**	$ 193,160,308	**$ 194,991,352**	$ 168,392,882
Issuance of units for exchangeable LP units, net of costs (Note 11)	**607,102**	655,326	**661,302**	655,326
Issuance of units under Holyrood acquisition (Note 3)	**6,891,490**	-	**6,891,490**	-
Issuance of units under DRIP, net of costs	**326,567**	279,202	**604,688**	511,607
Issuance of units under alternate compensation plan (Note 18)	**-**	5,000	**-**	22,500
Issuance of units under public offering, net of costs	**-**	(7,557)	**-**	24,509,964
BALANCE, END OF PERIOD	**203,148,832**	194,092,279	**203,148,832**	194,092,279
Contributed Surplus				
BALANCE, BEGINNING OF PERIOD	**565,080**	565,080	**565,080**	565,080
BALANCE, END OF PERIOD	**565,080**	565,080	**565,080**	565,080
Accumulated Other Comprehensive Income (Loss)				
BALANCE, BEGINNING OF PERIOD	**(15,253,174)**	5,081,335	**(10,677,775)**	1,106,690
Net income (loss) and comprehensive income (loss)	**(4,499,171)**	2,402,571	**(5,811,357)**	10,500,236
Distributions to unitholders (Note 16)	**(3,441,958)**	(4,140,261)	**(6,705,171)**	(8,263,281)
BALANCE, END OF PERIOD	**(23,194,303)**	3,343,645	**(23,194,303)**	3,343,645
TOTAL UNITHOLDERS' EQUITY	**$ 180,519,609**	$ 198,001,004	**$ 180,519,609**	$ 198,001,004
DISTRIBUTIONS PER UNIT	**$ 0.13**	$ 0.16	**$ 0.25**	$ 0.32

The accompanying notes are an integral part of these condensed consolidated financial statements.

PARTNERS REAL ESTATE INVESTMENT TRUST
Condensed Consolidated Statements of Cash Flows
unaudited (Cdn $)

	Three months ended June 30, 2014	Three months ended June 30, 2013	Six months ended June 30, 2014	Six months ended June 30, 2013
OPERATING ACTIVITIES				
Net income (loss) and comprehensive income (loss)	**$ (4,499,171)**	$ 2,402,571	**$ (5,811,357)**	$ 10,500,236
Adjusted for non-cash items:				
Fair value (gains) losses (Note 14)	**3,717,277**	(443,938)	**5,638,740**	(4,910,485)
Employee options costs	**-**	10,000	**-**	20,000
Alternate compensation plan costs	**-**	5,000	**-**	22,500
Straight-line rent	**(259,233)**	(504,138)	**(515,579)**	(1,150,271)
Amortization of tenant incentives and direct leasing costs	**190,758**	112,865	**355,869**	205,493
Amortization of deferred financing costs	**446,039**	273,182	**854,193**	510,828
Market interest rate adjustment on mortgages	**(261,789)**	(242,450)	**(523,766)**	(445,028)
Interest accretion expense	**102,473**	-	**204,483**	-
Net change in working capital (Note 17)	**(942,983)**	6,403,089	**(1,854,392)**	(4,866,906)
Cash flow used in operating activities	**(1,506,629)**	8,016,181	**(1,651,809)**	(113,633)
FINANCING ACTIVITIES				
Proceeds from mortgages	**15,000,000**	58,000,298	**15,000,000**	58,000,298
Financing costs of mortgages	**(615,337)**	(477,034)	**(615,337)**	(477,034)
Principal repayments on mortgages	**(2,269,570)**	(5,839,284)	**(4,472,332)**	(7,377,421)
Proceeds from debenture issuance	**-**	-	**-**	23,000,000
Cost to issue debentures	**(84,433)**	(179,309)	**(99,883)**	(1,150,854)
Drawdowns on credit facilities	**-**	20,000,000	**5,294,095**	46,000,000
Repayments of credit facilities	**(3,294,095)**	(2,000,000)	**(3,294,095)**	(35,500,000)
Financing fees on credit facilities	**(20,417)**	(92,779)	**(20,417)**	(180,349)
Proceeds from public offering	**-**	-	**-**	25,900,875
Costs to issue units (Note 16)	**(4,689)**	(14,487)	**(7,314)**	(1,399,431)
Distributions to unitholders	**(3,052,841)**	(3,858,402)	**(6,035,307)**	(7,747,299)
Cash flow provided by financing activities	**5,658,618**	65,539,003	**5,749,410**	99,068,785
INVESTING ACTIVITIES				
Acquisitions of income producing properties, net of non-cash transactions (Note 17)	**(1,109,445)**	(73,087,807)	**(1,160,623)**	(99,624,218)
Improvements to income producing properties	**(512,952)**	(3,546,372)	**(698,614)**	(3,749,982)
Expenditures on tenant incentives and direct leasing costs	**(277,219)**	(163,657)	**(357,146)**	(512,540)
Net proceeds from repayment of note receivable	**-**	1,941,762	**-**	5,935,816
Cash flow used in investing activities	**(1,899,616)**	(74,856,074)	**(2,216,383)**	(97,950,924)
NET INCREASE (DECREASE) IN CASH DURING THE PERIOD	**2,252,373**	(1,300,890)	**1,881,218**	1,004,228
CASH (BANK INDEBTEDNESS), BEGINNING OF PERIOD	**(506,023)**	4,158,748	**(134,868)**	1,853,630
CASH (BANK INDEBTEDNESS), END OF PERIOD	**$ 1,746,350**	$ 2,857,858	**$ 1,746,350**	$ 2,857,858

Supplemental cash flow information (Note 17)

The accompanying notes are an integral part of these condensed consolidated financial statements.

1. ORGANIZATION OF THE TRUST

Partners Real Estate Investment Trust ("Partners REIT" or the "REIT") is an unincorporated, open-ended real estate investment trust and was formed pursuant to a Declaration of Trust dated March 27, 2007 and as amended and restated on May 28, 2014. The address of its registered office and principal place of business is 249 Saunders Road, Unit #3, Barrie, Ontario, L4N 9A3. The principal business activity of Partners REIT is acquiring, developing and operating commercial retail properties. The units of the REIT have been listed on the Toronto Stock Exchange since April 3, 2012 (the "TSX") and trade under the symbol "PAR.UN". Prior to April 3, 2012, the REIT's units were listed on the TSX Venture Exchange under the same symbol.

2. SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies that are used in the preparation of these condensed consolidated financial statements:

(a) Statement of compliance

These condensed consolidated financial statements have been prepared to comply with International Accounting Standard 34 *Interim Financial Statements.* Selected explanatory notes are included to explain significant events and transactions that have occurred since December 31, 2013. These condensed consolidated financial statements do not contain all of the information and disclosures required by International Financial Reporting Standards ("IFRS") for annual reporting purposes and should be read in conjunction with the REIT's consolidated financial statements as at and for the year ended December 31, 2013.

These condensed consolidated financial statements were approved and authorized for issue by the Board of Trustees (the "Trustees") on August 14, 2014.

(b) Basis of presentation

The condensed consolidated financial statements have been prepared on a going concern basis and have been presented in Canadian dollars. The condensed consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of income producing properties and certain financial instruments at fair value.

(c) Significant accounting policies

Except as described below, these condensed consolidated financial statements follow the same accounting policies and methods of application as the consolidated financial statements as at and for the year ended December 31, 2013.

(d) Changes in accounting policies

The REIT has applied, for the first time, new accounting policies due to the adoption of new standards and amendments to existing standards. The nature and impact of the new standards and amendments are described below:

i. IFRIC 21. Levies

IFRIC 21 provides an interpretation of the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for the recognition of liabilities for obligations to pay levies that are within the scope of IFRIC 21. The standard has no impact on the REIT's consolidated financial statements.

3. HOLYROOD TRANSACTION

(a) Acquisition of three Ontario properties

On April 23, 2014 the REIT closed its acquisition (the "Acquisition") of three retail centres (the “Holyrood Properties”) from Holyrood Holdings Limited (the “Vendor” or “Holyrood”). Under the terms of the agreement, the REIT purchased the Holyrood Properties for $83.2 million satisfied by: (i) the refinancing of mortgages secured by the Holyrood Properties as described below, (ii) the issuance of 4,813,517 Partners Ontario exchangeable LP Units (see Note11 (b)) issued at an effective price of $5.80 per unit. The Partners Ontario exchangeable LP Units are exchangeable for REIT units on a one-for-one basis and are the economic equivalent of REIT units and carry the right to vote at the REIT level. The Holyrood Properties consist of a total of approximately 611,500 square feet of gross leasable area of which 462,027 square feet were leased at the time of acquisition. The purchase price paid for the Holyrood Properties related only to fully leased units and two head lease agreements. Concurrent with the purchase of the real estate assets, the REIT completed a private placement pursuant to which it issued 1,188,188 units from treasury at $5.80 per unit to Holyrood and this $6.9 million issuance was paid in full by Holyrood’s issuance of a promissory note. A second promissory note of $524,000 was also issued by Holyrood to the REIT, representing mark to market interest rate adjustments on the three mortgages re-financed at the time of the Acquisition.

Immediately following the close of the Acquisition the Vendor held approximately 18.7% of the REIT’s outstanding units, calculated on a fully diluted basis.

Pursuant to the Acquisition, the REIT and the Vendor entered into a development agreement wherein the Vendor, as developer, was granted the right to perform development and leasing activities in respect of certain vacant space and undeveloped space located on the Holyrood Properties. The REIT agreed to pay the Vendor (i) $25,000,000, as a deferred purchase price which is fully contingent on the Vendor entering into qualified leases in respect of certain vacant space located on the Holyrood Properties (the "Contingent Deferred Payment"), and (ii) earn-out payments contingent on the Vendor entering into qualified leases in respect of certain undeveloped space located on the Holyrood Properties (the "Earn-Out Payments"). Both the Contingent Deferred Payments and Earn-Out Payments will be calculated by dividing the amount that the qualified lease increases the REIT’s net operating income (on a 12 month basis) by a capitalization rate of 6.6%. The REIT has discretion to make payment of any Contingent Deferred Payment or Earn-Out Payment by way of (i) cash, (ii) the offsetting of certain debt of the Vendor, (iii) the issuance of up to 506,634 Partners Ontario exchangeable LP Units at an effective price of $5.95 per unit, (iv) requiring the Vendor to provide a vendor take-back mortgage for 60% of the amount payable, or (v) a combination thereof.

Pursuant to the Acquisition, the REIT entered into two head lease agreements with the Vendor in which the Vendor guaranteed to make rental payments in respect of a total gross leasable area of 146,830 square feet at both London Crossroads Centre and Hamilton City Centre. The Vendor has commenced with the specific improvements required under replacement tenants’ leases. The term of each head lease will expire once the REIT approved replacement tenant is in occupation and paying rent. To date the Vendor has made no payments on the Head Lease Agreement pending rescission.

The REIT also entered into a works agreement with the Vendor in which the Vendor, at its sole cost and expense, is to undertake the repair and replacement of non-recoverable capital expenditures at London Crossroads Centre and Hamilton City Centre. Such investments are material in nature and are in addition to any expenditure related to the cost of leasing transactions and development activities.

At closing the REIT entered into new mortgages with the previous lenders at a weighted average interest rate of 4.8% to replace the previous $55.2 million in mortgages that were on the properties. All such mortgages mature within one year of the transaction’s closing. The Vendor will pay interest rate normalization adjustments of $524,000 over a one year period. Ms. Laura Philp, owner of the Vendor, is a guarantor of each of these mortgages and the Vendor is a guarantor on the loan secured by the London Crossroads Centre. In addition, in connection with the transaction the Vendor agreed to provide an unlimited environmental indemnification to the REIT in respect of the Hamilton City Centre property.

Prior to completion of the Acquisition, Mr. Ron McCowan, at the time Chief Executive Officer of the REIT, and Ms. Laura Philp were guarantors of a loan secured by the Hamilton City Centre property. In connection with the completion of the Acquisition the original loan was repaid and the lender advanced a new loan to the REIT in respect of which Ms. Philp is a guarantor and Mr. McCowan is not.

(b) Commencement of process to unwind the Acquisition

Subsequent to closing the Acquisition, the Trustees obtained material new information regarding the relationship between the Vendor and Ron McCowan. Based on its review of this information, the REIT commenced discussions with the Vendor to unwind the Acquisition. On May 6, 2014 the REIT received a letter from the TSX, notifying the REIT that if the TSX had been made aware that Mr. McCowan had an interest in the Acquisition as a result of his relationship with Ms. Philp at the time the REIT had filed notice of the Acquisition, the TSX would have concluded that the Acquisition: (i) provided consideration to insiders in excess of 10% of the market capitalization of the REIT; and (ii) would materially affect control of the REIT, as such term is defined in the TSX Company Manual. The TSX further indicated that it would not have allowed the Acquisition to close without the approval of the holders of a majority of the voting units of the REIT, excluding votes attached to the securities held by Mr. McCowan and Ms. Philp.

The TSX advised the REIT that, among other matters, it would not be approving any further transactions by the REIT until the Compliance and Disclosure department of the TSX has completed a review of the REIT and is satisfied that the business of the REIT can be conducted in compliance with the rules and regulations of the TSX, as well as the best interests of the REIT's security holders and the investing public. The REIT's understanding is that this review is continuing pending the rescission of the Acquisition as described below.

(c) Rescission Agreement

As a result of the developments discussed herein and previously disclosed, the REIT's Trustees initiated a process to reverse the Acquisition. In June 2014, the REIT entered into a Rescission Agreement with the Vendor to unwind the Acquisition. The effect of the Rescission Agreement would be that the parties would apply to the Ontario Superior Court of Justice (the "Court") for a court order rescinding the Acquisition and returning the parties (to the greatest extent possible) to the position they would have been in prior to its occurrence. The three properties and the two promissory notes would be returned to the Vendor, and the units issued to the Vendor would be returned to the REIT and its subsidiary for cancellation. The REIT agreed that $900,000 in cost reimbursement and premise lease termination fees would be made to the Vendor upon completion of the rescission.

The Rescission Agreement requires the parties to use their reasonable commercial efforts to complete the rescission by August 31, 2014. The REIT intends to continue to utilize its reasonable commercial efforts to effect the rescission, but as of the date of approval of these financial statements, at least one significant condition remains outstanding that is beyond the REIT's control. ***Accordingly, these condensed financial statements have been prepared based on information as of August 14, 2014 and reflect the Acquisition as completed. In the event that the parties receive approval of the Court of the Rescission Agreement, the REIT will amend and restate these condensed financial statements for filing on SEDAR.***

(d) Failure to successfully complete the Rescission Agreement

As at August 14, 2014 the unwinding of the Acquisition has not been completed, nor is there certainty that it will be successfully completed. Should the REIT not be able to complete the rescission of the Acquisition, the REIT would retain the three properties purchased from the Vendor, the REIT units issued to Vendor would remain outstanding, and the REIT would consider its legal remedies.

As part of the Holyrood acquisition, the REIT has entered into two head lease agreements, a Works Agreement, an Environmental Investigations, Remediation and Indemnity Agreement, and a Development Agreement with Holyrood Holdings Ltd. Under the terms of the Rescission Agreement, if court approval is not obtained and the Rescission Agreement is terminated then the Development Agreement will also be terminated. As a result, the REIT will not be required to make either the Contingent Deferred Payment or Earn-Out Payment. The other agreements would remain in place. To date no payments have been made by Holyrood on these agreements pending rescission.

In the event that Holyrood Holdings is unable to meet its obligations under these remaining acquisition agreements, the REIT would lose the cash flows associated from the Head Lease Agreement and incur costs under the Works Agreement. The amounts expected for collection on the six units identified in the Head Lease Agreement is dependent on when the new tenants are moved in and paying rents directly to the REIT. Management estimates that the total collectible under the Head Lease Agreement would be approximately $2.4 million over the 17 months ending September 2015. Furthermore, under Holyrood's default of the Works Agreement the REIT would be required to perform revenue enhancing capital work and other non recoverable structural capital work on the Holyrood Properties.

As part of the acquisition of the three Holyrood properties the REIT has issued 6,001,705 units of the REIT (or Partners Ontario LP). In the past, the REIT has paid a monthly distribution and the suspension or reduction of future distributions would negatively affect the cash flow of Holyrood Holdings Ltd. and could reduce or eliminate Holyrood's capacity to complete its responsibilities under the Works, Environmental, Remediation and Indemnity Agreements, along with making payments to the REIT under the two head lease agreements and the two promissory notes (Note 6).

The Rescission Agreement requires the parties to use their reasonable commercial efforts to complete the rescission by August 31, 2014. The REIT intends to continue to work towards the completion of this Rescission Agreement. However, there can be no assurance that the rescission will be completed.

The table below presents the impact of the Holyrood Transaction on the REIT's condensed consolidated statement of financial position. The table is provided to show the pro forma impact on the REIT's financial position should the Holyrood Transaction be rescinded.

As at		***Partners REIT*** **June 30, 2014**		*Adjustments to Rescind Holyrood Transaction* June 30, 2014		*Partners REIT Pro Forma (Post Holyrood Rescission)* June 30, 2014
ASSETS						
Non-current assets						
Income producing properties	**$**	**664,204,898**	$	(84,312,646)	$	579,892,252
		664,204,898		(84,312,646)		579,892,252
Current assets						
Other assets		**6,228,409**		(37,205)		6,191,204
Notes receivable		**7,484,161**		(7,484,161)		-
Accounts receivable		**6,468,230**		(430,272)		6,037,958
Cash		**1,746,350**		-		1,746,350
		21,927,150		(7,951,638)		13,975,512
	$	**686,132,048**	$	(92,264,284)	$	593,867,764
LIABILITIES		-				
Non-current liabilities		-				
Mortgages payable	**$**	**242,223,088**	$	-	$	242,223,088
Convertible debentures		**82,889,239**		-		82,889,239
Credit facilities		-		-		-
		325,112,327		-		325,112,327
Current liabilities						
Mortgages payable		**107,271,247**		(55,561,719)		51,709,528
Credit facilities		**32,869,629**		-		32,869,629
Accounts payable and other liabilities		**15,192,259**		(143,921)		15,048,338
Distributions payable		**1,147,529**		-		1,147,529
Bank indebtedness		**-**		-		-
		156,480,664		(55,705,640)		100,775,024
		481,592,991		(55,705,640)		425,887,351
Exchangeable LP units		**24,019,448**		(24,019,448)		-
		505,612,439		(79,725,088)		425,887,351
UNITHOLDERS' EQUITY		**180,519,609**		(12,539,196)		167,980,413
	$	**686,132,048**	$	(92,264,284)	$	593,867,764

The table below presents the impact of the Holyrood Transaction on the REIT's condensed consolidated statement of comprehensive income (loss) for the six months ended June 30, 2014. The table is provided to show the pro forma impact on the REIT's financial position should the Holyrood Transaction be rescinded.

Six months ended June 30,	***Partners REIT*** **2014**	*Adjustments to Rescind Holyrood Transaction* 2014	*Partners REIT Pro Forma (Post Holyrood Rescission)* 2014
Revenues from income producing properties	**$ 31,600,856**	$ (1,223,175)	$ 30,377,681
Property operating expenses	**(4,989,282)**	466,939	(4,522,343)
Realty taxes	**(6,737,924)**	231,984	(6,505,940)
Property management fees	**(541,178)**	-	(541,178)
	19,332,472	(524,252)	18,808,220
Other expenses:			
Financing costs	**11,484,958**	(1,049,496)	10,435,462
General and administrative expenses	**2,757,128**	-	2,757,128
Other transaction costs	**5,263,003**	2,422,534	7,685,537
	19,505,089	1,373,038	20,878,127
Income before fair value gains (losses)	**(172,617)**	(1,897,290)	(2,069,907)
Fair value gains (losses)	**(5,638,740)**	(3,898,949)	(9,537,689)
	-		
Net income (loss) and comprehensive income (loss)	**$ (5,811,357)**	$ (5,796,239)	$ (11,607,596)
EARNINGS (LOSS) PER UNIT			
Basic and diluted	**$ (0.22)**	$ (0.19)	$ (0.39)

Revenues from income producing properties exclude $383,219 in Head Lease payments due from Holyrood for the two months ended June 30, 2014. Under IFRS these amounts are not considered revenues from income producing properties. This amount owing by Holyrood to the REIT is included in other receivables (Note 7) as no payments have been made by the Vendor pending the rescission of the Holyrood Acquisition.

The above increase in other transactions costs of $2.4 million resulting from the Holyrood rescission is the result of $0.9 million in fees which will be incurred if the rescission proceeds and $1.5 million increase in abandoned acquisition costs.

The above decrease in financing costs of $1.0 million is the result of $0.6 million in accrued distributions payable on the Partners Ontario exchangeable LP units and $0.5 million in interest on three assumed mortgages, partially offset by interest income earned. In addition, $3.9 million in fair value gains on the Partners Ontario exchangeable LP Units liability would be reversed.

4. INCOME PRODUCING PROPERTIES

As at		**June 30, 2014**		December 31, 2013
Balance, beginning of year	**$**	**588,391,005**	$	465,727,634
Acquisitions of income producing properties		**82,383,705**		120,167,628
Improvements to income producing properties		**698,614**		6,652,911
Expenditures on tenant incentives and direct leasing costs		**357,146**		1,070,725
Amortization of tenant incentives and direct leasing costs		**(355,869)**		(502,072)
Recognition of straight-line rent		**515,579**		1,968,009
Head lease rent receivable		**2,040,657**		-
Fair value gains (losses)		**(9,825,939)**		(6,693,830)
Balance, end of period	**$**	**664,204,898**	$	588,391,005

Income producing properties, which are classified as investment properties under IFRS, are appraised at fair value by management support on a sample basis by qualified external valuation professionals (“Appraisers”) in accordance with IAS 40 – *Investment Properties*. The Appraisers are independent valuation firms, not related to the REIT, that employ valuation professionals who are members of the Appraisal Institute of Canada and the Ordre des évaluateurs agréés du Québec, and who have appropriate qualifications and experience in the valuation of properties in the relevant locations.

For the period ended June 30, 2014 the fair value of the REIT’s income producing property portfolio was determined either internally by the REIT using the Direct Capitalization methodology or by obtaining external appraisals.

At June 30, 2014, external appraisals were obtained for nine of the REIT’s properties with an aggregate fair value of $97.0 million, representing 15.2% of the fair value of the income producing property portfolio. At December 31, 2013, external appraisals were obtained for thirteen of the REIT’s properties with an aggregate fair value of $185.7 million, representing 31.6% of the fair value of the income producing property portfolio as of that date. Properties acquired within the year are valued at the purchase price plus closing costs. The value of the remainder of the REIT’s income producing property portfolio is determined internally by the REIT using the same assumptions and valuation techniques used by the Appraisers.

For fiscal 2014 the external valuation of the income producing properties utilized the “Full Narrative” methodology. These reports rely on the Income Approach (Direct Capitalization and Discounted Cash Flows) in determining values while concurrently reviewing values in the context of the Investment Market Activity.

Fair values are most sensitive to change in capitalization and discount rates.

The following table outlines the range and weighted average of the capitalization rates applied to the stabilized net operating income in estimating the fair value for the REIT’s properties:

As at	**June 30, 2014**	December 31, 2013
Capitalization rates		
Maximum	**8.25%**	8.25%
Minimum	**6.00%**	6.00%
Weighted Average	**6.51%**	6.47%

At June 30, 2014, a 0.50% increase in capitalization rates for income producing properties would decrease fair value by $41.7 million (December 31, 2013 - $42.0 million) and a 0.50% decrease in capitalization rates would increase fair value by $48.6 million (December 31, 2013 - $49.0 million).

The aggregate cost of tenant incentives and direct leasing costs included in income producing properties are recognized as a reduction of rental income over the lease term, on a straight-line basis. As at June 30, 2014, income producing properties included $5.1 million (December 31, 2013 - $4.6 million) of net straight-line rent receivables arising from the recognition of rental revenue on a straight-line basis over the lease term in accordance with IAS 17 – *Leases*.

2014 Holyrood Transaction (see Note 3)

On April 22, 2014, the REIT completed the acquisition of three retail centers located in Hamilton, London and Kemptville, Ontario, totaling approximately 612,000 square feet of leasable space. The REIT paid $83.2 million for the properties, funded by a combination of $55.2 million of assumed debt with a contractual interest rates ranging from 4.50% to 5.40% and the issuance of exchangeable LP units (see Note 11).

Included in the purchase price of $83.2 million is an estimated $2.4 million collectible under the Head Lease Agreement which is expected to expire by September 2015.

5. OTHER ASSETS

The major components of other assets are as follows:

As at		**June 30, 2014**		December 31, 2013
Prepaid realty taxes and insurance	**$**	**2,937,666**	$	927,715
Restricted cash - amounts held in escrow		**2,478,865**		2,638,377
Deferred acquisition costs		**-**		155,518
Prepaid expenses and other		**811,878**		792,781
	$	**6,228,409**	$	4,514,391

Cash is considered restricted when it is held in escrow and is only available for use for specific purposes. The permitted use of restricted cash is to lease up vacant space and fund certain future capital expenditures for the REIT’s income producing property portfolio.

Prepaid expenses and other include general trust expenses paid in advance and other deferred amounts.

6. NOTES RECEIVABLE

In connection with the April 22, 2014 Holyrood transaction (see Note 3) two notes receivable were issued by Holyrood:

As at		**June 30, 2014**		December 31, 2013
First note receivable	**$**	**6,959,930**	$	-
Second note receivable		**524,231**		-
	$	**7,484,161**	$	-

The first note receivable was issued to the REIT by Holyrood in the amount of $6,891,492 in consideration for the REIT's issuance of 1,188,188 units at $5.80 per unit. The note is interest bearing at 5.4% per annum and commencing May 1, 2014 there are monthly payments of $47,017 due (blended interest and principal). The balance at June 30, 2014 now also includes accrued interest in the amount of $68,438. The note matures on April 22, 2015 or such later maturity date as in effect from time to time under the mortgage on the London Ontario property (that was acquired as part of the Holyrood transaction).

The second note receivable was issued by Holyrood on April 22, 2014 in the amount of $524,231. The second note receivable represents a mark to market interest adjustment received in exchange for the assumption of above market rate interest on mortgages the REIT obtained at close of the Holyrood transaction. The note is non-interest bearing and repayable in twelve equal monthly instalments commencing May 1, 2014 and ending April 1, 2015.

At June 30, 2014 no payments had been received on these two notes receivable as the REIT has acquiesced in this regard, pending satisfaction or other termination of the Rescission Agreement.

7. ACCOUNTS RECEIVABLE

As at		**June 30, 2014**		December 31, 2013
Rents receivable	**$**	**2,458,888**	$	1,261,870
Unbilled recoveries and other receivables		**4,516,376**		1,731,423
		6,975,264		2,993,293
Allowance for doubtful accounts		**(507,034)**		(270,652)
	$	**6,468,230**	$	2,722,641

The REIT records an allowance for doubtful accounts on tenant rent receivables on a tenant-by-tenant basis, using specific, known facts and circumstances that exist at the time of the analysis.

Included in other receivable is an amount from Holyrood of $191,337, net of unpaid distributions of $601,705 (Note 11(b)). This amount is made up of uncollected head lease and tenant rental amounts that are in excess of unpaid distributions owing on Partners Ontario exchangeable LP units.

See Note 22 for the REIT's exposure to credit risk regarding its receivables, and precautions taken to mitigate these risks.

8. MORTGAGES PAYABLE

As at		June 30, 2014		December 31, 2013
Mortgages payable	$	**347,931,977**	$	282,225,144
Unamortized above market interest rate adjustments		**3,510,762**		3,510,297
Unamortized commitment and other fees		**(1,948,404)**		(1,584,881)
	$	**349,494,335**	$	284,150,560
Non-current	$	**242,223,088**	$	250,046,544
Current		**107,271,247**		34,104,016
	$	**349,494,335**	$	284,150,560

Scheduled repayments of secured debt are as follows:

		Principal instalments		Principal maturing		Total
2014	$	4,789,790	$	24,870,435	$	29,660,225
2015		8,508,112		101,490,007		109,998,119
2016		7,139,252		28,376,013		35,515,265
2017		5,152,734		81,111,316		86,264,050
2018		2,407,464		35,029,628		37,437,092
Thereafter		6,397,377		42,659,849		49,057,226
Contractual obligations	$	34,394,729	$	313,537,248	$	347,931,977

Mortgages payable are secured by the income producing properties to which they relate with some having recourse to the REIT. The mortgages bear interest at effective rates ranging between 2.43% and 13.60% per annum (December 31, 2013 – 2.43% and 6.02%) and contractual rates ranging between 2.40% and 10.00% (December 31, 2013 – 2.40% and 6.70%). The REIT's weighted average effective interest rate is 4.83% per annum (December 31, 2013 – 4.34%). The total carrying value of the properties pledged as security is $598.8 million (December 31, 2013 - $522.8 million).

During the three months ended June 30, 2014 the REIT secured a $15.0 million second mortgage on six single tenant Shoppers Drug Mart properties. The mortgage bears interest at the greater of 10% or prime rate plus 6% per annum. The mortgage is repayable without penalty with 30 days notice.

During the three months ended June 30, 2014 the REIT also assumed three first mortgages totaling $55.7 million bearing interest at contractual interest rates ranging from 4.50% to 5.40% per annum. Each of the three mortgages mature during 2015. These mortgages were assumed as a part of the Holyrood transaction (see Note 3).

As at June 30, 2014 the REIT was in technical violation of one of its financial covenants on a mortgage secured by a property in Quebec. Under the terms of the loan the quarterly covenant calculation is due for filing on August 29, 2014 and the Lender considers whether or not there is a default within 30 days following receipt of the covenant calculation. The loan is not in default until the Lender provides written notice thereof. The mortgage for this property is coming due September 1, 2014 and on August 14, 2014 the REIT executed a commitment letter for a $23.0 million mortgage from a new lender that will replace this $20.6 million maturing mortgage.

9. CONVERTIBLE DEBENTURES

As at		**June 30, 2014**		December 31, 2013
8.0% Convertible debenture	**$**	**28,484,221**	$	28,395,933
6.0% Convertible debenture		**34,173,177**		34,118,941
5.5% Convertible debenture		**22,888,727**		22,872,867
Debentures, excluding convertible feature		**85,546,125**		85,387,741
Fair value of convertible features at issuance		**1,460,000**		1,460,000
Accumulated fair value (gain) loss on convertible feature		**(1,460,000)**		(1,430,000)
Convertible feature		**-**		30,000
Issue costs		**(4,998,547)**		(4,898,664)
Accumulated amortization of issue costs		**2,341,661**		1,833,524
Issue costs, net		**(2,656,886)**		(3,065,140)
	$	**82,889,239**	$	82,352,601

In March, 2011, the REIT issued $28,750,000 of 8.0% convertible unsecured subordinated debentures (the “8.0% convertible debentures”) due March 31, 2016. The 8.0% convertible debentures are convertible into REIT units at $8.80 per unit at the holder’s option at any time on or after March 31, 2014. On or after March 31, 2014 and prior to March 31, 2015, the 8.0% convertible debentures may be redeemed by the REIT, in whole or in part, at a price equal to their principal amount plus accrued and unpaid interest, provided that the volume weighted average trading price of the REIT’s units during the 20 consecutive trading days ending on the fifth trading day preceding the date on which the notice of redemption is given is not less than 125% of the conversion price. On or after March 31, 2015, the 8.0% debentures may be redeemed by the REIT at any time. The fair value of the convertible feature of the 8.0% convertible debentures as at June 30, 2014 is nil (December 31, 2013 - $20,000).

In September, 2012, the REIT issued $34,500,000 of 6.0% convertible unsecured subordinated debentures (the “6.0% convertible debentures”) due September 30, 2017. The 6.0% convertible debentures are convertible into REIT units at $10.35 per unit at the holder’s option at any time on or after September 30, 2015. On or after September 30, 2015 and prior to September 30, 2016, the 6.0% convertible debentures may be redeemed by the REIT, in whole or in part, at a price equal to their principal amount plus accrued and unpaid interest, provided that the volume weighted average trading price of the REIT’s units during the 20 consecutive trading days ending on the fifth trading day preceding the date on which the notice of redemption is given is not less than 125% of the conversion price. On or after September 30, 2016, the 6.0% debentures may be redeemed by the REIT at any time. The fair value of the convertible feature of the 6.0% convertible debentures as at June 30, 2014 is nil (December 31, 2013 - $10,000).

In March, 2013, the REIT issued $23,000,000 of 5.5% convertible unsecured subordinated debentures (the “5.5% convertible debentures”) due March 31, 2018. The 5.5% convertible debentures are convertible into REIT units at $10.25 per unit at the holder’s option at any time on or after March 31, 2016. On or after March 31, 2016 and prior to March 31, 2017, the 5.5% convertible debentures may be redeemed by the REIT, in whole or in part, at a price equal to their principal amount plus accrued and unpaid interest, provided that the volume weighted average trading price of the REIT’s units during the 20 consecutive trading days ending on the fifth trading day preceding the date on which the notice of redemption is given is not less than 125% of the conversion price. On or after March 31, 2017, the 5.5% debentures may be redeemed by the REIT at any time. The fair value of the convertible feature of the 5.5% convertible debentures as at June 30, 2014 is nil (December 31, 2013 – nil).

10. CREDIT FACILITIES

As at		June 30, 2014		December 31, 2013
Credit facilities	$	**33,000,000**	$	31,000,000
Issue costs		**259,491**		238,975
Accumulated amortization of issue costs		**(129,120)**		(34,778)
Issue costs, net		**130,371**		204,197
		32,869,629		30,795,803
Non-current	$	**-**	$	30,795,803
Current		**32,869,629**		-
	$	**32,869,629**	$	30,795,803

The REIT's revolving credit facility (the "Credit Facility) has a formula-based current maximum credit limit of $40.0 million, expandable up to $60 million with the securitization of additional unencumbered properties, and bears interest at the bank's prime rate (3.0% as at June 30, 2014) plus 1.0% per annum or the Banker's Acceptance stamping fee plus 2.25% per annum.

As at June 30, 2014, the Credit Facility was secured by the King George Square, Crossing Bridge Square, Centre Village Shopping Centre, Elgar Place and Centuria Urban Village properties with a formula-based amount available under the facility of $40.0 million (December 31, 2013 - $38.7 million). The Credit Facility matures in March 2015 and is renewable annually thereafter. The carrying value of properties pledged as security is $62.7 million (December 31, 2013 - $62.6 million).

11. EXCHANGEABLE LP UNITS

a) 137th Ave exchangeable LP units

During the six months ended June 30, 2014 157,500 137th Ave exchangeable LP units were converted into units of the REIT, leaving no remaining 137th Ave exchangeable LP units outstanding. The exchangeable units of 137th Avenue LP, a wholly owned subsidiary, were issued to the participating third party vendor in exchange for a property acquired by 137th Avenue LP.

b) Partners Ontario exchangeable LP units

During the period ended June 30, 2014, the REIT issued 4,813,517 Partners Ontario exchangeable LP units in conjunction with the Acquisition (Note 3). The units were issued at an average price of $5.80 per unit. The Partners Ontario exchangeable LP units are presented as a liability under IFRS and are measured at fair value. The fair value of the LP units as at June 30, 2014 was $24.0 million. The REIT recorded a fair value gain for the three months ended June 30, 2014 of $3.9 million. The gain was calculated with reference to the closing price of the REIT's units as at June 30, 2014.

The holder of the exchangeable LP units of Partners Ontario LP is entitled to receive distributions on a per unit basis equal to the amount that is paid to the holders of REIT units. Under IFRS, these distributions are considered interest expense and are included in financing costs in the condensed statements of comprehensive income. The units are exchangeable on a one-for-one basis, at the option of the holder, into REIT units. At June 30, 2014 financing costs on the REIT's condensed consolidated statements of comprehensive income include $601,737 of distributions payable on the Partners Ontario LP Exchangeable LP units which have been offset against other amounts owing to the REIT by Holyrood.

12. REVENUES FROM INCOME PRODUCING PROPERTIES

Revenues recognized from income producing properties for the three and six months ended June 30, 2014 were $16.4 million and $31.6 million, respectively (three and six months ended June 30, 2013 - $14.1 million and 27.3 million, respectively). The REIT leases commercial retail properties under operating leases generally with lease terms of between one and fifteen years, with options to extend for successive five year periods. Included in revenues from income producing properties are recoveries from tenants for the three and six months ended June 30, 2014 of $4.8 million and $9.6 million, respectively (three and six months ended June 30, 2013 - $4.2 million and 8.6 million, respectively), which represents the recovery of common area maintenance costs, realty taxes, insurance, and other permissible recoverable costs. Deducted from revenues are the amortization of tenant incentives and direct leasing costs.

As at June 30, 2014, the REIT is entitled under its non-cancellable tenant operating leases to the following minimum future receipts:

	Within 12 months	2 to 5 years	Beyond 5 years
Operating lease revenue	$ 41,726,399	$ 130,058,574	$ 102,202,944

13. OTHER TRANSACTION COSTS

The components of other transaction costs are as follows:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	**2014**	2013
Asset management contract reimbursement (Note 21)	**$ -**	$ -	**$ 1,500,000**	$ -
Internalization cost reimbursements (Note 21)	**-**	-	**432,947**	-
Internalization legal and other fees	**(109,832)**	-	**639,025**	-
Board transition	**19,325**	-	**53,769**	-
Abandoned acquisition costs	**1,195,589**	-	**1,199,410**	-
Proxy dispute	**894,352**	1,787,634	**894,352**	1,787,634
Strategic-review	**543,500**	-	**543,500**	-
Total other transaction costs	**$ 2,542,934**	$ 1,787,634	**$ 5,263,003**	$ 1,787,634

14. FAIR VALUE GAINS (LOSSES)

The components of fair value gains are as follows:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	**2014**	2013
Income producing properties	**$ (7,844,851)**	$ (117,699)	**$ (9,825,939)**	$ 4,088,257
Financial liabilities designated as FVTPL				
Deferred unit-based compensation	**-**	147,000	**79,000**	158,000
Convertible debentures	**-**	202,987	**30,000**	472,703
137th Ave exchangeable LP units	**228,625**	211,650	**179,250**	191,525
Partners Ontario exchangeable LP units	**3,898,949**	-	**3,898,949**	-
Total fair value gains (losses)	**$ (3,717,277)**	$ 443,938	**$ (5,638,740)**	$ 4,910,485

See Note 21 for a description of the techniques used to determine the above fair value gains/(losses).

15. EARNINGS PER UNIT

The table below presents the net income per unit and weighted average units outstanding calculations. Only dilutive elements have been included in the calculation of diluted per unit amounts.

		Three months ended June 30,				Six months ended June 30,		
		2014		2013		**2014**		2013
Numerator								
Net income (loss) and comprehensive income (loss) - basic	**$**	**(4,499,171)**	$	2,402,571	**$**	**(5,811,357)**	$	10,500,236
Contribution from dilutive instrument		**-**		(43,681)		**-**		(54,306)
Net income (loss) and comprehensive income (loss) - diluted	**$**	**(4,499,171)**	$	2,358,890	**$**	**(5,811,357)**	$	10,445,930
Denominator								
Weighted average units outstanding - basic		**27,096,137**		25,773,271		**26,562,998**		25,564,016
Dilutive convertible units		**-**		57,708		**-**		129,583
Weighted average units outstanding - diluted(1)		**27,096,137**		25,830,979		**26,562,998**		25,693,599

(1) The calculation of diluted per unit amounts for the three and six months ended June 30, 2014 and 2013 exclude convertible units when their inclusion is anti-dilutive.

Earnings (loss) per unit - basic and diluted	**$**	**(0.17)**	$	0.09	**$**	**(0.22)**	$	0.41

16. UNITHOLDERS' EQUITY

(a) Distributions

For the six months ended June 30, 2014 the REIT made monthly cash distributions to unitholders in an amount of $0.04167 per unit, representing an annualized distribution of $0.50 per unit. The amount of the REIT's cash distributions is determined by, or in accordance with, the guidelines established from time to time by the Trustees. The Trustees have discretion in declaring distributions. Pursuant to the REIT's Declaration of Trust, it is the intention of the Trustees to make distributions not less than the amount necessary to ensure that the REIT will not be liable to pay income taxes under Part I of the Income Tax Act. On August 14, 2014, the Trustees announced a reduction of the distribution to $0.02083 per unit, representing an annualized distribution of $0.25 per unit

(b) Distribution reinvestment plan

The REIT has a Distribution Reinvestment and Optional Unit Purchase Plan ("the Plan") to enable Canadian resident unitholders to acquire additional units of the REIT:

(i) through the reinvestment of regular monthly distributions on all or any part of their units; and

(ii) once enrolled in the Plan, through optional cash payments subject to a minimum of $1,000 per month and a maximum of $12,000 per calendar year.

Units issued in connection with the Plan are issued directly from the treasury of the REIT at a price based on the volume-weighted average of the closing price for the 20 trading days immediately preceding the relevant distribution date. Participants receive "bonus units" in an amount equal in value to 5% of each cash distribution.

At June 30, 2014, the REIT has 496,016 units remaining in its reserve for issuance of units under the Plan. The REIT will increase the unit reserve as required and with approval from the TSX.

(c) Unpaid Distributions

As requested by the TSX (Note 3), the REIT has suspended distributions in respect of the Partners Ontario exchangeable LP units. A total of 4,813,517 Partners Ontario exchangeable LP units were issued as a part of the Holyrood transaction (Note 11). Distributions of $601,737 on these units have not been paid to Holyrood, however the costs for these distributions has been accrued to financing costs and recorded as a reduction against other amounts owing to the REIT by the Vendor (Note 7). Distributions of $148,523 on the 1,188,188 REIT units issued as part of the Holyrood Acquisition have been paid.

(d) Outstanding units

As at			June 30, 2014			December 31, 2013
	Units		**Dollars**	Units		Dollars
Units outstanding, beginning of period	**25,988,800**	**$**	**194,991,352**	22,310,533	$	168,392,882
Units issued:						
Distribution reinvestment plan	**120,387**		**609,929**	174,711		1,196,547
Exchangeable LP units (Note 9)	**157,500**		**663,375**	130,000		922,000
Units issued in exchange for first note receivable	**1,188,188**		**6,891,490**			
Alternate compenation plan	**-**		**-**	9,806		64,900
Public offerings	**-**		**-**	3,363,750		25,900,875
Unit issue costs	**-**		**(7,314)**	-		(1,485,852)
	27,454,875	**$**	**203,148,832**	25,988,800	$	194,991,352

17. SUPPLEMENTAL CASH FLOW INFORMATION

The following table outlines supplemental cash flow information and the net change in the REIT's working capital:

		Three months ended June 30,				Six months ended June 30,		
		2014		2013		**2014**		2013
Non-cash transactions								
Secured debt assumed (Note 8)	**$**	**55,179,165**	$	-	**$**	**55,179,165**	$	-
Issuance of Partners Ontario LP exchangeable units (Note 11)		**27,918,397**		-		**27,918,397**		-
Issuance of second note receivable (Note 7)		**524,231**		-		**524,231**		-
Issuance of first note receivable (Note 7)		**6,891,492**		-		**6,891,492**		**-**
Supplemental								
Interest paid		**3,525,283**		1,929,141	**$**	**9,442,674**	$	6,623,047
Net change in working capital								
Net change in accounts receivable	**$**	**(2,864,385)**	$	(675,016)	**$**	**(3,745,589)**	$	(1,877,383)
Net change in other assets		**(785,708)**		3,979,754		**(1,714,018)**		(3,227,464)
Net change in accounts payable and other liabilities		**2,655,607**		3,095,145		**3,551,842**		52,687
Net change in distributions payable		**51,503**		3,206		**53,373**		185,254
	$	**(942,983)**	$	6,403,089	**$**	**(1,854,392)**	$	(4,866,906)

18. UNIT-BASED COMPENSATION PLANS

(a) *Incentive unit option plan*

The REIT's incentive unit option plan provides that the maximum number of units which may be reserved and set aside for issue under the incentive unit option plan shall not exceed 10% of the issued and outstanding units at the time that the options were granted (on a non-diluted basis). During the period ended June 30, 2014 all outstanding options were cancelled.

(b) Alternate compensation plan ("ACP")

Under the ACP, Trustees have the option to have their fees ("Trustees Fees") paid in units of the REIT. The number of units will be equivalent to the cash value of the Trustees Fees elected by the Trustee to be paid in units. The maximum number of units reserved for issuance under the ACP is 1% of the issued and outstanding units and the maximum number of units reserved under the ACP and all unit-based compensation plans of the REIT shall not exceed 10% of the REIT's issued and outstanding units at any given time.

The issue price of the units under the ACP is the closing price of the units on the market on the last trading date preceding the date of issuance to the Trustees. If there is no trading on that date, the issue price is the closing price on the next previous day on which trading took place preceding the date of issuance to the Trustees or such other amount as determined by the Trustees and permitted by the Exchange upon which the units are from time to time listed for trading and any other applicable regulatory authority.

The ACP became effective April 13, 2012. For the period ended June 30, 2014, there were no units issued under the ACP.

19. INCOME TAXES

One of the REIT's corporate entities, Charter Realty Holdings Ltd. (the "Company") does not have current taxes payable because it has a sufficient non-capital loss carry-forward balance from previous years to apply against any taxable income in the current year. All of the other corporate entities that consolidate into the REIT are nominee corporations and do not have any taxable income and therefore do not have any current income tax payable. The REIT also has two partnerships contained within the structure, 137th Ave LP and Partners Ontario LP. For Canadian tax purposes, these entities are flow-through entities and any income or loss of the partnership is allocated to its partners. The REIT expects to distribute all of its taxable income to unitholders and is entitled to deduct such distributions for income tax purposes. Accordingly, no provision for Canadian income tax payable has been made.

20. CAPITAL MANAGEMENT

The REIT actively manages both its debt capital[(1)] and its equity capital with the objectives of ensuring that the REIT can continue to grow and operate its business.

The real estate industry is capital intensive by nature. As a result, debt capital is a very important aspect in managing the business. In addition, financial leverage is used to enhance returns from purchased real estate. Part of the REIT's objectives in securing mortgages for its properties and managing its long-term debt is to stagger the maturities in order to mitigate short-term volatilities in the debt markets. As well, given the importance of debt capital to real estate entities, the REIT monitors its debt-to-gross book value ratio; a ratio that has become a common industry metric reviewed by analysts, unitholders and others within the industry. The REIT does not have a specific debt-to-gross book value threshold imposed on it in its Declaration of Trust; however the REIT's bank credit facility imposes a restriction on the REIT's debt-to-gross book value ratio, at a maximum of 75%.

The debt-to-gross book value ratio is measured as the REIT's total debt, including mortgages payable, corporate secured debt, debentures and bank credit facility, divided by the gross book value of its assets.

At June 30, 2014, the REIT is in compliance with its debt-to-gross book value ratio at 66.7% (December 31, 2013 – 66.7%), which is calculated as follows:

As at		**June 30, 2014**		December 31, 2013
Debt				
Mortgage principal	**$**	**347,931,977**	$	282,225,144
Debentures, excluding fair value of convertible feature		**85,546,125**		85,387,741
Credit facilities		**33,000,000**		31,000,000
	$	**466,478,102**	$	398,612,885
Gross Book Value of Assets				
Original cost of income producing properties [(2)]	**$**	**672,260,486**	$	585,677,396
Book value of all other assets		**21,927,150**		7,237,032
Deferred financing fees		**4,735,661**		4,854,218
	$	**698,923,297**	$	597,768,646
Debt-to-Gross Book Value		**66.7%**		66.7%
Debt-to-Gross Book Value Excluding Debentures		**54.5%**		52.4%

(1) Debt capital refers to secured debt, debenture and bank credit facility excluding deferred financing costs, the value of the debentures' convertible feature, fair value of embedded derivatives, and unamortized above market interest rate adjustments.

(2) Original cost of income producing properties represents the historical costs incurred to acquire the REIT's properties.

21. FAIR VALUES

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair values of the REIT's assets and liabilities were determined as follows:

(a) *Income producing properties*

The significant assumptions used to determine the fair value of investment properties are disclosed in Note 4.

(b) *Current assets and liabilities*

The carrying amounts for cash, accounts receivable, other assets, bank indebtedness, accounts payable and other liabilities, credit facilities and distributions payable approximate their fair values due to the short-term nature of these items.

(c) *Exchangeable LP units*

Exchangeable LP units are valued with reference to the closing price of REIT units.

(d) *Mortgages payable*

The fair value of secured debt is based on discounted future cash flows, using interest rates ranging between 3.22% and 4.35% that reflect current market conditions for instruments of similar term and risk.

Assets and liabilities measured at fair value in the statements of financial position are classified based on a three-level hierarchy that reflects the significance of the inputs used when determining the fair value as follows:

- Level 1 - determined by reference to quoted prices in active markets for identical assets and liabilities;
- Level 2 - determined by using inputs other than the quoted prices that are observable for the asset or liability, either directly or indirectly; and
- Level 3 - determined using inputs that are not based on observable market data.

The following table classifies assets and liabilities measured at fair value according to the three level hierarchy:

	June 30, 2014			December 31, 2013		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets measured at fair value:						
Income producing properties	**$ -**	**$ -**	**$ 664,204,898**	$ -	$ -	$ 588,391,005
Liabilities measured at fair value:						
Embedded derivatives	**$ -**	**$ -**	**$ -**	$ -	$ 30,000	$ -
Deferred unit based compensation	**-**	**-**	**-**	-	79,000	-
Partners Ontario exchangeable LP units	**24,019,448**	**-**	**-**	-	-	-
137th Ave exchangeable LP units	**-**	**-**	**-**	842,625	-	-
Liabilities for which fair values are disclosed:						
Mortgages payable	**-**	**-**	**354,532,902**	-	-	286,708,749

During the period ended June 30, 2014 there were no transfers between the hierarchy levels.

22. RISK MANAGEMENT

In the normal course of business, the REIT is exposed to a number of risks that can materially affect its operating performance.

(a) Interest rate risk

The REIT is exposed to interest rate risk when funds are drawn under the Credit Facility which has a floating rate of interest. An increase in interest rates would increase the interest cost of the Credit Facility having an adverse effect on the REIT's comprehensive income and earnings per unit. Based on the outstanding balance of the Credit Facility at June 30, 2014, a 1% increase or decrease in the prime rate would have an impact of $330,000 on the REIT's annual interest expense (December 31, 2013 – $310,000).

The REIT structures its fixed rate financing so as to stagger the maturities of its mortgages, thereby minimizing exposure to future interest rate fluctuations.

(b) Credit risk

Credit risk arises from the possibility that tenants may experience financial difficulty and be unable to fulfill their lease commitments. The REIT attempts to mitigate this risk by conducting credit assessments on new lessees, by ensuring that its tenant mix is diversified and by limiting its exposure to any one tenant. The maximum credit risk exposure at June 30, 2014 relates to the carrying value of the accounts receivable balance without taking into account any collateral held or other credit enhancements. Collateral held on certain leases are letters of credit or security deposits from the tenants. Refer to Note 7 for details of accounts receivable.

(c) Liquidity risk

Liquidity risk arises from the possibility of not having sufficient debt and equity capital available to fund future growth, refinance debts as they mature or meet the REIT's payment obligations as they arise. Furthermore, liquidity risk also arises from the REIT not being able to obtain financing or refinancing on favourable terms.

The REIT's main liquidity requirements arise from ongoing working capital requirements, debt servicing and repayment obligations, capital and leasing expenditures on existing properties, property acquisitions and distributions to unitholders. All of the aforementioned liquidity requirements, except for debt repayment obligations at maturity and property acquisitions, are generally funded from cash flows from operations or from drawing on the Credit Facility. Debt repayment obligations are generally funded from refinancing the related debt and property acquisitions are generally funded from equity raises as well as obtaining debt financing on the related property. Between capital raises, the REIT may use its Credit Facility to fund the equity portion of property acquisitions.

The REIT's financial condition and results of operations would be adversely affected if it were unable to obtain financing/refinancing, cost-effective financing/refinancing, or if it were unable to meet its other liquidity requirements from ongoing operating cash flows. The REIT attempts to mitigate its liquidity risk by:

- staggering the maturities of its debt; and,
- not entering into property acquisitions unless it has secured or knows that it can secure the appropriate capital (debt and equity) to fund the particular acquisitions; and,
- planning capital spending around the availability of cash from operations or debt/equity funding; and
- reviewing current liquidity position and forecasted cash flow in advance of approving the monthly distributions.

While the REIT generated positive cash flows from operations, during the three and six months ended June 30, 2014 the REIT has incurred other transactions costs of $2.5 million and $5.3 million respectively. These expenses relate to costs for an internalization process, rescinding the Holyrood transaction, a proxy dispute, and the strategic review. While these expenditures are considered to be transaction specific, as at August 14, 2014 the unwinding of the Holyrood Acquisition has not been completed, nor is there certainty that it will be successfully completed. As a consequence, additional costs will likely be incurred prior to completing the rescission. These transaction costs reduce cash otherwise available from operations and reduce funds available for the ongoing working capital requirements, the capital and leasing expenditures on existing properties and for distributions to unitholders. In addition, there are bi-annual interest payments of $2.8 million on the outstanding convertible debentures that result in periodic cash outflows (interest payments are due March 31st and September 30th).

As at June 30, 2014, the REIT has $1.7 million in cash and $7.0 million of capacity available under its $40.0 million revolving credit facility, thereby providing $8.7 million in liquidity. In order to ensure that the REIT continues to have sufficient cash flows to meet its obligations, the REIT plans to dispose of certain properties, re-finance certain mortgages including a mortgage maturing on September 1, 2014, while also reducing the monthly distribution commencing with the August distribution due for payment on September 15, 2014. While these measures will both provide a cash injection while reducing the outflows, thereby improving the REIT's cash flows and resulting liquidity position, there is no guarantee that management will be successful in closing the planned financings and sale of properties.

The following table shows the contractual cash flows (including principal and interest) on all of the REIT's non-derivative financial liabilities:

	2014	2015	2016	2017	2018	Thereafter
Mortgages payable						
Interest	$ 6,343,259	$ 10,931,731	$ 8,670,233	$ 5,258,219	$ 2,299,005	$ 5,455,569
Principal payments	4,789,790	8,508,112	7,139,252	5,152,734	2,407,464	6,397,379
Balances due on maturity	24,870,435	102,014,238	28,376,013	81,111,316	35,029,628	42,659,847
Debentures						
Interest	2,817,500	5,635,000	3,910,000	2,817,500	316,250	-
Balances due on maturity	-	-	28,750,000	34,500,000	23,000,000	-
Credit facilties						
Interest	661,575	-	-	-		-
Balances due on maturity	-	33,000,000	-	-		-
Accounts and distributions payable						
and other liabilities	16,339,788	-	-	-	-	-
Total	$ 55,822,347	$ 160,089,081	$ 76,845,498	$ 128,839,769	$ 63,052,347	$ 54,512,795

(d) *Concentration risk*

The REIT has one major tenant with 16 locations in the REIT's portfolio providing $5.8 million in annualized base rents, or 13.7% of the REIT's total annualized base rental revenue.

23. RELATED PARTY TRANSACTIONS

IAS 24 – Related Party Disclosures requires entities to disclose in their financial statements information about transactions with related parties. Generally, two parties are related to each other if one party controls, or significantly influences the other party. Balances and transactions between the REIT and its subsidiaries, which are related parties of the REIT, have been eliminated on consolidation and are not disclosed in this note.

Transactions between the REIT and related parties are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

The REIT previously entered into related party transactions with IGW Public LP ("IGW Public"), and its subsidiary, LAPP Global Asset Management Corp. ("LAPP"), which were the REIT's major unitholder and asset manager, respectively. Effective November 28, 2013, IGW Public disposed of its holdings of REIT units to McCowan and Associates ("McCowan") and effective December 25, 2013, McCowan purchased LAPP's interest in the management agreement with the REIT as noted below.

(a) Management agreement

Effective December 27, 2013, McCowan purchased the REIT's management contract for $1.5 million from LAPP. Under the management contract, McCowan was responsible to arrange for the provision of all necessary management services to the REIT by competent employees, including, as needed, by seconding employees of the former asset manager. On February 15, 2014, upon approval of the internalization plan by the Trustees, McCowan terminated the management agreement and received reimbursement by the REIT of the $1.5 million purchase price plus management fees outstanding. Upon internalization of management, Ron McCowan (shareholder of McCowan) became interim CEO of the REIT.

Pursuant to the management agreement between the REIT and McCowan, McCowan provided the REIT with strategic, advisory, asset management and administrative services in exchange for an annual management fee equal to 0.30% of the "adjusted book value" of the REIT's assets, paid quarterly in arrears, and an acquisition fee equal to 0.50% of the "property cost" for any acquired real property. "Adjusted book value" equals the original property cost of the income producing properties, plus the book value of all other assets, and plus the add-back of accumulated amortization of deferred costs. In accordance with the terms of the management agreement, McCowan was also reimbursed for costs incurred which were in excess of the management fees earned.

Prior to internalization of management on February 15, 2014, the REIT incurred the following fees:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	**2014**	2013
Acquisition fees	**$ -**	$ 362,750	**$ -**	$ 493,180
Asset management fees	**-**	349,882	**282,272**	789,855
Property management and accounting fees	**-**	184,940	**95,342**	298,898
Internalization cost reimbursements	**-**	-	**432,947**	-
	$ -	$ 897,572	**$ 810,561**	$ 1,581,933

(b) Employee services agreement

On February 14, 2014 the REIT entered into an employee services agreement with McCowan which permits certain employees of the REIT to provide specified property, facility management, administrative and support services on an as-needed basis to McCowan. The initial term of the agreement was for one year with an option for renewal for a further one year term. The agreement requires that McCowan reimburse the REIT a formula based amount using the square footage of McCowan owned properties that are receiving the services of REIT employees. During the six months ended June 30, 2014 the REIT received total reimbursements of $242,690.

The REIT understands that McCowan shared a portion of its costs for some of these employees under a separate arrangement, whereby from time to time some of these employees provide services on properties owned or controlled by Ms. Laura Philp.

On May 5, 2014 the REIT and McCowan amended the terms of the employee services agreement to reflect the fact that the majority of the employees that were previously subject to such agreement were providing services separately to either McCowan or the REIT and were therefore employees of the applicable entity. A total of 17 employees resigned on this date. On July 1, 2014 the REIT and McCowan mutually agreed to terminate the employee services agreement effective August 31, 2014.

(c) Related party balances

Amounts owed by the REIT to related parties at June 30, 2014 are $88,766 (December 31, 2013 - $15,919). This amount has been classified in accounts payable and other liabilities, and consists of accrued directors' fees and employee reimbursements. Amounts owed to the REIT from related parties at June 30, 2014 are nil (December 31, 2013 – $40,038).

24. SUBSEQUENT EVENTS

National Bank Strategic Review Updates

On August 14, 2014, the REIT's Board of Trustees announced an update on the strategic review commenced on May 6, 2014:

- Effective as of the August 2014 distribution, the REIT has reduced its monthly distribution to $0.02083 per unit per month, or $0.25 per unit on an annualized basis. This reduction will result in annual cash savings of approximately $7.7 million, based on the REIT's consolidated unit count at the end of the second quarter. The REIT currently has 27,454,875 units outstanding and after considering the effect of exchangeable units of its subsidiaries, Partners REIT has 32,268,392 units outstanding.
- The REIT has agreed to sell a small portfolio of properties in exchange for net cash consideration of approximately $14 million.
- The REIT has executed a commitment letter to re-finance an existing mortgage that comes due on September 1, 2014. After costs, the $23.0 million re-financing on a $20.6 million maturing mortgage will result in a cash inflow of $2.2 million.
- Proceeds from the property sales and the refinancing will be applied against the REIT's revolving credit facility, providing liquidity for the REIT's planned capital expenditures and for general corporate purposes.

The Trustees have received several non-binding written proposals registering interest in a transaction involving the REIT. These proposals range from a significant investment in the equity of the REIT to the purchase of all or a substantial portion of the REIT. None of the proposals received to date are binding, and each of them would be subject to due diligence and various other pre-conditions to closing.

Holyrood Rescission (Note 3)

For the past several months, the parties have been working to satisfy the pre-conditions to the rescission. The Rescission Agreement requires the parties to use their reasonable commercial efforts to complete the rescission by August 31, 2014. The REIT intends to continue to do so, but at least one significant condition remains outstanding that is beyond its control and so there can be no assurance that the rescission will be completed. If the unwind is not completed, the REIT would retain the Holyrood Properties, the REIT units issued to Holyrood would remain outstanding and the REIT would consider its legal remedies.

As part of the acquisition of the three Holyrood properties the REIT has issued 6,001,705 units of the REIT (or Partners Ontario LP). In the past, the REIT has paid a monthly distribution and the suspension or reduction of future distributions would negatively affect the cash flow of Holyrood Holdings Ltd. and could reduce or eliminate

Holyrood's capacity to complete their responsibilities under the Works, Environmental, Remediation and Indemnity Agreements, along with making payments to the REIT under the Head Lease Agreements and the two promissory notes (Note 6). The effect of Holyrood's default under one or all of these agreements would have an impact to the results of operations, cash flows and asset valuations and these effects could be material (see Note 3d – Holyrood Transaction).