Condensed Consolidated Financial Statements of

# PARTNERS REAL ESTATE INVESTMENT TRUST

For the three and nine months ended September 30, 2016 and 2015

# PARTNERS REAL ESTATE INVESTMENT TRUST
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For the three and nine months ended September 30, 2016 and 2015

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

| As at | | September 30, 2016 | | December 31, 2015 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Income producing properties (Note 3) | **$** | **514,928,533** | $ | 511,817,617 |
| | | **514,928,533** | | 511,817,617 |
| **Current assets** | | | | |
| Other assets (Note 4) | | **4,472,042** | | 3,146,165 |
| Accounts receivable (Note 5) | | **1,507,676** | | 3,336,619 |
| Cash | | **2,954,044** | | 2,670,021 |
| | | **8,933,762** | | 9,152,805 |
| | **$** | **523,862,295** | $ | 520,970,422 |
| **LIABILITIES** | | | | |
| **Non-current liabilities** | | | | |
| Mortgages payable (Note 6) | **$** | **197,295,577** | $ | 234,796,421 |
| Convertible debentures (Note 7) | | **22,557,082** | | 56,014,181 |
| | | **219,852,659** | | 290,810,602 |
| **Current liabilities** | | | | |
| Mortgages payable (Note 6) | | **106,986,600** | | 70,152,574 |
| Convertible debentures (Note 7) | | **34,021,344** | | - |
| Credit facility (Note 8) | | **-** | | 1,976,561 |
| Accounts payable and other liabilities | | **9,163,544** | | 8,438,814 |
| Distributions payable | | **709,843** | | 703,787 |
| | | **150,881,331** | | 81,271,736 |
| | | **370,733,990** | | 372,082,338 |
| **UNITHOLDERS' EQUITY** | | **153,128,305** | | 148,888,084 |
| | **$** | **523,862,295** | $ | 520,970,422 |

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 September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| Revenues from income producing properties (Note 9) | **$ 14,046,194** | $ 14,334,061 | **$ 42,387,006** | $ 42,714,770 |
| Property operating expenses | **(2,086,181)** | (2,283,675) | **(6,580,255)** | (6,733,928) |
| Realty taxes | **(3,366,860)** | (3,368,414) | **(10,130,857)** | (10,295,098) |
| Property management fees | **(288,830)** | (398,290) | **(1,116,228)** | (1,213,814) |
| | **8,304,323** | 8,283,682 | **24,559,666** | 24,471,930 |
| Other expenses: | | | | |
| Financing costs | **$ 4,360,690** | $ 4,949,104 | **$ 13,495,070** | $ 15,116,173 |
| General and administrative expenses | **967,723** | 1,088,850 | **3,069,502** | 2,956,962 |
| Other transaction costs (Note 10) | **187,738** | 178,100 | **217,271** | 519,017 |
| | **5,516,151** | 6,216,054 | **16,781,843** | 18,592,152 |
| **Income before gains/(losses) and insurance proceeds** | **2,788,172** | 2,067,628 | **7,777,823** | 5,879,778 |
| Insurance proceeds: | | | | |
| Insuance recoveries | **-** | - | **-** | 1,403,080 |
| Insurance costs | **-** | - | **-** | (343,317) |
| Fair value gains (losses) (Note 11) | **549,798** | (1,684,003) | **1,284,082** | (9,863,217) |
| **Comprehensive income (loss)** | **$ 3,337,970** | $ 383,625 | **$ 9,061,905** | $ (2,923,676) |
| INCOME (LOSS) PER UNIT (Note 12) | | | | |
| Basic and diluted | **$ 0.10** | $ 0.01 | **$ 0.27** | $ (0.11) |

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 September 30, | | | | Nine months ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | | **2016** | | 2015 | | **2016** | | 2015 |
| **Trust Units** (Note 13) | | | | | | | | |
| BALANCE, BEGINNING OF PERIOD | **$** | **219,198,706** | $ | 197,293,470 | **$** | **218,173,771** | $ | 196,646,106 |
| Issuance of units under DRIP, net of costs | | **511,567** | | 350,679 | | **1,536,502** | | 998,043 |
| BALANCE, END OF PERIOD | | **219,710,273** | | 197,644,149 | | **219,710,273** | | 197,644,149 |
| **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 Loss** | | | | | | | | |
| BALANCE, BEGINNING OF PERIOD | | **(68,358,713)** | | (54,820,505) | | **(69,850,767)** | | (48,174,818) |
| Comprehensive income (loss) | | **3,337,970** | | 383,625 | | **9,061,905** | | (2,923,676) |
| Distributions to unitholders (Note 13) | | **(2,126,305)** | | (1,676,161) | | **(6,358,186)** | | (5,014,547) |
| BALANCE, END OF PERIOD | | **(67,147,048)** | | (56,113,041) | | **(67,147,048)** | | (56,113,041) |
| TOTAL UNITHOLDERS' EQUITY | **$** | **153,128,305** | $ | 142,096,188 | **$** | **153,128,305** | $ | 142,096,188 |
| DISTRIBUTIONS PER UNIT | **$** | **0.06** | $ | 0.06 | **$** | **0.19** | $ | 0.19 |

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 September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| **OPERATING ACTIVITIES** | | | | |
| Comprehensive income (loss) | **$ 3,337,970** | $ 383,625 | **$ 9,061,905** | $ (2,923,676) |
| Adjusted for non-cash items: | | | | |
| Fair value (gains) losses (Note 11) | **(549,798)** | 1,684,003 | **(1,284,082)** | 9,863,217 |
| Straight-line rent | **(79,591)** | (222,034) | **(288,894)** | (498,533) |
| Tenant incentives and direct leasing costs amortization | **202,415** | 198,451 | **608,480** | 583,889 |
| Financing cost amortization and mortgage prepayment costs | **385,700** | 376,538 | **1,135,136** | 1,406,304 |
| Market interest rate adjustment on mortgages | **(213,981)** | (221,463) | **(685,799)** | (669,367) |
| Interest accretion expense | **31,421** | 65,174 | **203,474** | 228,983 |
| Interest expense | **4,157,550** | 4,728,855 | **12,842,259** | 14,150,253 |
| Net change in working capital (Note 14) | **2,289,599** | (1,044,244) | **2,061,753** | (2,379,924) |
| Interest paid | **(5,117,152)** | (6,150,366) | **(13,710,903)** | (15,600,856) |
| Cash flow provided by operating activities | **4,444,133** | (201,461) | **9,943,329** | 4,160,290 |
| **FINANCING ACTIVITIES** | | | | |
| Proceeds from mortgages | **11,850,000** | - | **25,500,000** | 5,600,000 |
| Financing costs on mortgages | **(98,622)** | (54,328) | **(271,878)** | (174,043) |
| Repayments of mortgages at maturity | **(9,111,906)** | - | **(18,936,089)** | (1,458,353) |
| Regular principal repayments on mortgages | **(2,290,325)** | (2,248,422) | **(6,914,768)** | (6,686,310) |
| Cost to issue debentures | **-** | - | **-** | (17,459) |
| Credit facility draws | **-** | 5,000,000 | **5,500,000** | 7,000,000 |
| Credit facility repayments | **(2,000,000)** | - | **(7,500,000)** | - |
| Costs to issue units (Note 13) | **(4,421)** | (3,124) | **(13,678)** | (12,378) |
| Distributions to unitholders | **(1,607,227)** | (1,323,087) | **(4,801,949)** | (4,000,824) |
| Cash flow used by financing activities | **(3,262,501)** | 1,371,039 | **(7,438,362)** | 250,633 |
| **INVESTING ACTIVITIES** | | | | |
| Settlement of purchase liability | **-** | 585,500 | **-** | 585,500 |
| Capital improvements (net of recoveries) | **(1,361,229)** | (755,990) | **(1,435,418)** | (2,486,183) |
| Expenditures on tenant incentives and direct leasing costs | **(171,443)** | (280,677) | **(785,526)** | (1,557,546) |
| Cash flow used by investing activities | **(1,532,672)** | (451,167) | **(2,220,944)** | (3,458,229) |
| NET INCREASE (DECREASE) IN CASH DURING THE PERIOD | **(351,040)** | 718,411 | **284,023** | 952,694 |
| CASH, BEGINNING OF PERIOD | **3,305,084** | 2,386,554 | **2,670,021** | 2,152,271 |
| CASH END OF PERIOD | **$ 2,954,044** | $ 3,104,965 | **$ 2,954,044** | $ 3,104,965 |

The accompanying notes are an integral part of these 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 March 23, 2015. The address of its registered office and principal place of business is 36 Toronto Street, Suite 1160, Toronto, Ontario, M5C 2C5. The principal business activity of Partners REIT is acquiring, developing and operating commercial retail properties. The units of the REIT were originally listed on the Toronto Stock Exchange on 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 in compliance with International Accounting Standard 34, *Interim Financial Statements*. The accompanying condensed consolidated financial statements should be read in conjunction with the notes to the REIT's audited financial statements for the year ended December 31, 2015 which have been prepared in accordance with IFRS, since they do not contain all disclosures required by IFRS for annual financial statements. These condensed consolidated financial statements reflect all normal and recurring adjustments which are in the opinion of management, necessary for a fair presentation of the respective interim periods presented.

These condensed consolidated financial statements were approved and authorized for issue by the Board of Trustees on November 2, 2016.

*(b) Basis of presentation*

The 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.

### 3. INCOME PRODUCING PROPERTIES

| As at | **September 30, 2016** | December 31, 2015 |
|---|---|---|
| Balance, beginning of year | **$ 511,817,617** | $ 531,041,031 |
| Settlement of purchase liability | **-** | (585,500) |
| Capital improvements (net of recoveries) | **1,435,418** | 3,278,141 |
| Expenditures on tenant incentives and direct leasing costs | **785,526** | 1,765,846 |
| Amortization of tenant incentives and direct leasing costs | **(608,480)** | (799,075) |
| Recognition of straight-line rent | **288,894** | 696,302 |
| Unrealized fair value gains (losses) | **1,209,558** | (23,579,128) |
| Balance, end of period | **$ 514,928,533** | $ 511,817,617 |

Income producing properties, which are classified as investment properties under IFRS, are appraised at fair value by management. Management obtains support for the appraised value by obtaining on a sample basis appraisals from 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 September 30, 2016 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.

During the nine months ended September 30, 2016, external appraisals were obtained for nine of the REIT's properties with an aggregate fair value of $112.7 million, representing 21.9% of the fair value of the income producing property portfolio. During the year ended December 31, 2015, external appraisals were obtained for thirteen of the REIT's properties with an aggregate fair value of $237.7 million, representing 46.4% 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 unless there is evidence of a significant change in the fair value of the property. The value of the remainder of the REIT's income producing property portfolio is determined internally by the REIT by applying significant new information obtained to adjust previous externally prepared appraisals.

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 | **September 30, 2016** | December 31, 2015 |
|---|---|---|
| Capitalization rates | | |
| Maximum | **8.50%** | 8.25% |
| Minimum | **5.75%** | 5.75% |
| Weighted Average | **6.66%** | 6.66% |

At September 30, 2016, a 0.25% increase in capitalization rates for income producing properties would decrease fair value by $19.4 million (December 31, 2015 - $19.4 million) and a 0.25% decrease in capitalization rates would increase fair value by $20.9 million (December 31, 2015 - $20.9 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 September 30, 2016, income producing properties included $5.3 million (at December 31, 2015 - $5.0 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*.

## 4. OTHER ASSETS

The major components of other assets are as follows:

| As at | | **September 30, 2016** | | December 31, 2015 |
|---|---|---|---|---|
| Prepaid realty taxes and insurance | **$** | **3,132,216** | $ | 1,333,202 |
| Restricted cash - amounts held in escrow | | **648,500** | | 1,092,034 |
| Prepaid expenses and other | | **691,326** | | 720,929 |
| | **$** | **4,472,042** | $ | 3,146,165 |

Cash is considered restricted when it is held in escrow as required under loan agreements 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 REIT expenses paid in advance and other deferred amounts.

## 5. ACCOUNTS RECEIVABLE

| As at | | **September 30, 2016** | | December 31, 2015 |
|---|---|---|---|---|
| Rents receivable | **$** | **1,374,667** | $ | 1,301,836 |
| Unbilled recoveries | | **279,029** | | 990,179 |
| Other receivables | | **438,857** | | 1,623,569 |
| | | **2,092,553** | | 3,915,584 |
| Allowance for doubtful accounts | | **(584,877)** | | (578,965) |
| | **$** | **1,507,676** | $ | 3,336,619 |

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. See Note 19 for the REIT's exposure to credit risk regarding its receivables, and precautions taken to mitigate these risks.

## 6. MORTGAGES PAYABLE

| As at | | **September 30, 2016** | | December 31, 2015 |
|---|---|---|---|---|
| Mortgage principal | **$** | **304,699,261** | $ | 305,050,117 |
| Unamortized above market interest rate adjustments | | **1,163,746** | | 1,849,545 |
| Unamortized commitment and other fees | | **(1,580,830)** | | (1,950,667) |
| | **$** | **304,282,177** | $ | 304,948,995 |
| Non-current | **$** | **197,295,577** | $ | 234,796,421 |
| Current | | **106,986,600** | | 70,152,574 |
| | **$** | **304,282,177** | $ | 304,948,995 |

Scheduled repayments of mortgage principal are as follows:

| | | Principal instalments | | Principal maturing | | Total |
|---|---|---|---|---|---|---|
| 2016 (remaining 3 months) | $ | 2,299,615 | $ | 26,482,699 | $ | 28,782,314 |
| 2017 | | 7,296,805 | | 118,092,125 | | 125,388,930 |
| 2018 | | 4,609,443 | | 18,439,813 | | 23,049,256 |
| 2019 | | 4,444,181 | | 18,590,780 | | 23,034,961 |
| 2020 | | 3,330,894 | | 28,734,621 | | 32,065,515 |
| Thereafter | | 5,907,854 | | 66,470,431 | | 72,378,285 |
| Contractual obligations | $ | 27,888,792 | $ | 276,810,469 | $ | 304,699,261 |

Mortgages payable are secured by the properties to which they relate with some having recourse to the REIT. The mortgages bear interest at effective rates ranging between 2.43% and 7.08% per annum (December 31, 2015 – 2.43% and 6.86%) and contractual rates ranging between 2.40% and 6.70% (December 31, 2015 – 2.40% and 6.70%). The REIT's weighted average effective interest rate is 4.42% per annum (December 31, 2015 – 4.57%). The total carrying value of the properties pledged as security is $510.1 million (December 31, 2015 - $507.0 million).

As at December 31, 2015 the REIT was in technical violation of annual financial covenants on two mortgages secured by properties in Quebec. These mortgages do not contain cross-default provisions that would trigger the breach of other financial covenants. During the period ended September 30, 2016 the REIT obtained a covenant tolerance waiver letter for both these mortgages.

Interest rate swaps are in place to fix the interest rates for three mortgages payable for a notional amount of $18.1 million between 3.34% and 3.72% until 2020. As at September 30, 2016, the fair value of the interest rate swap is $0.6 million (December 31, 2015 - $0.6 million) and is included in accounts payable and accrued liabilities on the statement of financial position. For the nine months ended September 30, 2016, a fair value gain on the interest rate swaps of less than $0.1 million was recorded on the statements of comprehensive income (nine months ended September 30, 2015 – nil).

In September 2016, the REIT completed an $11.9 million financing secured on a multi-tenant property in British Columbia. The mortgage has a term of five years with an interest rate of 2.85% per annum and an amortization period of 25 year. This financing replaced a maturing mortgage with a principal balance of $9.1 million and a contractual interest rate of 3.80%.

In June 2016, the REIT completed a $13.7 million financing secured on a multi-tenant property in Ontario. The mortgage has a term of five years with an interest rate of 2.94% per annum and an amortization period of 25 years. This financing replaced two maturing mortgages with a combined principal balance of $9.8 million and a weighted average contractual interest rate of 5.71% per annum.

## 7. CONVERTIBLE DEBENTURES

| As at | | **September 30, 2016** | | December 31, 2015 |
|---|---|---|---|---|
| 6.0% convertible debentures | | **34,403,477** | | 34,331,084 |
| 5.5% convertible debentures | | **22,956,257** | | 22,934,387 |
| Debentures, excluding convertible feature | | **57,359,734** | | 57,265,471 |
| Fair value of convertible features at issuance | | **660,000** | | 660,000 |
| Accumulated fair value gain on convertible feature | | **(660,000)** | | (660,000) |
| Convertible feature | | **-** | | - |
| Issue costs | | **(2,886,983)** | | (2,886,983) |
| Accumulated amortization of issue costs | | **2,105,675** | | 1,635,693 |
| Issue costs, net | | **(781,308)** | | (1,251,290) |
| | **$** | **56,578,426** | $ | 56,014,181 |
| Non-current | **$** | **22,557,082** | $ | 56,014,181 |
| Current | | **34,021,344** | | - |
| | **$** | **56,578,426** | $ | 56,014,181 |

In September, 2012, the REIT issued $34,500,000 of 6.0% convertible unsecured subordinated debentures (the Series II Debentures") due September 30, 2017. The Series II 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 Series II 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 Series II Debentures may be redeemed by the REIT at any time. The fair value of the convertible feature of the Series II Debentures as at September 30, 2016 is nil (December 31, 2015 - nil).

In March, 2013, the REIT issued $23,000,000 of 5.5% convertible unsecured subordinated debentures (the "Series III Debentures") due March 31, 2018. The Series III 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 Series III 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 Series III Debentures may be redeemed by the REIT at any time. The fair value of the convertible feature of the Series III Debentures as at September 30, 2016 is nil (December 31, 2015 - nil).

## 8. CREDIT FACILITIES

As at September 30, 2016, the REIT's credit facility (the "Credit Facility") had been fully repaid (December 31, 2015 - $2.0 million outstanding).

The Credit Facility has a credit limit of $10.0 million, with interest at the greater of 5.0% or prime plus 2.0% per annum. The Credit Facility bears a standby fee of 0.25% of the undrawn balance, annually in arrears. The Credit Facility matures December 1, 2016.

Subsequent to September 30, 2016 the REIT renewed its Credit Facility for 18 months, now maturing June 1, 2018.

## 9. REVENUES FROM INCOME PRODUCING PROPERTIES

Revenues recognized from income producing properties for the three and nine months ended September 30, 2016 were $14.0 million and $42.3 million, respectively (three and nine months ended September 30, 2015 - $14.3 million and $42.7 million, respectively). The REIT leases commercial retail properties under operating leases generally with lease terms of between one and fifteen years, and in many cases with options to extend for successive five year periods. Included in revenues from income producing properties are recoveries from tenants for the three and nine months ended September 30, 2016 of $4.8 million and $14.7 million, respectively (three and nine months ended September 30, 2015 - $4.7 million and $14.2 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 which for the three and nine months ended September 30, 2016 totaled $0.2 million and $0.6 million, respectively (three and nine months ended September 30, 2015 - $0.2 million and $0.6 million, respectively).

As at September 30, 2016, 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 | $ 36,449,932 | $ 105,788,325 | $ 62,554,214 |

## 10. OTHER TRANSACTION COSTS

The components of other transaction costs are as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| Litigation | **$ 201,198** | $ 149,350 | **$ 230,731** | $ 206,672 |
| Board transition and other | **-** | - | **-** | 4,059 |
| Abandoned acquisition costs (recoveries) | **(13,460)** | 38,750 | **(13,460)** | 179,455 |
| Strategic-review | **-** | (10,000) | **-** | 128,831 |
| Total other transaction costs | **$ 187,738** | $ 178,100 | **$ 217,271** | $ 519,017 |

## 11. FAIR VALUE GAINS (LOSSES)

The components of fair value gains/(losses) are as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| Unrealized gain (loss) on income producing properties | **$ 486,658** | $ (1,684,003) | **$ 1,209,558** | $ (9,863,217) |
| Financial liabilities designated as FVTPL: | | | | |
| Interest rate swaps | **63,140** | - | **74,524** | - |
| Total fair value gains (losses) | **$ 549,798** | $ (1,684,003) | **$ 1,284,082** | $ (9,863,217) |

## 12. INCOME (LOSS) PER UNIT

The table below presents the net income (loss) 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 September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| **Numerator** | | | | |
| Comprehensive income (loss) - basic and diluted | **$ 3,337,970** | $ 383,625 | **$ 9,061,905** | $ (2,923,676) |
| **Denominator** | | | | |
| Weighted average units outstanding - basic and diluted | **33,761,829** | 26,582,481 | **33,617,574** | 26,491,139 |
| Income (loss) per unit - basic and diluted | **$ 0.10** | $ 0.01 | **$ 0.27** | $ (0.11) |

## 13. UNITHOLDERS' EQUITY

*(a) Distributions*

For the nine months ended September 30, 2016 the REIT made monthly cash distributions to unitholders in an amount of $0.02083 per unit, representing an annualized distribution of $0.25 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. As at September 30, 2016, distributions accrued but not yet paid totaled $0.7 million (December 31, 2015 - $0.7 million).

*(b) Distribution reinvestment plan*

The REIT has a Distribution Reinvestment Plan ("DRIP") to enable Canadian resident unitholders to acquire additional units of the REIT through the reinvestment of regular monthly distributions on all or any part of their units.

The REIT has an Optional Unit Purchase Plan ("OUPP") to enable Canadian resident unitholders to acquire additional units of the REIT 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 DRIP and OUPP 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 3% (5% for distributions prior to the March 2016 DRIP payable in April 2016) of each cash distribution.

At September 30, 2016, the REIT had 1,249,543 units remaining in its reserve for issuance of units under the DRIP and OUPP.

*(c) Rights Offering*

During August, 2015, the REIT announced its intention to raise gross proceeds of $20.6 million by issuing rights entitling unitholders to subscribe for one additional REIT unit for each four REIT units held as of the record date of September 14, 2015 and with payment of a subscription price of $3.10 per REIT unit. The Rights Offering closed on October 22, 2015 and the maximum amount available of $20.6 million, excluding issuance costs of $0.4 million, was raised and the REIT issued 6,649,364 units.

*(d) Outstanding Units*

| As at | **September 30, 2016** | | | December 31, 2015 | | |
|---|---|---|---|---|---|---|
| | **Units** | | **Dollars** | Units | | Dollars |
| Units outstanding, beginning of period | **33,387,646** | **$** | **218,173,771** | 26,356,069 | $ | 196,646,106 |
| Units issued: | | | | | | |
| Distribution reinvestment plan | **444,260** | | **1,550,181** | 382,213 | | 1,344,938 |
| Rights offering | **-** | | **-** | 6,649,364 | | 20,613,028 |
| Unit issue costs | **-** | | **(13,679)** | - | | (430,301) |
| | **33,831,906** | **$** | **219,710,273** | 33,387,646 | $ | 218,173,771 |

## 14. 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 September 30,** | | | | **Nine months ended September 30,** | | | |
|---|---|---|---|---|---|---|---|---|
| | | **2016** | | 2015 | | **2016** | | 2015 |
| **Net change in working capital** | | | | | | | | |
| Net change in accounts receivable | **$** | **1,080,097** | $ | 1,042,775 | **$** | **1,719,732** | $ | 1,105,649 |
| Net change in other assets | | **872,488** | | (234,663) | | **(1,325,877)** | | (1,631,590) |
| Net change in accounts payable and other liabilities | | **337,014** | | (1,852,356) | | **1,667,898** | | (1,853,983) |
| | **$** | **2,289,599** | $ | (1,044,244) | **$** | **2,061,753** | $ | (2,379,924) |

## 15. 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).

As at September 30, 2016 there are no options outstanding under the incentive unit option plan.

(b) *Deferred unit plan ("DUP")*

Under the DUP, Trustees have the option to have their fees ("Trustees Fees") and Officers have the option to have annual bonus payments ("Officer Bonus") paid in deferred units of the REIT. The number of units will be equivalent to the cash value of the Trustees Fees or Officer Bonus elected by the Trustee or Officer, as applicable to be paid in units. The maximum number of units reserved for issuance under the DUP is 1% of the issued and outstanding units and the maximum number of units reserved under the DUP 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 DUP is volume-weighted average price of the units for the last 20 trading days preceding the date of issuance to the Trustees.

The DUP became effective May 17, 2015 and was amended and restated effective November 1, 2016. As at September 30, 2016, no units have been issued under the DUP.

## 16. INCOME TAXES

All of the REIT's 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.

Partners REIT qualifies as a REIT for income tax purposes. The REIT intends to distribute all of its taxable income to unitholders and is entitled to deduct such distributions for income tax purposes. Accordingly, a provision for current income taxes payable is not required.

## 17. 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.

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

At September 30, 2016, the REIT's debt-to-gross book value ratio is 68.8% (December 31, 2015 – 69.5%), which is calculated as follows:

| As at | **September 30, 2016** | December 31, 2015 |
|---|---|---|
| **Debt[(1)]** | | |
| Mortgage principal | **$ 304,699,261** | $ 305,050,117 |
| Debenture principal | **57,500,000** | 57,500,000 |
| Credit facility principal | **-** | 2,000,000 |
| | **$ 362,199,261** | $ 364,550,117 |
| **Gross Book Value of Assets** | | |
| Book value of income producing properties | **$ 514,928,533** | $ 511,817,617 |
| Book value of all other assets | **8,933,762** | 9,152,805 |
| Unamortized deferred financing fees | **2,362,138** | 3,225,396 |
| | **$ 526,224,433** | $ 524,195,818 |
| **Debt-to-Gross Book Value** | **68.8%** | 69.5% |
| **Debt-to-Gross Book Value Excluding Debentures** | **57.9%** | 58.6% |

*(1) Debt capital refers to the principal portion of mortgages, debenture and the credit facility. This excludes deferred financing costs, the value of the debentures' convertible feature, and unamortized above market interest rate adjustments.*

## 18. FAIR VALUE OF FINANCIAL INSTRUMENTS

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 3.

*(b)* *Current assets and liabilities*

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

*(c)* *Mortgages payable*

The fair value of secured debt is based on discounted future cash flows, using interest rates ranging between 2.71% and 3.20% that reflect current market conditions for instruments of similar term and risk.

*(d)* Interest rate swaps

The fair value of the interest rate swap contracts is calculated through discounting future expected cash flows using the appropriate BA rate swap curve adjusted for credit risk. Since the BA rate swap curve is an observable input, these financial instruments are considered Level 2.

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:

| | **September 30, 2016** | | | December 31, 2015 | | |
|---|---|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | Level 1 | Level 2 | Level 3 |
| Assets measured at fair value: | | | | | | |
| Income producing properties | **$ -** | **$ -** | **$ 514,928,533** | $ - | $ - | $ 511,817,617 |
| Liabilities for which fair values are disclosed: | | | | | | |
| Mortgages payable | **$ -** | **$ -** | **$ 312,515,294** | $ - | $ - | $ 316,054,967 |
| Interest rate swaps | **$ -** | **$ 558,110** | **$ -** | $ - | $ 632,634 | $ - |

The fair value of assets and liabilities is performed on a quarterly basis using the valuation approaches noted above. During the nine months ended September 30, 2016 there were no transfers between the hierarchy levels.

## 19. 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 mortgages with floating interest rates. An increase in interest rates would increase the interest cost of these mortgages having an adverse effect on the REIT's comprehensive income and earnings per unit. Based on the outstanding $39.3 million balance of variable rate debt at September 30, 2016, a 1% increase or decrease in the prime rate would have an impact of $0.4 million on the REIT's annual interest expense (December 31, 2015 – $0.4 million).

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 September 30, 2016 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.

The following table presents an analysis of the age of tenant and other accounts receivable inclusive of amounts for which an allowance has been made.

| As at | **September 30, 2016** | December 31, 2015 |
|---|---|---|
| **Tenant rents receivable** | | |
| Less than 30 days past billing date | **447,146** | 349,056 |
| 30-60 days past billing date | **108,763** | 36,428 |
| 61-90 days past billing date | **315,348** | 53,443 |
| Greater than 90 days past billing date | **503,410** | 862,909 |
| | **1,374,667** | 1,301,836 |
| Allowance for doubtful accounts - tenant | **(459,877)** | (453,965) |
| Other receivables | **438,857** | 1,623,569 |
| Allowance for doubtful accounts - other | **(125,000)** | (125,000) |
| Unbilled recoveries | **279,029** | 990,179 |
| | **1,507,676** | 3,336,619 |

The following table presents a summary of the activity related to the REIT's allowance for doubtful accounts.

| | | **September 30, 2016** | | December 31, 2015 |
|---|---|---|---|---|
| Opening allowance for doubtful accounts | **$** | **578,965** | $ | 797,068 |
| Change to allowance for doubtful accounts | | **33,787** | | (146,513) |
| Receivables written-off | | **(27,875)** | | (71,590) |
| Ending allowance for doubtful accounts | **$** | **584,877** | $ | 578,965 |

Refer to Note 5 for further details of accounts receivable.

*(c) Liquidity risk*

The REIT's main liquidity requirements arise from ongoing working capital requirements, debt servicing and repayment obligations, capital and leasing expenditures and distributions to unitholders. All of the aforementioned liquidity requirements, except for debt repayment obligations are generally funded from cash flows from operations or from drawing on the $10.0 million Credit Facility ($nil drawn at September 30, 2016). Property debt repayment obligations are generally funded from obtaining debt refinancing on maturing mortgages. Convertible debenture obligations that are not converted to equity can be repaid at maturity from either a new convertible debenture issue, mortgage financings on existing properties or property dispositions and/or from an equity raise.

Within the next 12 months the REIT has $9.5 million in regularly scheduled principal repayments and $98.8 million in maturing mortgages on ten properties for a total mortgage commitment of $108.3 million. The REIT also has $34.5 million in maturing convertible debentures, as disclosed further below. 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 on-going operating cash flows.

The REIT attempts to mitigate its liquidity risk by:

- staggering the maturities of its maturing mortgages;
- 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;
- planning capital spending around the availability of cash from operations or debt/equity funding; and
- reviewing the current liquidity position and forecasted cash flows in advance of the quarterly approval of monthly distributions.

Except for the periodic impact to cash for the $1.7 million in bi-annual interest payments on the two series of debentures (interest payments are due March 31st and September 30th) most operating revenues and expenses are consistent on a month to month basis thereby assisting managements' forecasting of cash flows and liquidity.

As at September 30, 2016, the REIT had $3.0 million in cash and $10.0 million of capacity available under its Credit Facility, thereby providing $13.0 million in liquidity. Despite this liquidity, management will need to complete re-financings of maturing mortgages and continue to reduce other transaction costs or the REIT may be required to obtain further financing(s) or sell property(s).

In addition to re-financing maturing mortgages, the REIT will need to raise funds from a debt / equity issue(s) or net cash from property disposition(s), or a combination thereof, so that there is sufficient cash to repay two series of convertible debentures. There is currently a significant spread between the REIT's unit price and the conversion price for the two series of convertible debentures, and this reduces the likelihood that the debentures will be converted to equity in advance of their maturity. The convertible debentures are set to mature on September 30, 2017 ($34.5 million) and March 31, 2018 ($23.0 million). Obtaining replacement capital through new debt financing, new equity raises, the sale of property(s), or any combination of these options will be essential to ensuring the REIT's continued financial flexibility.

The following table shows the contractual cash flows on all of the REIT's non-derivative financial liabilities:

| | 2016 | 2017 | 2018 | 2019 | 2020 | Thereafter |
|---|---|---|---|---|---|---|
| Mortgages payable | | | | | | |
| Interest | 3,245,498 | 8,943,776 | 4,993,466 | 4,478,662 | 3,338,562 | 5,373,619 |
| Principal payments | 2,299,615 | 7,296,805 | 4,609,443 | 4,444,181 | 3,330,894 | 5,907,854 |
| Balances due on maturity | 26,482,699 | 118,092,125 | 18,439,813 | 18,590,780 | 28,734,621 | 66,470,431 |
| Debentures | | | | | | |
| Interest | - | 3,335,000 | 632,500 | - | - | - |
| Balances due on maturity | - | 34,500,000 | 23,000,000 | - | - | - |
| Credit Facility | | | | | | |
| Interest | - | - | - | - | - | - |
| Balances due on maturity | - | - | - | - | - | - |
| Accounts and distributions payable and other liabilities | 9,315,277 | - | - | - | - | - |
| Total | $ 41,343,089 | $ 172,167,706 | $ 51,675,222 | $ 27,513,623 | $ 35,404,077 | $ 77,751,904 |

*(d) Concentration risk*

The REIT has one major tenant with 16 locations in the REIT's portfolio providing $6.1 million in annualized base rents, or 16.3% of the REIT's total annualized base rental revenue.

## 20. CONTINGENCIES AND COMMITMENTS

*(a) Contingent liability*

As a condition of closing the Holyrood Rescission in October 2014, the REIT provided a $35.0 million loan guarantee to the lender of a loan to Holyrood Holdings Ltd. The loan was scheduled to mature June 30, 2015. The REIT has been advised that the loan was not repaid at maturity and that Holyrood is in the process of refinancing the loan with another lender. In the interim the loan has been extended on a short-term basis and we have made inquiries and have no reason to believe that all interest payments are not up-to-date. The REIT has taken the position with the lender that its guarantee has expired, but the lender disputes that. Should the lender make a demand on the REIT as a guarantor, the REIT may deny that it has any continuing liability under the guarantee or may at its sole discretion purchase the lender's interest in the loan thus granting the REIT a first charge over Hamilton City Centre. The REIT currently has a registered second mortgage on the property. The REIT has no ongoing interest in the Hamilton City Centre and does not intend to guarantee any debt in connection with Holyrood's refinancing of the property.

*(b) Lease commitments – The REIT as lessee*

The REIT as lessee is committed under operating leases to renewal periods or notice periods ranging from one month to five years for its three office locations in Barrie, Ontario, Toronto, Ontario and Victoria, British Columbia. In aggregate the leases represent a future commitment to the REIT of approximately $0.7 million.

*(c) Uncertified class action lawsuit*

The REIT has been notified that a Statement of Claim dated November 28, 2014 has been issued in the Ontario Superior Court seeking certification of a class action on behalf of persons who held units of the REIT on April 1, 2014 against certain parties, including a former Officer and former Trustees of the REIT. The REIT itself has not been named as a defendant in the legal proceedings which allege that the conduct of the defendants in connection with the acquisition by the REIT of three properties from Holyrood in April 2014 caused harm to the plaintiffs. The Holyrood transaction was rescinded by the REIT and Holyrood in October 2014. The REIT has certain indemnity obligations to its former Officer and former Trustees with respect to this claim, subject to exceptions including where it is determined that there has been a failure to act honestly and in good faith. The REIT has insurance which it expects to be applicable in these circumstances. Given that the REIT has not been named in the litigation, the REIT does not believe it will be material to its business and affairs.

## 21. 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.