

INOVALIS REAL ESTATE INVESTMENT TRUST 2018 Second Quarter Report

**INOVALIS REAL ESTATE INVESTMENT TRUST
CONDENSED INTERIM CONSOLIDATED FINANCIAL
STATEMENTS (unaudited)**

Three-month and six-month periods ended June 30, 2018

INOVALIS REIT

Interim Consolidated Balance Sheets

(Unaudited - All dollar amounts in thousands of Canadian dollars)

Assets	Note	As at June 30, 2018	As at December 31, 2017
Non-current assets			
Investment properties	4	451,367	440,813
Investments accounted for using the equity method	5	92,337	79,094
Acquisition loan and deposit	6	26,348	27,035
Derivative financial instruments	7	440	59
Restricted cash		1,535	1,509
Total non-current assets		572,027	548,510
Current assets			
Trade and other receivables		6,273	5,192
Other current assets		1,769	1,395
Other financial current assets		-	1,267
Cash		26,995	20,345
Total current assets		35,037	28,199
Total assets		607,064	576,709
Liabilities and Unitholders' equity			
Liabilities			
Non-current liabilities			
Mortgage loans		102,269	113,342
Finance lease liabilities		121,635	122,735
Lease equalization loans		2,678	3,196
Tenant deposits		2,357	2,292
Derivative financial instruments	7	1,313	650
Deferred tax liabilities	8	8,393	3,059
Exchangeable securities	9	5,108	6,907
Deferred income		-	3,260
Total non-current liabilities		243,753	255,441
Current liabilities			
Promissory Notes	10	45,415	23,789
Mortgage loans		15,098	2,660
Finance lease liabilities		6,314	6,014
Lease equalization loans		1,249	1,247
Tenant deposits		247	162
Derivative financial instruments	7	1,750	1,316
Exchangeable securities	9	9,196	9,836
Trade and other payables		9,628	6,341
Other current liabilities		420	431
Deferred income		4,685	4,195
Total current liabilities		94,002	55,991
Total liabilities		337,755	311,432
Equity			
Trust units		200,840	195,739
Retained earnings		38,431	44,749
Accumulated other comprehensive income	14	29,672	24,436
Total Unitholders' equity		268,943	264,924
Non-controlling interest		366	353
Total equity		269,309	265,277
Total liabilities and equity		607,064	576,709

See accompanying notes to condensed interim consolidated financial statements

On behalf of the Board of Trustees of Inovalis Real Estate Investment Trust:

Daniel Argiros

Chairman and Trustee

INOVALIS REIT

Interim Consolidated Statements of Earnings

(Unaudited - All dollar amounts in thousands of Canadian dollars except per unit amount)

(in thousands of Canadian dollars, except per unit amounts)

	Note	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Rental income		6,539	6,271	13,253	12,242
Service charge income		1,957	1,358	4,103	3,208
Service charge expenses		(1,721)	(1,165)	(6,893)	(5,782)
Other revenues		180	219	424	303
Other property operating expenses		(73)	(73)	(163)	(114)
Net rental earnings		6,882	6,610	10,724	9,857
Administration expenses		(1,510)	(1,326)	(3,027)	(2,572)
Foreign exchange gain		27	(62)	83	(62)
Net change in fair value of investment properties	4	(587)	(2,181)	1,338	108
Acquisition costs		-	-	(20)	(37)
Share of net earnings from investments accounted for using the equity method	5	739	1,114	1,574	391
Operating earnings		5,551	4,155	10,672	7,685
Loss on financial instruments at fair value through profit or loss		(179)	(2,352)	(1,162)	(1,781)
Finance income	11	2,305	1,524	5,668	3,308
Finance costs	11	27	(1,404)	(5,222)	(3,057)
Distributions on Exchangeable securities	9	(286)	(398)	(554)	(777)
Net change in fair value of Exchangeable securities	9	(48)	(1,034)	66	(1,698)
Net change in fair value of Promissory Notes		(2,202)	-	(1,074)	-
Earnings before income taxes		5,168	491	8,394	3,680
Current income tax expense (income)		105	(87)	(14)	(97)
Deferred income tax expense	8	(242)	(190)	(5,320)	(224)
Earnings for the period		5,031	214	3,060	3,359
Earnings (Loss) for the period attributable to :					
Non-controlling interest		(1)	55	1	59
Unitholders' of the Trust		5,032	159	3,059	3,300
		5,031	214	3,060	3,359
Earnings per unit attributable to unit holders:	12				
Basic and diluted earnings per unit		0.18	0.01	0.11	0.15

See accompanying notes to condensed interim consolidated financial statements

INOVALIS REIT
Interim Consolidated Statements of Comprehensive Income
(Unaudited - All dollar amounts in thousands of Canadian dollars)

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Earnings for the period	5,031	214	3,060	3,359
Other comprehensive income				
Items that may be reclassified subsequently to net earnings (loss), net of tax :				
Derivatives designated as a hedge of the net investment in a foreign entity				
Net gains	1,000	1,431	42	1,290
Derivatives designated as cash flow hedges	171	233	348	472
Items that are not to be reclassified subsequently to net earnings (loss), net of tax :				
Change in cumulative translation adjustment	(10,030)	10,059	4,858	11,572
Total other comprehensive income	(8,859)	11,723	5,248	13,335
Total comprehensive income for the period	(3,828)	11,937	8,308	16,715
Total comprehensive income for the period attributable to :				
Non-controlling interest	(25)	74	13	81
Unitholders of the Trust	(3,803)	11,863	8,295	16,634
Total comprehensive income (loss) for the period	(3,828)	11,937	8,308	16,715

See accompanying notes to condensed interim consolidated financial statements

Interim Consolidated Statements of changes in Unitholders' Equity
(Unaudited - All dollar amounts in thousands of Canadian dollars except number of Units)

	Note	Number of Units issued and outstanding	Trust Units	Retained earnings	Accumulated other comprehensive income	Total attributable to the Unitholders' of the Trust	Non-controlling interest	Total equity
As at December 31, 2017		22,235,421	195,739	44,749	24,436	264,924	353	265,277
Issuance of units	9	419,059	3,939	-	-	3,939	-	3,939
Distributions earned by Unitholders	13	-	-	(9,377)	-	(9,377)	-	(9,377)
Distributions reinvestment Plan	13	120,405	1,162	-	-	1,162	-	1,162
Transactions with owners		539,464	5,101	(9,377)	-	(4,276)	-	(4,276)
Earnings (Loss) for the period		-	-	3,059	-	3,059	1	3,060
Other comprehensive income		-	-	-	5,236	5,236	12	5,248
As at June 30, 2018		22,774,885	200,840	38,431	29,672	268,943	366	269,309
As at December 31, 2016		21,525,775	189,158	43,455	8,395	241,008	121	241,129
Distributions earned by Unitholders	13	-	-	(8,898)	-	(8,898)	-	(8,898)
Distributions reinvestment Plan	13	78,939	711	-	-	711	-	711
Transactions with owners		78,939	711	(8,898)	-	8,187	-	(8,187)
Earnings for the period		-	-	3,300	-	3,300	59	3,359
Other comprehensive income		-	-	-	13,334	13,334	22	13,356
As at June 30, 2017		21,604,714	189,869	37,857	21,729	249,455	202	249,657

See accompanying notes to condensed interim consolidated financial statements

INOVALIS REIT

Interim Consolidated Statements of Cash Flows

(Unaudited - All dollar amounts in thousands of Canadian dollars)

	Not e	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Operating activities					
Earnings before income taxes for the period		5,168	491	8,394	3,680
Adjustments for non-cash items and other reconciling items	17	2,733	5,746	2,491	5,342
		<u>7,901</u>	<u>6,237</u>	<u>10,885</u>	<u>9,022</u>
Working capital adjustments	17	(10,142)	46	(948)	7,065
Net cash flows related to operating activities		<u>(2,241)</u>	<u>6,283</u>	<u>9,937</u>	<u>16,087</u>
Investing activities					
Acquisition costs		-	-	(20)	(37)
Investment properties (additions and capitalized letting fees)	4	(1,346)	(728)	(2,321)	(884)
Investments in joint ventures	5	(1,529)	(12,782)	(11,272)	(12,782)
Distribution from joint ventures	5	-	11	-	629
Loan repayments received from joint ventures	5	413	-	875	-
Investment in acquisition loans and deposit	6	-	(7,906)	-	(18,232)
Reimbursement of acquisition deposit	6	1,159	-	1,159	-
Decrease in financial current assets		-	6,874	1,159	27,366
Net cash flows related to investing activities		<u>(1,303)</u>	<u>(14,531)</u>	<u>(10,420)</u>	<u>(3,940)</u>
Financing activities					
Distributions on Units paid in cash	13	(4,245)	(4,068)	(8,178)	(8,161)
Distributions in respect of exchangeable securities paid in cash	9	(380)	(233)	(634)	(1,270)
Proceeds from promissory notes net of transaction costs	10	20,106	13,717	20,106	13,717
Repayment of mortgage loans and finance lease liabilities		(1,696)	(2,013)	(3,903)	(3,935)
Repayment of lease equalization loans		(299)	(190)	(597)	(426)
Net cash flows related to financing activities		<u>13,487</u>	<u>7,213</u>	<u>6,795</u>	<u>(75)</u>
Net increase (decrease) in cash		9,943	(1,035)	6,312	12,071
Effects of foreign exchange adjustments on cash		88	46	338	374
Cash at the beginning of the period		16,964	24,508	20,345	11,074
Cash at the end of the period		<u>26,995</u>	<u>23,519</u>	<u>26,995</u>	<u>23,519</u>

See accompanying notes to condensed interim consolidated financial statements

INOVALIS REIT

Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

Note 1 – Organization

Inovalis Real Estate Investment Trust (the “Trust”) is an open-ended real estate investment trust created pursuant to a Declaration of Trust dated February 8, 2013, under the laws of the Province of Ontario, Canada. These condensed interim consolidated financial statements include the accounts of the Trust and its subsidiaries (together the “REIT”). The REIT’s investment property portfolio, owned directly or through joint arrangements, is comprised of office rental properties located in France and Germany.

The REIT’s head and registered office is located at 151 Yonge Street, 11th floor, Toronto, Ontario, M5C 2W7. The REIT’s units are listed on the Toronto Stock Exchange (“TSX”) under the symbol INO.UN.

The REIT’s condensed interim consolidated financial statements for the six-month period ended June 30, 2018, were authorized for issuance by the Board of Trustees on August 8, 2018.

The REIT has hired Inovalis S.A. (“Inovalis”), a real estate asset manager having operations in France and Germany, to manage certain functions. Refer to Note 6 – Acquisition loans and deposit, and Note 9 – exchangeable securities, for more information about the relationship between Inovalis and the REIT, and to Note 15 – Transactions with related parties, for information regarding the services provided by Inovalis to the REIT.

Inovalis is considered as a related party of the REIT as they share the same management (President of the REIT, CIO and CEO).

Note 2 – Basis of preparation of condensed interim consolidated financial statements

Statement of compliance

These unaudited condensed interim consolidated financial statements have been prepared in accordance with International Accounting Standard (“IAS”) 34, *Interim Financial Reporting*. They are condensed and do not include all disclosures that would otherwise be required in a complete set of financial statements and should be read in conjunction with the 2017 audited consolidated annual financial statements.

Basis of presentation

The unaudited condensed interim consolidated financial statements are prepared on a going concern basis. All financial information has been rounded to the nearest thousand (CAD\$ 000 or EUR€ 000) except when otherwise indicated.

These unaudited condensed interim consolidated financial statements have been prepared on the historical cost basis except for Investment properties, Exchangeable securities, Promissory Notes and Derivative financial instruments, which are measured at their fair values.

The figures presented for the period ended June 30, 2017 have been reclassified, when appropriate, in order to ensure comparability with the figures for the period ending June 30, 2018.

Note 3 – Significant accounting policies

The condensed interim consolidated financial statements have been prepared in accordance with the accounting policies adopted in the REIT’s most recent annual financial statements for the year ended December 31, 2017, except for the fact that interest receivables from joint ventures are reclassified from “Other current assets” to “Trade and other receivables” for an amount of \$ 626 as at December 31, 2017, and because of adoption of IFRS 9 Financial Instruments

Changes in accounting policies

The REIT has initially adopted IFRS 9 Financial Instruments from January 1, 2018. A number of other standards are effective from January 1, 2018 but they do not have a material effect on the REIT’s consolidated financial statements.

IFRS 9 – Financial Instruments

IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement for annual periods beginning on or after January 1, 2018, covering all three aspects of the accounting for financial assets and liabilities: classification and measurement, impairment and hedge accounting.

With the exception of hedge accounting, which the REIT applied prospectively, the REIT has applied IFRS 9 retrospectively, with the date of initial application of January 1, 2018 and without restating comparative periods with respect to classification and measurement (including impairment) requirements. Management performed an analysis of the carrying values of assets and liabilities held at January 1, 2018 to determine whether any impairments were necessary following the adoption of IFRS 9. Based on the results of this analysis, no impairments to the carrying values of assets and liabilities held at January 1, 2018 have been deemed necessary.

INOVALIS REIT

Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

(a) Classification and measurement

Similar to IAS 39, financial assets are classified under different categories, of which some are measured at amortized cost and others at fair value (recognized either in earnings or in other comprehensive income).

IFRS 9 is systematizing the use of the fair value for the measurement of financial assets. Indeed, under IFRS 9 financial assets can be measured at amortized cost only when both of the following criteria are met:

- The asset is held to collect its contractual cash flows; and
- The asset's contractual cash flows represent "solely payments of principal and interest" (SPPI criterion).

The assessment of the REIT's business models was made as of the date of initial application, January 1, 2018, and then applied retrospectively to those financial assets that were not derecognized before January 1, 2018. The assessment of whether contractual cash flows on financial assets are solely comprised of principal and interest was made based on the facts and circumstances as at the initial recognition of the assets.

The new classification and measurement of the REIT's financial assets are as follows:

Financial assets at amortized cost comprise the REIT's Loans to joint ventures, Deposit, Trade and other receivables, Other financial current assets, Restricted cash and Cash. The new classification had no impact on the consolidated financial statements.

Financial assets at fair value through profit or loss (FVTPL) comprise Derivative financial instruments that are not designated as hedging instruments in hedge relationships, at initial recognition or transition. This category also includes the Acquisition loan whose cash flow characteristics fail the SPPI criterion. Under IAS 39, the Acquisition loan was classified as loans and receivables. Upon transition to IFRS 9, the change in classification of the Acquisition loan did not impact the consolidated financial statements as the carrying amount was approximately equal to its fair value as at January 1, 2018.

IFRS 9 essentially corresponds to IAS 39 in terms of financial liabilities. However, for liabilities designated at FVTPL, the portion of the change in fair value that is attributable to the credit risk of the liabilities recognized under other comprehensive income instead of earnings, provided that this does not cause inconsistencies in reporting. This guidance applies to the Promissory notes and Exchangeable securities. Transition to IFRS 9 did not affect other comprehensive income, because the fair value of these liabilities is based exclusively on the fair value of the REIT's units and the credit risk of these liabilities is not significant as the REIT can settle the liabilities through the issuance of units.

(b) Impairment of financial assets at amortized cost

IFRS 9 also introduces changes for the impairment of financial assets as it establishes a new model for loans and receivables. The purpose of the new model includes the reporting of credit losses at an earlier stage than under IAS 39. Under the "expected credit loss" (ECL) model, an entity calculates the allowance for credit losses by considering on a discounted basis the cash shortfalls it would incur in various default scenarios for prescribed future periods and multiplying the shortfalls by the probability of each scenario occurring. The loss allowance is the sum of these probability-weighted outcomes. Because every debt instrument carries with it some risk of default, every such asset has an expected loss attached to it – from the moment of its origination or acquisition. In all cases, the loss allowance and any changes to it are recognized by recognizing impairment gains and losses in earnings. IFRS 9 establishes three separate approaches for measuring and recognizing expected credit losses, depending on the nature of the financial assets.

For Trade and other receivables, Other financial current assets, Restricted cash and Cash, the REIT has applied IFRS 9's simplified approach and has calculated ECLs based on lifetime expected credit losses.

For the Loans to joint ventures and Deposit, the ECL is based on the general approach. Under the general approach, the REIT determined the 12-month ECL that is the portion of lifetime ECLs that results from default events on a financial instrument that are possible within 12 months after the reporting date. However, when there has been a significant increase in credit risk since initial recognition, the allowance will be based on the lifetime ECL. In all cases, the REIT considers that there has been a significant increase in credit risk when contractual payments are more than 30 days past due.

The REIT considers a financial asset in default when contractual payment are 90 days past due. However, in certain cases, the REIT may also consider a financial asset to be in default when internal or external information indicates that the REIT is unlikely to receive the outstanding contractual amounts in full before taking into account any credit enhancements held by the REIT.

(c) Hedge accounting

The REIT has elected to adopt the new general hedge accounting model in IFRS 9. This requires the REIT to ensure that hedge accounting relationships are aligned with its risk management objective and strategy and to apply a more qualitative and forward-looking approach to assessing hedge effectiveness.

INOVALIS REIT

Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

The REIT applied hedge accounting prospectively. At the date of the initial application, the REIT's existing hedging relationship was eligible to be treated as continuing hedging relationship under IFRS 9.

Consistent with prior periods, the REIT uses foreign exchange contracts to hedge a portion of its net investment in its foreign operations. The REIT designates only the change in fair value of the spot element of the foreign exchange contracts as the hedging instrument in its net investment hedging relationships. The effective portion of changes in fair value of the hedging instruments is recognized in other comprehensive income.

Under IAS 39, the change in fair value of the forward element of the foreign exchange contracts ("forward points") was recognized immediately in profit or loss. Under IFRS 9, the REIT continues to recognize immediately in profit or loss the forward points. Accordingly, the adoption of the hedge accounting requirements of IFRS 9 had no significant impact on the REIT's consolidated financial statements.

In 2017, the REIT discontinued the application of hedge accounting to its interest rate swap and cap relationships. Accordingly, the REIT began in 2017 the reclassification of a portion of the cumulative gain or loss on the interest rate swaps or caps that were initially recognized in other comprehensive income through profit or loss. Since these hedging relationships were discontinued prior to the adoption of IFRS 9 and the accounting for the discontinuance of a cash flow hedging relationship in the same under IFRS 9, the adoption of IFRS 9 had no impact on the REIT's consolidated financial statements and the same method will be used under IFRS 9 for the reclassification of the cumulative loss from other comprehensive income through profit or loss.

Note 4 – Investment properties

	For the three months ended June 30, 2018	For the year ended December 31, 2017
Beginning of the period	440,813	412,232
Additions	2,289	1,616
Capitalized letting fees	32	120
Rent free periods	(649)	(893)
Net change in fair value of investment properties ¹	1,338	892
Foreign currency translation adjustment	7,544	26,846
End of the period	451,367	440,813

Note 1 : Including the increase in 'Net change of fair value of investment properties' of 1,726 \$ (nil as at December 31, 2017) is the impact of IFRIC 21 for recoverable French property taxes, which has a similar impact on service charge expenses.

INOVALIS REIT

Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

Note 5 – Investments accounted for using the equity method

Carrying amount of investment in joint ventures	CCD	Walpur	Arcueil ²	Cologne	Stuttgart	Delizy	Neu Isenburg	Kösching	Total
Balance - December 31, 2016	18,684	6,865	13,149	5,189	-	-	-	-	43,887
Additional investment of the year	-	-	-	-	12,794	8,682	12,230	-	33,706
Share of net earnings (loss) from investments accounted for using the equity method ¹	388	1,432	(217)	21	2,390	(551)	(1,042)	-	2,421
Partial disposal	-	-	-	835	-	-	-	-	835
Loan repayments	-	-	-	(5,544)	-	-	-	-	(5,544)
Exchange differences	1,226	489	848	197	451	244	334	-	3,789
Balance - December 31, 2017³	20,298	8,786	13,780	698	15,635	8,375	11,522	-	79,094
Additional investment of the period	-	-	-	-	-	-	2,439	8,833	11,272
Share of net earnings (loss) from investments accounted for using the equity method ¹	54	184	178	1	26	5	1,033	93	1,574
Loan repayments	-	-	-	-	(583)	-	(292)	-	(875)
Exchange differences	348	149	235	13	272	144	175	(64)	1,272
Balance - June 30, 2018³	20,700	9,119	14,193	712	15,350	8,524	14,877	8,862	92,337

- (1) The share of net earnings includes the interest expense to the shareholders in relation to the loans granted to joint venture. The interest earned by the REIT in relation to these loans amounts to \$ 2,687 and are included in the item "Finance income".
- (2) The REIT is entitled to receive a 25% share of the net earnings and, upon asset disposal, 75% of the variance of fair value of investment properties, reduced by 100% of foreign exchange derivative costs. The \$ 178 share of net earnings regarding Arcueil property includes the loss from the foreign exchange hedge for \$199. As at June 30, 2018 the fair value of the forward is \$(2,128).
- (3) The balance of the investments accounted for using the equity method as at June 30, 2018 includes loans to Joint Ventures for an amount of \$ 66,215 which can be detailed as follows:

Loans from joint ventures	CCD	Walpur	Arcueil	Cologne	Stuttgart	Delizy	Neu Isenburg	Kösching	Total
Balance - June 30, 2018	15,278	5,065	15,349	810	12,950	9,094	4,821	2,848	66,215
Balance - December 31, 2017	15,020	4,980	15,090	797	13,300	8,941	3,515	-	61,643

Kösching (Ingolstadt)

On February 28, 2018, the REIT, through its subsidiary CCE, completed the acquisition of its 50% interest in the Kösching (Ingolstadt) investment, a joint venture which built an office property located in Germany, for a total cash consideration of €5,389 (\$8,333). This total consideration is composed of a cash consideration paid of € 3,437 (\$5,314) for the equity interest, €421 (\$ 651) of acquisition costs and a 6.5% interest-bearing loan of € 1,531 (\$2,368), repayable the date the Joint Venture Agreement terminates. A drawdown of €325 (\$500) occurred in May 2018.

Neu Isenburg

On March 15, 2018, the REIT, through its subsidiary CCE contributed an additional cash consideration of €1,000 (\$1,538) through an additional drawdown under the interest bearing loan facility. The additional cash contribution also includes acquisition costs for an amount of €576 (\$886). A repayment of €189 (\$292) occurred in May 2018.

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Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

Note 6 – Acquisition loan and deposit

	As at June 30, 2018	As at December 31, 2017
Ingolstadt deposit	-	1,132
Rueil loan ⁽¹⁾	26,348	25,903
Acquisition loan and deposit	26,348	27,035

The increase of \$445 for the period from December 31, 2017 to June 30, 2018 corresponds to foreign currency translation adjustments.

Kösching (Ingolstadt) deposit

On September 15, 2016, the REIT and a co-investor entered into an agreement with a third-party for the forward purchase of an office property to be developed in Ingolstadt, Germany. A deposit of €1.5 million (\$ 22 million) has already been paid upon signature of the forward purchase agreement. The share of the deposit of €70 (\$ 1,063) of the co-investor has been paid by the REIT on behalf of the co-investor. This advance to the co-investor was disclosed under the caption “Other financial current assets”.

On February 28, 2018, the REIT has finalised the acquisition of the shares of TK Bau Verwaltung GmbH the entity holding the Kösching (Ingolstadt) property (see note 5) and the amount of the deposit has been deducted against the acquisition price.

Rueil loan

During the year 2016, the REIT has committed to fund a €21.7 million (\$34.5 million) acquisition and redevelopment loan to a company 80% owned by Inovalis related to a property located in Rueil, in Paris Western periphery. The facility amount will be drawn in several instalments until the completion of the project in 2020. The loan bears an annual interest rate of 8.50% with an effective interest rate of 13.89% and gives the REIT 20% of the profit generated upon the sale of the underlying investment property and also gives the REIT an option for the purchase of up to 20% of the property once it meets the REIT’s investment criteria.

To date, €17.2 million (\$26.348 million) was funded by the REIT as a loan. The loan is secured by a share pledge that would enable the REIT to obtain 80% of the shares of Rueil SCCV which is developing the project.

Advance payments have been received by the REIT. These advance payments cover accrued interest due on the loan for subsequent financial periods ending with the loan’s maturity in December 2019. Advance payments related to the accrued interests have been classified as deferred income. As at June 30, 2018 and December 31, 2017, advance payments related to accrued interest for future periods amount respectively to \$ 2,625 and \$ 5,462.

Note 7 – Financial derivatives and hedging activities

Following the completion of the refinancing of the Baldi and Jeuneurs properties on October 26, 2017, two interest rate cap arrangements were contracted by the REIT at the beginning of 2018. These arrangements are settled on a net basis at every interest payment date. These contracts are not designated as part of a hedging relationship. Accordingly, they are classified as financial instruments at fair value through profit or loss, with changes in fair value recognized in profit or loss.

On April 5th, 2018, the REIT entered into 18 new monthly foreign currency hedge contracts whereby the REIT will purchase \$1,300 each month at a weighted average exchange rate of 1.6412 Canadian dollars per euro. The new contracts cover the period from May 10, 2019 to October 9, 2020. These contracts have been designated as hedges of the REIT’S net investment in a foreign operation.

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Notes to the Condensed Interim Consolidated Financial Statements

Three-month and six-month periods ended June 30, 2018

(Unaudited - All dollar amounts are in thousands of Canadian dollars, unless otherwise stated)

Note 8 – Deferred tax liabilities

The deferred income tax liabilities correspond to the deferred income tax expense relating to the origination of temporary differences arising from the unrealized gains on investment properties located in France and Germany.

The current Double Taxation Treaty (DTT) in force between France and Luxembourg require that the REIT should incur French withholding tax of 5% on the dividend received from their France based OPCI*. On March 20, 2018 the Governments of France and Luxembourg signed a new DTT and accompanying Protocol. The revised DTT is currently pending ratification before it comes into force. If the DTT is ratified by both parties before December 31, 2018 it will come into effect in 2019. Should ratification occur after that date, the changes will not come into effect until 2020. Management believes the DTT to be substantively enacted as of March 20, 2018

The revised DTT requires that these dividend distributions be subject to a withholding tax rate of as much as 30% which can potentially be reduced to a 15% withholding tax in some specific cases.

Management believes that the increase in tax rates can have a significant impact on the REIT as such, management is currently assessing available alternatives that would result in the REIT being subjected to a reduced rate of 15% once the DTT comes into effect. Management has accounted for the deferred income tax liabilities based on the reduced rate of 15% and the assumption of the distribution of 50% of the OPCIs' net profits arising from capital gains upon disposition during the period ending June 30, 2018 since management is actively working to ensure the REIT will take the measures necessary to be subjected to this reduced rate. However, as management is still considering alternatives, any resulting impact on the operating structure has not yet been determined.

\$ 4,850 of the deferred tax liabilities recorded in the six-month period results in a one-time charge due to the change in the DTT.

*"OPCI" refers to *Organisme de placement collectif en immobilier* which refers to French real estate collective investment undertakings. OPCIs are they are tax exempt vehicles as long as they distribute 50% of their net profit.

Note 9 – Exchangeable securities

	Exchangeable securities	
	Number of Exchangeable securities	Carrying amount of Exchangeable securities
Exchangeable securities issued and outstanding		
Balance - December 31, 2016	1,808,051	16,598
Transactions in 2017		
Asset management fees paid in Exchangeable securities	375,824	3,711
Distribution in respect of Exchangeable securities		
Conversion of Exchangeable securities into units of the REIT	(500,014)	(4,426)
Redemption of Exchangeable securities	(4,491)	(44)
Net change in fair value of Exchangeable securities	-	904
Balance -December 31, 2017	1,679,370	16,743
Transactions in 2018		
Asset management fees paid in Exchangeable securities	155,903	1,566
Conversion of Exchangeable securities into units of the REIT	(419,059)	(3,939)
Net change in fair value of Exchangeable securities	-	(66)
Balance - June 30, 2018	1,416,214	14,304

The exchangeable securities represent a financial liability and were designated at fair value through profit or loss.

The exchangeable securities of a total amount of \$ 14,304 (\$ 16,743 as at December 31, 2017) are presented as non-current for \$ 5,108 (\$ 6,907 as at December 31, 2017) and current for \$9,196 (\$ 9,836 as at December 31, 2017).

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Distributions in respect of exchangeable securities:

The exchangeable securities entitle the holders to cash distributions from CanCorpEurope S.A., a subsidiary of the Trust, equal, on a per unit basis, to the distributions paid to holders of units by the REIT.

The following table breaks down distribution payments:

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Amount payable at the beginning of the period	276	324	262	982
Declared and recognized in earnings during the period	286	398	554	777
Distribution on exchangeable securities paid in cash	(380)	(233)	(634)	(1,270)
Amount payable at the end of the period	182	489	182	489
Weighted average number of Exchangeable securities outstanding	1,375,566	1,897,715	1,369,793	1,853,621
Distributions paid per unit (based on weighted average Exchangeable securities outstanding)	0.2762	0.1228	0.0463	0.6851
Distributions paid per unit (based on three-month)	0.2063	0.2063	0.4125	0.4125

The amount of distributions payable is included in "trade and other payables".

Note 10 – Promissory notes – Private Placement

On June 22, 2017, the REIT entered into a private placement in the form of a Euro denominated promissory note (hereafter "Promissory Note 1") through its subsidiary CCE to a single non-Canadian investor "the Investor" for € 9,146 (\$ 13,801) paying interest at 8.18%. The Promissory Note 1 matures on June 22, 2020 and includes a prepayment option allowing the REIT to repay all or any portion of the Promissory Notes 1 as from June 22, 2018. On August 11, 2017, a partial repayment of the Promissory Note 1 was done for € 440 (\$ 664).

On October 4, 2017, the REIT issued a second Euro denominated promissory note (hereafter "Promissory Note 2") through its subsidiary CCE to the same investor "the Investor" for € 7,262 (\$ 10,958) paying interest at 8.13%. The Promissory Note 2 matures on October 4, 2020 and includes a prepayment option allowing the REIT to repay all or any portion of the Promissory Note 2 as from October 4, 2018.

On April 19, 2018, the REIT issued a third Euro denominated promissory note (hereafter "Promissory Note 3") through its subsidiary CCE to the Investor for € 13584 (\$ 20,999) paying interest at 7.95%. The Promissory Note 3 matures on April 19, 2021, and includes a prepayment option allowing the REIT to repay all or any portion of the Promissory Note 3 as from April 19, 2019.

Concurrent with the issuance of Promissory Note 1, Promissory Note 2 and Promissory Note 3 (together referred as "the Notes"), the Investor and the REIT entered into put/call agreements. Pursuant to the call option, the REIT can satisfy its obligation to the Investor at any time by delivering a fixed number of units of the REIT determined at the issuance of the Notes ("Conversion Prices"). Pursuant to the put option, at any time after June 25, 2018 for Promissory Note 1, October 7, 2018 for Promissory Note 2 and April 19, 2019 for Promissory Note 3 the Investor can transfer all or any portion of the Notes to the REIT in consideration for cash, in which case the REIT has the option to exercise its call option.

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Note 11 – Finance costs and finance income

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Interest costs related to mortgage loans	(537)	(395)	(1,077)	(779)
Interest costs related to finance leases	(623)	(678)	(1,253)	(1,326)
Interest costs related to lease equalization loans	(48)	(61)	(100)	(121)
Interest costs related to promissory notes	(958)	(32)	(1,536)	(32)
	(2,166)	(1,166)	(3,966)	(2,258)
Interest SWAP	(341)	(316)	(661)	(606)
Finance costs from joint ventures ¹	2,858	-	-	-
Other finance costs	(250)	130	(446)	(78)
	101	(1,352)	(5,073)	(2,942)
Amortization of fair value adjustment on finance leases assumed at a discount at the time of a business	-	(22)	-	(44)
Amortization of transaction costs on mortgage loans	(74)	(30)	(149)	(71)
Finance costs	27	(1,404)	(5,222)	(3,057)
Finance income from Inovalis relating to the acquisition loan	925	(12)	2,951	183
Finance income from joint ventures ¹	1,371	612	2,687	974
Other finance income	9	924	30	2,151
Finance income	2,305	1,524	5,668	3,308

¹ see note 5

Note 12 – Earnings per Unit

The REIT has classified the Units that it issued as equity pursuant to the provisions of IAS 32, *Financial Instruments: Presentation*, on the basis that the Units meet all of the criteria in IAS 32 for such classification, also referred to as the “puttable exemption”.

(a) Basic earnings per Unit

Basic earnings per unit is calculated by dividing the profit attributable to the Unitholders of the REIT by the weighted average number of Units outstanding during the period.”

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Basic earnings per unit				
Earnings attributable to unitholders	5,033	159	3,059	3,300
Weighted average number of units outstanding	28,203,145	21,584,020	27,266,172	21,564,609
Basic earnings per unit	0.18	0.01	0.11	0.15

(b) Diluted earnings per Unit

Diluted earnings per unit is calculated by adjusting the weighted average number of Units outstanding to assume conversion of all dilutive potential Units. The REIT has one category of dilutive potential Units: the exchangeable securities. Refer to Note 9 - exchangeable securities for the number of exchangeable securities outstanding.

All exchangeable securities and promissory notes were not included in the calculation of the diluted EPS because they are anti-dilutive

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Note 13 – Distributions

	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Amount payable at the beginning of the period	1,563	1,482	1,529	1,479
Declared and recognised during the period	4,693	4,454	9,377	8,898
Distributions paid in units (Distribution Reinvestment Plan)	(445)	(382)	(1,162)	(730)
Paid in cash	<u>(4,245)</u>	<u>(4,068)</u>	<u>(8,178)</u>	<u>(8,161)</u>
Amount payable at the end of the period	<u>1,566</u>	<u>1,486</u>	<u>1,566</u>	<u>1,486</u>
Distributions paid per unit (based on weighted average number of units outstanding)	0.2062	0.2063	0.4121	0.4124
Distributions paid per unit (based on an annual basis)	0.2063	0.2063	0.4125	0.4125

The amount of distributions payable is included in “trade and other payables”.

Distributions in respect of exchangeable securities are detailed in Note 9 – exchangeable securities.

Note 14 – Accumulated other comprehensive income

	As at June 30, 2018	As at 31 December 2017
Net unrealized gains on derivatives designated as a hedge of the net investment in a foreign entity	1,204	1,162
Net unrealized losses on interest rate derivatives designated as a cash flow hedge	(729)	(1,077)
Cumulative translation adjustment account	<u>29,197</u>	<u>24,351</u>
Accumulated other comprehensive income	<u>29,672</u>	<u>24,436</u>

Note 15 – Transactions with related parties

Inovalis Asset manager

Pursuant to the Management agreement, Inovalis is the Asset manager of the REIT and provides the strategic, advisory, asset management, project management, construction management, property management and administrative services necessary to manage the operations of the REIT and its subsidiaries.

Unless otherwise stated, none of these transactions incorporated special terms and conditions. Outstanding balances are usually settled in cash, with the exception of management fees to Inovalis that are settled quarterly through the issuance of either exchangeable securities or in cash, in Q1 2018, 100% of the management fees were settled in exchangeable securities. In Q2 2018, the management fees were settled half in exchangeable securities and half in cash.

INOVALIS REIT

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	Financial statement line item	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Revenues			
Interest income from acquisition loan	Finance income	2,951	922
Other revenues	Other revenues	410	419
		<u>3,361</u>	<u>1,341</u>
Expenses			
Asset management fees ¹	Administration expenses	(2,086)	(1,438)
Facilities management fees	Service charge expenses	(307)	(272)
Property management Fees	Service charge expenses	(681)	(658)
Letting fees	Service charge expenses	(40)	(38)
Reimbursement of travel expenses	Acquisition costs	(20)	(49)
Interest expense on lease equalization loans	Finance costs	(100)	(121)
Reimbursement of travel expenses	Administration expenses	(116)	(72)
Trustee fees	Administration expenses	(158)	(120)
		<u>(3,508)</u>	<u>(2,768)</u>
Unitholders' Equity			
Conversion of Exchangeable securities into units of the REIT		3,939	-

- (1) Asset management fees of \$2,086 and \$1,438 for the six months ended June 30, 2018 and June 30, 2017 respectively, correspond to the asset management fees earned for the entire portfolio, including \$761 and \$289 attributable to assets held through joint-ventures for the six months ended June 30, 2018 and June 30, 2017 respectively. Since April 1, 2018 asset management fees have been reduced from 0.75% to 0.50% and calculated based on the book value of assets. Fees are payable in cash and/or exchangeable securities, the exact composition of which is determined by the Board annually based on the REIT's cash resources.

	Due from (to) Inovalis	
	As at June 30, 2018	As at December 31, 2017
Trade and other receivables	316	588
Trade and other payables	(1,302)	(1,366)
Acquisition loan	26,348	25,903
Distributions payable	(182)	(262)
Lease equalization loans	(3,928)	(4,443)
	<u>21,252</u>	<u>20,420</u>

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Joint ventures

The transactions and balances with entities accounted for using the equity method are summarized below:

Joint ventures	Financial statement line item	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Management fees invoiced to joint ventures	Administration expenses	761	289
Earnings from joint ventures	Share of net earnings from investments accounted for using the equity method	1,574	391
Finance income	Finance income	2,687	2,151
		<u>5,022</u>	<u>2,831</u>
		Due from joint ventures	
		As at June 30, 2018	As at December 31, 2017
Loan receivable	Investments accounted for using the equity method	66,215	61,643
Interest payables	Other current assets	664	626
Accounts receivable	Trade and other receivables	-	61
		<u>66,879</u>	<u>62,330</u>

Note 16 – Fair value measurements

Fair value hierarchy

The following table shows an analysis of the fair values of financial instruments (including exchangeable securities) and non-financial assets measured at fair value on a recurring basis recognized on the consolidated balance sheet by level of the fair value hierarchy:

	As at June 30, 2018			
	Level 1	Level 2	Level 3	Total
Investment properties	-	-	451,367	451,367
Acquisition loan	-	-	26,348	26,348
Derivative financial instruments - assets	-	440	-	440
Derivative financial instruments - liabilities	-	(3,063)	-	(3,063)
Exchangeable securities	-	(14,304)	-	(14,304)
Promissory notes	-	(45,415)	-	(45,415)
	As at December 31, 2017			
	Level 1	Level 2	Level 3	Total
Investment properties	-	-	440,813	440,813
Derivative financial instruments - assets	-	59	-	59
Derivative financial instruments - liabilities	-	(1,966)	-	(1,966)
Exchangeable securities	-	(16,743)	-	(16,743)
Promissory notes	-	(23,789)	-	(23,789)

- Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 - use of a model with inputs (other than quoted prices included in Level 1) that are directly or indirectly observable market data.
- Level 3 - use of a model with inputs that are not based on observable market data.

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There were no transfers between Level 1 and Level 2 during the period ended June 30, 2018 (none in 2017).

The REIT's management is responsible for determining fair value measurements included in the condensed interim consolidated financial statements, including Level 3 fair values. The inputs, processes and results for recurring measurements, including those valuations calculated by an independent appraiser every semester, are reviewed each quarter by senior management to ensure conformity with IFRS.

The reconciliation of the carrying amounts of non-financial assets classified within Level 3 is in Note 4 – Investment properties. The gains or losses relating to the investment properties are recognized in profit or loss on the income statement line entitled "Net change in fair value of investment properties". The entire amount of the gain or loss reported on this line in the reporting period is unrealized.

The following methods and assumptions were used to estimate the above-mentioned fair values:

- The fair value of derivative financial instruments is determined based on discounted cash flows using interest rate yield curves and volatilities that are observable on an active market, as at the balance sheet date.
- The fair value of the exchangeable securities is based on the quoted price of the REIT's own units, on the basis that they are exchangeable on a one for one basis throughout their life at the request of the unit holders, and upon maturity of the underlying notes, at the request of the REIT. Other features of the exchangeable securities have no significant impact on their fair value.
- The fair value of the promissory notes is based on the quoted price of the REIT's own units, on the basis that they are exchangeable for a fixed number of units throughout their life at the request of the unit holders, and upon maturity of the underlying notes, at the request of the REIT. Other features of the exchangeable securities have no significant impact on their fair value.
- The fair value of the acquisition loans and deposit is estimated using the nominal amounts expected to be received at maturity and a discount rate based on prevailing market interest rates adjusted by an internally determined credit spread. The fair value approximates its carrying amount as there were no material changes during the period in the assumptions used for fair value determination at inception.

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Note 17 – Cash flow information

CASH FLOW INFORMATION

	Note	For the three months ended June 30, 2018	For the three months ended June 30, 2017	For the six months ended June 30, 2018	For the six months ended June 30, 2017
Adjustments for non-cash items and other reconciling items:					
Rent free period	4	320	226	649	305
Management fees paid in Exchangeable securities	9	804	738	1,566	1,438
Net change in fair value of investment properties	4	587	2,181	(1,338)	(108)
Net change in fair value of financial instruments at fair value through profit or loss		179	2,352	1,162	1,781
Distributions recognized on Exchangeable securities	9	286	398	554	777
Net change in fair value of Exchangeable securities	9	48	1,034	(66)	1,698
Net change in fair value of Promissory notes		2,202	-	1,074	-
Finance income	11	(2,305)	(1,524)	(5,668)	(3,308)
Finance costs	11	(27)	1,404	5,222	3,057
Share of net earnings from investments accounted for using the equity method	5	(739)	(1,115)	(1,574)	(391)
Net unrealized exchange loss (gain)		(27)	62	(83)	62
Cash items					
Interest received		4,381	983	5,640	2,018
Interest paid		(2,963)	(906)	(4,652)	(1,927)
Income tax paid		(12)	(87)	(14)	(97)
Acquisition costs classified as investing activities		-	-	20	37
		<u>2,733</u>	<u>5,746</u>	<u>2,491</u>	<u>5,342</u>
Working capital adjustments					
Increase in trade and other receivables		(1,953)	(940)	(1,188)	(1,936)
Increase in tenant deposits		147	(17)	25	(24)
(Decrease) Increase in trade and other payables		(8,336)	1,003	215	9,025
		<u>(10,142)</u>	<u>46</u>	<u>(948)</u>	<u>7,065</u>

Corporate information

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Website: www.inovalisreit.com

Stock exchange listing

The Toronto Stock Exchange
Listing symbol: INO.UN

Distribution Reinvestment Plan

Inovalis has implemented a Distribution Reinvestment Plan (“**DRIP**”). By participating in the Plan, Unitholders have cash distributions from Inovalis REIT reinvested in additional Units as and when cash distributions are made with a “bonus” distribution of Units equal to 3% of the amount of the cash distribution reinvested pursuant to the Plan.

INOVALIS

REAL ESTATE INVESTMENT TRUST

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