



**H&R Real Estate Investment Trust and H&R Finance Trust
2017 Annual Report
Including Combined MD&A and Financial Statements**



The Bow, Calgary



Orchard Park, Kelowna



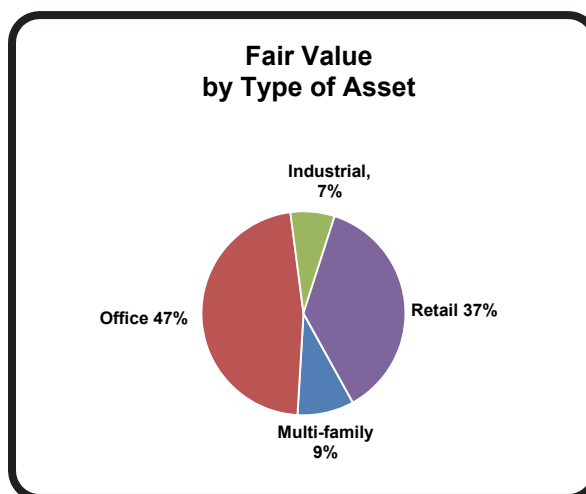
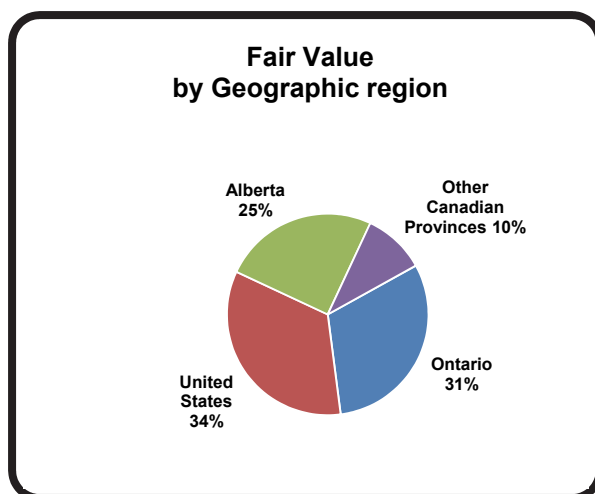
Airport Road, Brampton – Sleep Country

H&R Profile

H&R REIT is Canada's largest diversified real estate investment trust with total assets of approximately \$14.6 billion at December 31, 2017. H&R REIT is a fully internalized real estate investment trust and has ownership interests in a North American portfolio of high quality office, retail, industrial and residential properties comprising over 45 million square feet.

H&R Finance Trust is an unincorporated investment trust, which primarily invests in notes issued by a U.S. corporation which is a subsidiary of H&R REIT. The current note receivable balance is U.S. \$223.9 million. In 2008, H&R REIT completed an internal reorganization which resulted in each issued and outstanding H&R REIT unit trading together with a unit of H&R Finance Trust as a "Stapled Unit" on the Toronto Stock Exchange.

Additional information regarding H&R REIT and H&R Finance Trust is available at www.hr-reit.com and on www.sedar.com.



Primary Objectives

H&R strives to achieve two primary objectives: to maximize the value of units through active management of H&R's assets and to provide unitholders with stable and growing cash distributions generated by revenues derived from a diversified portfolio of investment properties. We are committed to maximizing returns to unitholders while maintaining prudent risk management and conservative use of financial leverage.

Stability and Growth through Discipline

Since inception in 1996, H&R has executed a disciplined and proven strategy that has provided stable cash flow from a high quality portfolio. We achieve our primary objectives and mitigate risks through long-term property leasing and financing, combined with conservative management of assets and liabilities.



February 14, 2018

Fellow Unitholders,

As we report on our 2017 performance and look forward to 2018, we are pleased to provide an update on the strides we have recently made to enhance the business of H&R REIT. We view these improvements in three categories: 1) Governance; 2) Assets; and 3) Investment Profile.

Governance

The improvements we have made to our governance over the past five years are significant, and include adopting a fully internalized management structure; adopting new board management policies including term limits; adding three new trustees to our board; and undertaking a comprehensive review and reform of our executive compensation program, with Willis Towers Watson providing independent advice on the design and governance of the new program which came into effect in 2017. Following these improvements, we believe that we have adopted best governance practices for H&R REIT. With management, trustees and their families owning more than \$400 million of H&R units we have excellent alignment with investors.

Assets

We have continued to enhance the quality of the REIT's assets, through acquisitions, developments and dispositions. Notable acquisitions in recent years have included a series of large trophy office property acquisitions, beginning in late 2011, including Hess Tower in Houston, Two Gotham in New York and Corus Quay and The Atrium in Toronto. In 2013, we acquired Primaris REIT, one of the very few fully integrated enclosed shopping centre platforms in Canada. Since late 2014, we have also created a residential apartment platform acquiring more than 5,600 suites, primarily in Texas and Florida, operating under the Lantower Residential banner.

Our efforts to improve our asset base have not been limited to acquisitions. We have also undertaken value-creating developments, including a number of U.S. gateway city multi-residential developments, as well as Toronto industrial developments. The largest and most notable is our 50% interest in Jackson Park, a multi-residential development in Long Island City, New York. This 1,871-suite development is nearing completion, with phased occupancy commencing in the first quarter of 2018. We conservatively expect this project alone will have added more than \$1.00 to our net asset value per unit upon stabilization. We are confident that our other multi-residential developments, while individually smaller in scale, spanning markets such as Miami, Seattle, Long Beach and San Francisco Bay among others, will also result in positive contributions to our net asset value.

And lastly, as we have acquired and developed high-quality properties, we have also completed significant asset sales, recycling more of our capital into our larger and core properties. We have sold more than \$2.6 billion of property over the past four years, including partial interests in our smaller and older Canadian industrial properties; most of our U.S. industrial property portfolio; partial interests in several Primaris properties; and we are currently negotiating to sell our U.S. \$750 million U.S. retail portfolio.

We have executed these asset sales for a number of reasons. In some cases, we have pursued partial dispositions, leveraging our management expertise to enhance returns through property management fees from our joint venture partners, while also conservatively managing our risk exposures. In other cases, we have taken advantage of strong property markets to sell some of the smaller and older properties that had been eclipsed in quality and scale by subsequent acquisitions and developments. Some asset sales have reflected our desire to streamline our portfolio to fewer, but larger focus areas, such as our decision to sell all of our U.S. industrial properties and U.S. retail properties. Perhaps most importantly, as we have enhanced the quality of our portfolio through capital recycling, we have done so in a gradual, conservative and measured manner, safeguarding the stability of our capital structure and financial performance.

Investment Profile

This brings us to the third area of improvement: the profile of H&R REIT as an investment. While we operate the business with a long-term perspective and will not allow short-term thinking to drive our decision making, there are several areas where we are spending more time and effort to improve our profile with our unitholders. Some of these initiatives coincide with our strategy, such as reducing leverage significantly over the past five years



consistent with investor preference, but also supportive of our strategy of increased investment in developments, as well as cushioning against the potential for interest rates to be a headwind in the future.

As we look to improve our investment profile we continue to listen to our investors, as demonstrated by our “Say on Pay” resolution, which 96% of unitholders supported at our last annual meeting. We have significantly improved our disclosure and communications with unitholders, in an effort to help investors better understand and appreciate our business, our strategy and the opportunity in our units. This quarter marks the seventh consecutive quarter where we have held a conference call, we hosted our first two investor and analyst tours in Toronto and New York in the fall, and we have enhanced the transparency of our financial reporting. We plan to continue to spend time working with our investors to improve communication and disclosure.

Looking ahead, we see a number of positive factors that will contribute to our financial performance, including development completions, rising rents and steady to rising occupancy. We are also pleased with our conservative balance sheet, after a period of de-leveraging that muted FFO growth, and we plan to target maintaining leverage in the 43% - 47% range. In the near term, we expect leverage to remain close to the bottom end of that range, with the dispositions of our remaining U.S. industrial and U.S. retail properties, anticipated in the near future, expected to generate roughly US\$800 million of gross proceeds. We are actively pursuing reinvestment opportunities, particularly in our Lantower Residential U.S. apartment platform. We are also buying back units regularly under our normal course issuer bid, at significant discounts to our IFRS fair value, in efforts to minimize the impact of capital recycling on FFO in the near term, and also to take advantage of the discount at which our units trade. However, we expect the process of recycling this capital will have a modest negative impact on FFO growth in 2018, until sale proceeds are reinvested.

After two years of relatively flat performance from our Primaris platform, reflecting the departure of Target, we expect modest positive growth in FFO contribution for the full year 2018 as replacement tenants take occupancy, despite the impact of Sears’ closures. The balance between Target replacement tenants and the impact of Sears closures is tilted in our favour by the significantly higher rents generated by replacement tenants, as well as the exceptionally low rents Sears paid (Target’s former rents were 50% higher). As we address the re-leasing of Sears vacancies, we are encouraged by the stronger than expected tenant demand experienced, with 400,000 sq.ft. of the 675,000 sq.ft. of total Sears vacancy under advanced leasing discussions. We expect Sears replacement tenants to begin rent payments in 2019, supporting FFO growth, with an even greater positive impact in 2020.

We spent a considerable amount of time in 2017 reflecting on our business. Among the more notable conclusions we reached was that we would focus on streamlining our property portfolio by narrowing our focus to fewer property types, which led to our decisions to sell our U.S. industrial and U.S. retail property portfolios. We expect to continue to evaluate all aspects of our business on an on-going basis, looking for ways we can 1) create value for unitholders; 2) best position H&R REIT for long term success; and 3) enhance the profile of the REIT among investors and analysts and bridging the gap between our trading price and our net asset value.

In our pursuit of continually improving H&R REIT, we remain focused on achieving the main goal we have pursued throughout our history: To build a high quality portfolio of real estate, in order to deliver strong per unit performance over the long term.

Our mandate for 2018 is clear: Continue to improve the quality and profile of our business, and invest time and energy into improving our communication, disclosure and investor relations so that investors can better see the opportunity we see in H&R REIT units.

Respectfully,

A blue ink signature of Ronald C Rutman.

Ronald C Rutman
Chairman

A blue ink signature of Thomas J Hofstedter.

Thomas J Hofstedter
President & Chief Executive Officer

**COMBINED MANAGEMENT'S DISCUSSION
AND ANALYSIS OF H&R REAL ESTATE INVESTMENT
TRUST AND H&R FINANCE TRUST**

For the Year ended December 31, 2017

Dated: February 14, 2018

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SECTION I

BASIS OF PRESENTATION

Financial data included in this combined Management's Discussion and Analysis ("MD&A") of combined results of operations and combined financial position of H&R Real Estate Investment Trust ("H&R") and H&R Finance Trust ("Finance Trust" and together with H&R, the "Trusts") for the year ended December 31, 2017 includes material information up to February 14, 2018. Financial data for the years ended December 31, 2017 and 2016 provided has been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). This MD&A should be read in conjunction with the combined financial statements of the Trusts and appended notes for the year ended December 31, 2017. The "Trusts' Financial Statements" are defined to refer to the financial statements for the applicable period. All amounts in this MD&A are in thousands of Canadian dollars, except where otherwise stated. Historical results, including trends which might appear, should not be taken as indicative of future operations or results.

On October 24, 2013, the Ontario Securities Commission (on its behalf and on behalf of the other provincial securities regulators) issued a decision which permits H&R and Finance Trust to file one set of combined financial statements rather than separate financial statements. The Trusts' Financial Statements have been presented on a basis whereby the assets and liabilities of H&R and Finance Trust have been combined in accordance with the accounting principles applicable to both H&R and Finance Trust in accordance with IFRS, to reflect the financial position and results of H&R and Finance Trust on a combined basis. This same decision permits H&R and Finance Trust to file one combined MD&A which has been done for the year ended December 31, 2017.

FORWARD-LOOKING DISCLAIMER

Certain information in this MD&A and accompanying letter to unitholders contain forward-looking information within the meaning of applicable securities laws (also known as forward-looking statements) including, among others, statements made or implied under the headings "Results of Operations", "Liquidity and Capital Resources", "Risks and Uncertainties" and "Subsequent Events" relating to the Trusts' objectives, strategies to achieve those objectives, the Trusts' beliefs, plans, estimates, projections and intentions and similar statements concerning anticipated future events, results, circumstances, performance or expectations that are not historical facts including, the amount of distributions to unitholders, H&R's intentions and expectations regarding, and timing of, future U.S. industrial and U.S. retail dispositions, H&R's targeted overall leverage, the contribution to FFO (as defined below) of H&R's capital recycling initiatives, H&R's expectation with respect to the activities of H&R's development properties, including redevelopment of existing properties and building of new properties, the expected total cost and lease-up of Jackson Park, the contribution to net asset value from Jackson Park, the first year's property operating income from Jackson Park, the total cost, timing and expected financing of the Hercules Project, the expected development of 2217 Bryan St. and the Koenig Project, the expected capital and tenant expenditures, including 160 Elgin St., Ottawa, ON, management's expectation relating to the opportunity to increase property operating income as a result of Sears' departure and the growth in FFO from replacement tenants in Sears vacancies, the timing of completion and occupancy of any leases relating to premises vacated by Target, contributions to FFO by new tenants in former Target locations, that all necessary conditions will be met for the completion of the Reorganization, management's belief that H&R has sufficient funds for future commitments and management's expectation to be able to meet all of the Trusts' ongoing obligations and to finance short-term development commitments through the Trusts' general operating facilities and the adoption of new accounting policies. Forward-looking statements generally can be identified by words such as "outlook", "objective", "may", "will", "expect", "intend", "estimate", "anticipate", "believe", "should", "plans", "project", "budget" or "continue" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect the Trusts' current beliefs and are based on information currently available to management.

Forward-looking statements are provided for the purpose of presenting information about management's current expectations and plans relating to the future and readers are cautioned that such statements may not be appropriate for other purposes. These statements are not guarantees of future performance and are based on the Trusts' estimates and assumptions that are subject to risks, uncertainties and other factors including those described below under "Risks and Uncertainties" and those discussed in the Trusts' materials filed with the Canadian securities regulatory authorities from time to time, which could cause the actual results, performance or achievements of the Trusts to differ materially from the forward-looking statements contained in this MD&A. Factors that could cause actual results, performance or achievements to differ materially from those expressed or implied by forward-looking statements include, but not are limited to, the general economy is stable; local real estate conditions are stable; interest rates are relatively stable; and equity and debt markets continue to provide access to capital. Additional risks and uncertainties include, among other things, risks related to: real property ownership, credit risk and tenant concentration; lease rollover risk, interest and other debt-related risk; construction risks; currency risk; liquidity risk, financing credit risk, cyber security risk, environmental risk; co-ownership interest in properties, joint arrangement risks; unit price risk; availability of cash for distributions; ability to access capital markets; dilution; unitholder liability; redemption right risk; risks relating to debentures, tax risk and tax consequences to U.S. holders. The Trusts caution that these lists of factors, risks and uncertainties are not exhaustive. Although the forward-looking statements contained in this MD&A are based upon what the Trusts believe are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements.

Readers are also urged to examine H&R and Finance Trust's materials filed with the Canadian securities regulatory authorities from time to time as they may contain discussions on risks and uncertainties which could cause the actual results and performance of H&R and Finance Trust to differ materially from the forward-looking statements contained in this MD&A. Neither Finance Trust nor any of its trustees or officers, assumes any responsibility for the

completeness of the information contained in H&R's materials filed with the Canadian securities regulatory authorities or for any failure of H&R or its trustees or officers to disclose events or facts which may have occurred or which may affect the significance or accuracy of any such information. Neither H&R nor any of its trustees or officers, assumes any responsibility for the completeness of the information contained in Finance Trust's materials filed with the Canadian securities regulatory authorities or for any failure of Finance Trust or its trustees or officers to disclose events or facts which may have occurred or which may affect the significance or accuracy of any such information.

All forward-looking statements in this MD&A are qualified by these cautionary statements. These forward-looking statements are made as of February 14, 2018 and the Trusts, except as required by applicable Canadian law, assume no obligation to update or revise them to reflect new information or the occurrence of future events or circumstances.

NON-GAAP FINANCIAL MEASURES

The Trusts' Financial Statements are prepared in accordance with IFRS. However, in this MD&A and the accompanying letter to unitholders, a number of measures are presented that are not measures under generally accepted accounting principles ("GAAP") in accordance with IFRS. These measures, as well as the reasons why management believes these measures are useful to investors, are described below.

None of these non-GAAP financial measures should be construed as an alternative to financial measures calculated in accordance with GAAP. Furthermore, the Trusts' method of calculating these supplemental non-GAAP financial measures may differ from the methods of other real estate investment trusts or other issuers, and accordingly may not be comparable.

(a) The Trusts' proportionate share

The Trusts account for investments in joint ventures and associates as equity accounted investments in accordance with IFRS. The Trusts' proportionate share is a non-GAAP measure that adjusts the Trusts' Financial Statements to reflect H&R's equity accounted investments and its share of net income (loss) from equity accounted investments on a proportionately consolidated basis at H&R's ownership percentage of the applicable investment. Management believes this measure is important for investors as it is consistent with how the Trusts' review and assess operating performance of their entire portfolio. Throughout this MD&A, the balances at the Trusts' proportionate share have been reconciled back to relevant GAAP measures.

(b) Property operating income (cash basis)

Property operating income is the rental revenue generated from H&R's investment properties, net of the property operating expenses incurred. Property operating income (cash basis) is a non-GAAP measure which adjusts property operating income to exclude two non-cash items; straight-lining of contractual rent and realty taxes accounted for under IFRS Interpretations Committee Interpretation 21, *Levies* ("IFRIC 21"), which relates to the timing of the liability recognition for U.S. realty taxes. By excluding the impact of IFRIC 21, U.S. realty tax expenses are evenly matched with realty tax recoveries received from tenants throughout the period. Management believes this non-GAAP measure is important for investors as it adjusts property operating income for non-cash items which allows investors to better understand H&R's operating performance and it is also used as a key input in determining the value of investment properties. Refer to the "Property Operating Income" section in this MD&A for a reconciliation of Property operating income to Property operating income (cash basis).

(c) Same-Asset property operating income and Same-Asset property operating income (cash basis)

Same-Asset property operating income and Same-Asset property operating income (cash basis) are non-GAAP financial measures used by H&R to assess period-over-period performance for properties owned and operated since January 1, 2016. This typically excludes acquisitions, business combinations, dispositions and transfers of properties under development to investment properties during the last two years (collectively, "Transactions"). Management believes that these two measures are useful for investors in understanding period-over-period changes due to occupancy, rental rates, realty taxes and operating costs, before evaluating the changes attributable to Transactions. Refer to the "Property Operating Income" section in this MD&A for a reconciliation of Property operating income to Same-Asset property operating income and Same-Asset property operating income (cash basis).

(d) Funds from operations ("FFO") and Adjusted Funds from Operations ("AFFO")

FFO and AFFO are non-GAAP financial measures widely used in the real estate industry as a measure of operating performance particularly by those publicly traded entities that own and operate investment properties. The Trusts present their combined FFO and AFFO calculations in accordance with the Real Property Association of Canada (REALpac) February 2017 *White Paper on Funds From Operations and Adjusted Funds From Operations for IFRS*. FFO provides an operating performance measure that when compared period over period, reflects the impact on operations of trends in occupancy levels, rental rates, property operating costs, acquisition activities and finance costs, that is not immediately apparent from net income determined in accordance with IFRS. Management believes FFO to be a useful earnings measure for investors as it adjusts net income for items that are not recurring including gain (loss) on sale of real estate assets, as well as non-cash items such as the fair value adjustments on

investment properties. AFFO is calculated by adjusting FFO for the following items: straight-lining of contractual rent, capital expenditures, tenant expenditures and leasing costs. Although capital and tenant expenditures can vary from quarter to quarter due to tenant turnovers, vacancies and the age of a property, the Trusts have elected to deduct actual capital and tenant expenditures in the period. This may differ from others in the industry that deduct a normalized amount of capital and tenant expenditures, based on historical activity, in their AFFO calculation. Capital expenditures excluded and not deducted in the calculation of AFFO relate to capital expenditures which generate a new investment stream, such as the construction of a new retail pad during property expansion or intensification, development activities or acquisition activities. The Trusts' method of calculating FFO and AFFO may differ from other issuers' calculations. FFO and AFFO should not be construed as an alternative to net income or any other operating or liquidity measure prescribed under IFRS. Management uses FFO and AFFO to better understand and assess operating performance since net income includes several non-cash items which management believes are not fully indicative of the Trusts' performance. Refer to the "Funds From Operations and Adjusted Funds From Operations" section of this MD&A for a reconciliation of Net income to FFO and AFFO.

(e) Interest coverage ratio

The interest coverage ratio is a non-GAAP measure that is calculated by dividing the sum of: (i) property operating income (cash basis), (ii) finance income and (iii) trust expenses (excluding unit-based compensation) by finance costs from operations (excluding effective interest rate accretion and exchangeable unit distributions). This excludes other income, transaction costs, gain (loss) on sale of investments and unrealized gains (losses) that may occur under IFRS. Management uses this ratio and believes it is useful for investors as it is an operational measure used to evaluate the Trusts' ability to service the interest requirements of their outstanding debt. Interest coverage ratio is presented in the "Financial Highlights" and "Liabilities and Unitholders' Equity" sections of this MD&A.

(f) Debt to total assets at the Trusts' proportionate share

H&R's Declaration of Trust limits the indebtedness of H&R (subject to certain exceptions) to a maximum of 65% of the total assets of H&R, based on the Trusts' Financial Statements. The Trusts also present this ratio at the Trusts' proportionate share which is a non-GAAP measure. Debt includes mortgages payable, debentures payable and bank indebtedness. Management uses this ratio to determine the Trusts' flexibility to incur additional debt. Management believes this is useful for investors in order to assess the Trusts' leverage and debt obligations. Refer to the "Financial Highlights" and "Liabilities and Unitholders' Equity" sections of this MD&A for debt to total assets per the Trusts' Financial Statements and at the Trusts' proportionate share.

(g) Payout ratio per Stapled Unit as a % of FFO

Payout Ratio per Stapled Unit as a % of FFO is a non-GAAP measure which assesses the Trusts' ability to pay distributions and is calculated by dividing distributions per Stapled Unit by FFO per Stapled Unit for the respective period. The Trusts use this ratio amongst other criteria to evaluate the Trusts' ability to maintain current distribution levels or increase future distributions as well as assess whether sufficient cash is being held back for operational and capital expenditures. Refer to the "Financial Highlights" and "Funds From Operations and Adjusted Funds From Operations" sections of this MD&A for the Trusts' payout ratio per Stapled Unit as a % of FFO.

OVERVIEW

H&R is an unincorporated open-ended trust created by a declaration of trust ("H&R's Declaration of Trust") and governed by the laws of the Province of Ontario. Unitholders are entitled to have their H&R units comprising part of the Stapled Units (as defined below) redeemed at any time on demand payable in cash (subject to monthly limits) and/or *in specie*, provided that the corresponding Finance Trust units are being contemporaneously redeemed.

Finance Trust is an unincorporated investment trust. Finance Trust was established pursuant to a Plan of Arrangement (the "Plan of Arrangement") on October 1, 2008, as described in H&R's information circular dated August 20, 2008, as an open-ended limited purpose unit trust pursuant to its declaration of Trust ("Finance Trust's Declaration of Trust"). Each issued and outstanding Finance Trust unit is "stapled" to a unit of H&R on a one-for-one basis such that Finance Trust units and H&R units trade together as stapled units ("Stapled Units"), and such Stapled Units are listed and posted for trading on the Toronto Stock Exchange ("TSX"). Apart from provisions necessary to achieve such stapling, each H&R unit and Finance Trust unit retains its own separate identity and is separately listed (but not posted for trading) on the TSX (unless there is an "event of uncoupling" (as described below), in which case Finance Trust units will cease to be listed on the TSX).

H&R has two primary objectives:

- to maximize unit value through ongoing active management of H&R's assets, acquisition of additional properties and the development and construction of projects which are pre-leased to creditworthy tenants; and
- to provide unitholders with stable and growing cash distributions, generated by the revenue it derives from a diversified portfolio of income producing real estate assets.

H&R's strategy to accomplish these two objectives is to accumulate a diversified portfolio of high quality investment properties in Canada and the United States occupied by creditworthy tenants.

H&R's strategy to mitigate risk includes diversification both by asset class and geographic location. H&R invests in four real estate asset classes which management views as comprising six separate operating segments. H&R invests in office, retail, industrial and residential properties and acquires properties both in Canada and the United States. H&R's retail asset class is further viewed by management as being comprised of three different operating segments: (i) enclosed shopping centres and multi-tenant retail plazas throughout Canada managed by Primaris Management Inc. ("Primaris"); (ii) other retail properties throughout Canada and the United States managed by H&R REIT Management Services LP and Lantower Management Services LP, both subsidiaries of H&R, ("H&R Retail"), and (iii) H&R's 33.6% interest in Echo Realty LP ("ECHO"), a privately held real estate and development company which focuses on developing and owning a core portfolio of grocery anchored shopping centres in the United States. H&R's residential segment operates as Lantower Residential, a wholly-owned subsidiary of H&R, and focuses on acquiring and developing multi-family properties in the United States. H&R therefore has six operating segments and management assesses the results of these operations separately.

The primary purpose of Finance Trust is to be a flow-through vehicle to allow H&R to indirectly access capital in a tax-efficient manner. Finance Trust's primary activity is to hold debt issued by H&R REIT (U.S.) Holdings Inc. ("U.S. Holdco"), a wholly-owned U.S. subsidiary of H&R. As at December 31, 2017, Finance Trust holds U.S. \$223.9 million of aggregate principal amount of notes payable by U.S. Holdco ("U.S. Holdco Notes") (December 31, 2016 – U.S. \$220.5 million). Subject to cash flow requirements, Finance Trust intends to distribute to its unitholders, who are also unitholders of H&R, all of its cash flow, consisting primarily of interest paid by U.S. Holdco, less administrative and other expenses and amounts to satisfy liabilities. The U.S. Holdco Notes are eliminated in the Trusts' Financial Statements, however the related foreign exchange difference is not eliminated upon combination as it flows through net income (loss) on the Finance Trust Financial Statements and net income (loss) on the H&R Financial Statements.

Mechanics of "Stapling" the Units of Finance Trust and H&R

Pursuant to the provisions of the Declarations of Trust for Finance Trust and H&R at all times each H&R unit must be "stapled" to a Finance Trust unit (and each Finance Trust unit must be "stapled" to a H&R unit) unless there is an event of uncoupling. Any references in this MD&A to units should be considered references to Stapled Units. As part of the Plan of Arrangement, H&R and Finance Trust entered into a support agreement (the "Support Agreement") which provided, among other things, for the co-ordination of the declaration and payment of all distributions so as to provide for simultaneous record dates and payment dates; for co-ordination so as to permit H&R to perform its obligations pursuant to H&R's Declaration of Trust, Unit Option Plan, Incentive Unit Plan, Distribution Reinvestment Plan and Unit Purchase Plan ("DRIP") and Unitholder Rights Plan; for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable and permit H&R to perform its obligations arising under any security issued by H&R (including securities convertible, exercisable or exchangeable into Stapled Units); for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable H&R to perform its obligations or exercise its rights under its convertible debentures; and for Finance Trust to take all such actions and do all such things as are necessary or desirable to issue Finance Trust units simultaneously (or as close to simultaneously as possible) with the issue of H&R units and to otherwise ensure at all times that each holder of a particular number of H&R units holds an equal number of Finance Trust units, including participating in and cooperating with any public or private distribution of Stapled Units by, among other things, executing prospectuses or other offering documents.

In the event that H&R issues additional H&R units, pursuant to the Support Agreement, H&R and Finance Trust will coordinate so as to ensure that each subscriber receives both H&R units and Finance Trust units, which shall trade together as Stapled Units. Prior to such event, H&R shall provide notice to Finance Trust to cause Finance Trust to issue and deliver the requisite number of Finance Trust units to be received by and issued to, or to the order of, each subscriber as H&R directs. In consideration of the issuance and delivery of each such Finance Trust unit, H&R (solely as agent for and on behalf of the purchaser) or the purchaser, as the case may be, shall pay (or arrange for the payment of) a purchase price equal to the fair market value (as determined by Finance Trust in consultation with H&R) of each such Finance Trust unit at the time of such issuance. The remainder of the subscription price for Stapled Units shall be allocated to the issuance of H&R units by H&R. The proceeds received by Finance Trust from any such issuance shall be invested in additional notes of the same series as the U.S. Holdco Notes or distributed to unitholders of Finance Trust.

An event of uncoupling ("Event of Uncoupling") shall occur only: (a) in the event that unitholders of H&R vote in favour of the uncoupling of units of Finance Trust and units of H&R such that the two securities will trade separately; or (b) at the sole discretion of the trustees of Finance Trust, but only in the event of the bankruptcy, insolvency, winding-up or reorganization (under an applicable law relating to insolvency) of H&R or U.S. Holdco or the taking of corporate action by H&R or U.S. Holdco in furtherance of any such action or the admitting in writing by H&R or U.S. Holdco of its inability to pay its debts generally as they become due. The trustees of the Trusts shall use all reasonable efforts to obtain and maintain a listing for the units of H&R and, unless an Event of Uncoupling has occurred, the Stapled Units, on one or more stock exchanges in Canada.

Investment Restrictions

Under Finance Trust's Declaration of Trust, the assets of Finance Trust may be invested only in:

- (a) U.S. Holdco Notes; and
- (b) temporary investments in cash, term deposits with a Canadian chartered bank or trust company registered under the laws of a province of Canada, short-term government debt securities, or money market instruments (including banker's acceptances) of, or guaranteed by, a Schedule 1 Canadian bank ("Cash Equivalents"), but only if each of the following conditions are satisfied: (a) if the Cash Equivalents have a maturity date, the trustees hold them until maturity; (b) the Cash Equivalents are required to fund expenses of Finance Trust, a redemption of units, or distributions to unitholders, in each case before the next distribution date; and (c) the purpose of holding the Cash Equivalents is to prevent funds from being non-productive, and not to take advantage of market fluctuations.

Finance Trust's Declaration of Trust provides that Finance Trust shall not make any investment, take any action or omit to take any action which would result in the units of Finance Trust not being considered units of a "mutual fund trust" for purposes of the Income Tax Act (Canada) (the "Tax Act") or that would disqualify Finance Trust as a "fixed investment trust" under the Internal Revenue Code of 1986 as amended (the "Code") and the applicable regulations. In order to qualify as a "fixed investment trust" under the Code, Finance Trust generally may not acquire assets other than the U.S. Holdco Notes or certain investments in cash or cash equivalents.

SECTION II

SELECTED FINANCIAL INFORMATION

Summary of Quarterly Results

The following tables summarize certain financial information of the Trusts per the Trusts' Financial Statements for the quarters indicated below:

| (in thousands of Canadian dollars) | Q4 2017 | Q3 2017 | Q2 2017 | Q1 2017 |
|--|------------|------------|------------|------------|
| Rentals from investment properties | \$298,042 | \$289,568 | \$286,987 | \$293,857 |
| Net income from equity accounted investments | 118,337 | 3,072 | 26,280 | 19,718 |
| Net income | 325,213 | 78,784 | 153,070 | 110,803 |
| Total comprehensive income (loss) | 335,466 | (1,511) | 104,181 | 98,462 |

| | Q4 2016 | Q3 2016 | Q2 2016 | Q1 2016 |
|---|------------|------------|------------|------------|
| Rentals from investment properties | \$305,500 | \$297,258 | \$289,835 | \$303,418 |
| Net income (loss) from equity accounted investments | 82,176 | 4,758 | (19,722) | (18,871) |
| Net income | 140,616 | 113,865 | 104,079 | 30,185 |
| Total comprehensive income (loss) | 180,987 | 139,798 | 88,387 | (58,794) |

Fluctuations between quarterly results are generally due to property acquisitions, dispositions, changes in foreign exchange rates and changes in the fair value of real estate assets and financial instruments. From January 1, 2016 to December 31, 2017, H&R continued its strategy of redeploying capital by selling certain investment properties and equity accounted investments for total proceeds of \$1.2 billion and acquiring \$915.1 million in new properties and properties held for development. These acquisitions were primarily in the multi-family segment in the U.S. The proceeds from these net dispositions have been used to reduce debt leading to a stronger balance sheet and accordingly, rentals from investment properties declined. Revenues may also have significant fluctuations due to recoveries from tenants for changes to property operating costs depending on the timing of major maintenance project costs.

Net income from equity accounted investments increased by \$115.3 million in Q4 2017 compared to Q3 2017 primarily due to the fair value adjustment on real estate assets increasing by \$117.6 million mainly due to the value of Jackson Park increasing by U.S. \$98.7 million at H&R's ownership interest. An independent third party appraisal was obtained for this property in Q4 2017.

Net income increased by \$246.4 million in Q4 2017 compared to Q3 2017 primarily as a result of an increase in net income from equity accounted investments further explained above, a decrease in deferred income taxes and an increase in fair value adjustments on real estate assets.

Total comprehensive income (loss) increased by \$337.0 million in Q4 2017 compared to Q3 2017 primarily due to the increase in net income previously explained and a greater unrealized gain on translation of U.S. denominated foreign operations.

Selected Annual information

The following table summarizes certain financial information of the Trusts per the Trusts' Financial Statements for the years indicated below:

| (in thousands of Canadian dollars except per unit amounts) | Year Ended December 31, 2017 | Year Ended December 31, 2016 | Year Ended December 31, 2015 |
|---|---|------------------------------------|------------------------------------|
| Rentals from investment properties | \$1,168,454 | \$1,196,011 | \$1,188,314 |
| Net income from equity accounted investments | 167,407 | 48,341 | 841 |
| Finance income | 4,999 | 4,715 | 3,770 |
| Net income | 667,870 | 388,745 | 340,148 |
| Total comprehensive income | 536,598 | 350,378 | 567,609 |
| Total assets | 14,558,863 | 14,155,012 | 13,990,315 |
| Total liabilities | 7,379,100 | 7,242,362 | 7,165,395 |
| Cash distributions per unit | \$1.38 | \$1.35 | \$1.35 |

FINANCIAL HIGHLIGHTS

| (in thousands of Canadian dollars except per unit amounts) | December 31, 2017 | December 31, 2016 | December 31, 2015 |
|---|------------------------------|----------------------|----------------------|
| Total assets | \$14,558,863 | \$14,155,012 | \$13,990,315 |
| Debt to total assets per the Trusts' Financial Statements ⁽¹⁾ | 44.6% ⁽²⁾ | 44.3% | 46.2% |
| Debt to total assets at the Trusts' proportionate share ⁽¹⁾⁽³⁾ | 46.6% ⁽²⁾ | 46.0% | 48.4% |
| Unencumbered asset to unsecured debt coverage ratio ⁽⁴⁾ | 1.69 | 1.76 | 1.38 |
| Stapled Units outstanding | 291,320 | 285,280 | 279,610 |
| Exchangeable units outstanding | 15,979 | 16,564 | 16,664 |

| | Three months ended December 31, 2017 | Three months ended December 31, 2016 | Year ended December 31, 2017 | Year ended December 31, 2016 |
|---|---|--|---|------------------------------------|
| Rentals from investment properties | \$298,042 | \$305,500 | \$1,168,454 | \$1,196,011 |
| Property operating income | 199,414 | 202,366 | 741,441 | 764,740 |
| Same-Asset property operating income (cash basis) ⁽³⁾ | 180,650 | 182,291 | 720,572 | 716,879 |
| Net income from equity accounted investments | 118,337 | 82,176 | 167,407 | 48,341 |
| Net income | 325,213 | 140,616 | 667,870 | 388,745 |
| FFO ⁽³⁾ | 137,447 | 142,899 | 560,090 | 584,301 |
| Weighted average number of basic Stapled Units for FFO ⁽³⁾ | 306,629 | 300,482 | 304,462 | 298,404 |
| FFO per basic Stapled Unit ⁽³⁾ | 0.45 | 0.48 | 1.84 | 1.96 |
| Distributions paid per Stapled Unit | 0.35 | 0.34 | 1.38 | 1.35 |
| Payout ratio per Stapled Unit as a % of FFO ⁽³⁾ | 77.8% | 70.8% | 75.0% | 68.9% |
| Interest coverage ratio ⁽³⁾ | 2.99 | 2.90 | 3.00 | 2.81 |

Net income is reconciled to FFO which is reconciled to AFFO. See page 34.

⁽¹⁾ Debt includes mortgages payable, debentures payable and bank indebtedness.

⁽²⁾ H&R had \$115.1 million in restricted cash relating to Internal Revenue Code Section 1031 ("Section 1031") U.S. property exchanges, at the Trusts' proportionate share. These funds were released in January 2018 and were used to repay bank indebtedness. Debt to total assets per the Trusts' Financial Statements and at the Trusts' proportionate share would have been 44.2% and 46.2%, respectively, as at December 31, 2017 if these funds were available in 2017.

⁽³⁾ These are non-GAAP measures. See the "Non-GAAP Financial Measures" section of this MD&A.

⁽⁴⁾ Unencumbered assets are investment properties and properties under development without encumbrances for mortgages or bank indebtedness. Unsecured debt includes senior debentures and H&R's unsecured bank facilities.

KEY PERFORMANCE DRIVERS

The following table is presented at the Trusts' proportionate share and includes investment properties classified as assets held for sale:

| OPERATIONS⁽¹⁾ | | Office | Primaris | H&R Retail | ECHO | Industrial | Lantower Residential | Total |
|---|-------------|----------------|-----------------------------|----------------|----------------|---------------|-------------------------|----------------|
| <i>Occupancy as at December 31</i> | 2017 | 97.0% | 92.6% ⁽³⁾ | 97.4% | 94.1% | 98.4% | 90.0% | 95.6% |
| | 2016 | 96.9% | 87.4% | 98.6% | 94.3% | 99.8% | 93.1% | 95.7% |
| <i>Occupancy – Same-Asset as at December 31⁽¹⁾</i> | 2017 | 98.3% | 92.6% ⁽³⁾ | 97.4% | 93.8% | 98.3% | 93.9% | 96.5% |
| | 2016 | 98.3% | 87.4% | 98.6% | 94.2% | 99.7% | 94.5% | 96.1% |
| <i>Average contractual rent per sq.ft. for the year ended December 31-Canadian properties⁽²⁾</i> | 2017 | \$25.92 | \$23.36 | \$11.75 | N/A | \$6.65 | N/A | \$18.10 |
| | 2016 | \$26.12 | \$23.83 | \$11.70 | N/A | \$6.52 | N/A | \$18.32 |
| <i>Average contractual rent per sq.ft. for the year ended December 31-U.S. properties (USD)⁽²⁾</i> | 2017 | \$35.75 | N/A | \$13.11 | \$15.17 | \$3.54 | \$15.99 | \$16.77 |
| | 2016 | \$35.07 | N/A | \$13.25 | \$15.01 | \$3.64 | \$14.99 | \$14.79 |
| <i>Average remaining term to maturity of leases as at December 31 (in years)</i> | 2017 | 11.8 | 4.9 | 6.1 | 10.6 | 7.2 | N/A | 9.1 |
| | 2016 | 12.6 | 4.6 | 7.1 | 11.3 | 7.5 | N/A | 9.5 |
| <i>Average remaining term to maturity of mortgages payable as at December 31 (in years)</i> | 2017 | 5.0 | 4.2 | 5.0 | 11.0 | 6.0 | 8.4 | 5.6 |
| | 2016 | 5.2 | 4.3 | 5.8 | 11.1 | 6.4 | 8.3 | 5.7 |

⁽¹⁾ Same-Asset refers to those properties owned by H&R for the two-year period ended December 31, 2017.

⁽²⁾ Excludes properties sold in their respective year.

⁽³⁾ Primaris Occupancy and Occupancy-Same Asset as at December 31, 2017 includes eight Sears' store locations totalling 609,749 square feet which closed and became vacant in January 2018. Primaris Occupancy would have been 84.9% had these eight Sears store locations become vacant as at December 31, 2017.

PORTFOLIO OVERVIEW

The geographic diversification of the portfolio of properties in which the Trusts have an interest and their related square footage, are disclosed at the Trusts' proportionate share as at December 31, 2017 in the tables below:

| Number of Properties⁽¹⁾ | Canada | | | United States | Total |
|---|----------------|----------------|--------------|----------------------|--------------|
| | Ontario | Alberta | Other | | |
| Office | 20 | 5 | 4 | 7 | 36 |
| Primaris | 6 | 18 | 7 | - | 31 |
| H&R Retail | 35 | 2 | 7 | 79 | 123 |
| ECHO ⁽²⁾ | - | - | - | 227 | 227 |
| Industrial | 39 | 18 | 30 | 6 | 93 |
| Lantower Residential ⁽³⁾ | - | - | - | 17 | 17 |
| Total | 100 | 43 | 48 | 336 | 527 |

| Square Feet (in thousands) | Canada | | | United States | Total |
|-------------------------------------|----------------|----------------|--------------|----------------------|---------------|
| | Ontario | Alberta | Other | | |
| Office | 6,416 | 2,960 | 893 | 2,023 | 12,292 |
| Primaris | 2,096 | 3,859 | 2,095 | - | 8,050 |
| H&R Retail | 1,773 | 240 | 707 | 4,455 | 7,175 |
| ECHO ⁽²⁾ | - | - | - | 3,150 | 3,150 |
| Industrial | 4,941 | 1,895 | 2,053 | 1,068 | 9,957 |
| Lantower Residential ⁽³⁾ | - | - | - | 5,309 | 5,309 |
| Total | 15,226 | 8,954 | 5,748 | 16,005 | 45,933 |

⁽¹⁾ H&R has one parcel of vacant land and ownership interests in three development projects which are not included in the table above.

⁽²⁾ ECHO has five parcels of vacant land and three development projects which are not included in the table above.

⁽³⁾ Lantower Residential's properties contain 5,633 multi-family units.

LEASE MATURITY PROFILE

The following tables disclose H&R's leases expiring in Canada and the United States at the Trusts' proportionate share, excluding Lantower Residential.

Canadian Portfolio:

| LEASE EXPIRIES | Office | | Primaris | | H&R Retail | | Industrial | | Total | |
|-------------------------|-----------|--------------------------------|-----------|--------------------------------|------------|--------------------------------|------------|--------------------------------|------------|--------------------------------|
| | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry |
| 2018 | 272,968 | 21.83 | 1,413,967 | 17.13 | 159,696 | 11.02 | 350,124 | 3.81 | 2,196,755 | 15.15 |
| 2019 | 518,089 | 21.12 | 1,019,904 | 21.17 | 900,090 | 10.29 | 1,120,477 | 6.40 | 3,558,560 | 13.76 |
| 2020 | 229,268 | 22.08 | 901,755 | 21.65 | 98,095 | 15.36 | 725,664 | 8.49 | 1,954,782 | 16.50 |
| 2021 | 464,013 | 19.51 | 691,401 | 26.94 | 530,249 | 12.99 | 276,949 | 5.83 | 1,962,612 | 18.44 |
| 2022 | 651,687 | 24.35 | 743,612 | 23.65 | 117,867 | 14.50 | 1,147,156 | 6.82 | 2,660,322 | 16.16 |
| | 2,136,025 | 21.95 | 4,770,639 | 21.29 | 1,805,997 | 11.70 | 3,620,370 | 6.66 | 12,333,031 | 15.70 |
| Total % of each segment | 20.8% | | 59.3% | | 66.4% | | 40.7% | | 41.2% | |

During the year ended December 31, 2017, H&R renewed and/or re-leased 994,580 square feet of its 2018 lease expiries reported as at December 31, 2016. Included in the Primaris 2018 lease expiries above are eight Sears' stores locations totalling 609,749 square feet which closed and became vacant in January 2018.

U.S. Portfolio⁽¹⁾:

| LEASE EXPIRIES | Office | | H&R Retail | | ECHO | | Industrial | | Total | |
|-------------------------|--------|--------------------------------|------------|--------------------------------|---------|--------------------------------|------------|--------------------------------|-----------|--------------------------------|
| | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry | Sq.ft. | Rent per sq.ft. (\$) on expiry |
| 2018 | - | - | 219,707 | 10.54 | 177,294 | 10.71 | 145,056 | 3.78 | 542,057 | 8.79 |
| 2019 | - | - | 418,227 | 11.19 | 107,665 | 13.58 | - | - | 525,892 | 11.68 |
| 2020 | - | - | 111,158 | 38.36 | 360,665 | 7.74 | - | - | 471,823 | 14.95 |
| 2021 | - | - | 284,494 | 12.88 | 141,892 | 17.41 | 341,396 | 2.14 | 767,782 | 8.94 |
| 2022 | 563 | 71.76 | 1,213,323 | 11.32 | 163,688 | 16.35 | 54,654 | 4.94 | 1,432,228 | 11.68 |
| | 563 | 71.76 | 2,246,909 | 12.75 | 951,204 | 11.88 | 541,106 | 2.86 | 3,739,782 | 11.11 |
| Total % of each segment | 0.0% | | 50.4% | | 30.2% | | 50.7% | | 35.0% | |

⁽¹⁾ U.S. dollars.

During the year ended December 31, 2017, H&R renewed and/or re-leased 152,642 square feet of its 2018 lease expiries reported as at December 31, 2016.

TOP TWENTY SOURCES OF REVENUE BY TENANT

The following table discloses H&R's top twenty tenants at the Trusts' proportionate share:

| Tenant | % of rentals from investment properties ⁽¹⁾ | Number of locations | H&R owned sq.ft. (in 000's) | Average lease term to maturity (in years) ⁽²⁾ | Credit Ratings (S&P) |
|--|--|---------------------|-----------------------------|--|----------------------|
| 1. Encana Corporation ⁽³⁾ | 11.8% | 2 | 2,016 | 20.2 | BBB Negative |
| 2. Bell Canada | 8.3% | 24 | 2,539 | 7.6 | BBB+ Stable |
| 3. Hess Corporation | 5.2% | 2 | 848 | ⁽⁸⁾ | BBB- Stable |
| 4. New York City Department of Health | 3.6% | 1 | 660 | 12.9 | AA Stable |
| 5. Giant Eagle, Inc. | 3.5% | 191 | 1,900 | 12.7 | Not Rated |
| 6. Lowe's Companies, Inc. ⁽⁴⁾ | 2.6% | 22 | 2,664 | 3.2 | A- Stable |
| 7. Canadian Tire Corporation ⁽⁵⁾ | 2.5% | 19 | 2,636 | 7.9 | BBB+ Stable |
| 8. TransCanada Pipelines Limited | 2.1% | 2 | 542 | 12.1 | A- Negative |
| 9. Canadian Imperial Bank of Commerce | 1.7% | 9 | 555 | 6.4 | A+ Stable |
| 10. Corus Entertainment Inc. | 1.7% | 1 | 472 | 15.2 | BB Stable |
| 11. Telus Communications | 1.5% | 18 | 426 | 5.9 | BBB+ Stable |
| 12. Government of Ontario | 1.2% | 4 | 370 | 2.5 | A+ Stable |
| 13. Shell Oil Products | 1.2% | 17 | 223 | 4.5 | A+ Positive |
| 14. Toronto-Dominion Bank | 1.0% | 8 | 280 | 8.9 | AA- Stable |
| 15. Public Works and Government Services, Canada | 0.9% | 5 | 307 | 4.4 | AAA Stable |
| 16. Empire Company Limited ⁽⁶⁾ | 0.9% | 15 | 565 | 7.3 | BB+ Stable |
| 17. Loblaw Companies Limited ⁽⁷⁾ | 0.9% | 20 | 287 | 8.7 | BBB Stable |
| 18. Royal Bank of Canada | 0.9% | 4 | 244 | 6.6 | AA- Negative |
| 19. Publix Super Markets, Inc. | 0.8% | 16 | 555 | 8.5 | Not Rated |
| 20. Wal-Mart Stores, Inc. | 0.7% | 10 | 859 | 5.6 | AA Stable |
| Total | 53.0% | 390 | 18,948 | 11.1 | |

⁽¹⁾ The percentage of rentals from investment properties is based on estimated annualized gross revenue excluding straight-lining of contractual rent, rent amortization of tenant inducements and capital expenditure recoveries.

⁽²⁾ Average lease term to maturity is weighted based on net rent.

⁽³⁾ Encana Corporation has sublet 27 floors to Cenovus Energy at The Bow located in Calgary, AB. Encana Corporation's lease obligations expire on May 13, 2038.

⁽⁴⁾ Lowe's Companies, Inc. includes Rona.

⁽⁵⁾ Canadian Tire Corporation includes Canadian Tire, Mark's, Sport Chek, Atmosphere and Sports Experts.

⁽⁶⁾ Empire Company Limited includes Sobeys, Sobey's Liquor, Safeway and Lawtons Drugs.

⁽⁷⁾ Loblaw Companies Limited includes Loblaw, No Frills and Shoppers Drug Mart.

⁽⁸⁾ Due to the confidentiality under the tenant's lease, the term is not disclosed.

| Primaris Enclosed Shopping Centres | All Store Sales (in thousands of Canadian dollars) Rolling 12 month ended December 31 | | | Same Store Sales (per square foot) Rolling 12 month ended December 31 | | |
|--------------------------------------|---|--------------------|---------------|---|--------------|-------------|
| | 2017 | 2016 | % Change | 2017 | 2016 | % Change |
| Cataraqui Town Centre ⁽¹⁾ | \$86,340 | \$87,874 | (1.7%) | \$526 | \$510 | 3.1% |
| Dufferin Mall | 121,296 | 113,645 | 6.7 | 689 | 683 | 0.9 |
| Grant Park ⁽¹⁾ | 26,662 | 25,269 | 5.5 | 455 | 443 | 2.7 |
| Kildonan Place ⁽¹⁾ | 80,876 | 77,355 | 4.6 | 537 | 525 | 2.3 |
| McAllister Place ⁽¹⁾ | 53,280 | 56,263 | (5.3) | 482 | 507 | (4.9) |
| Medicine Hat Mall | 50,572 | 55,125 | (8.3) | 394 | 421 | (6.4) |
| Orchard Park Shopping Centre | 167,793 | 166,362 | 0.9 | 699 | 691 | 1.2 |
| Park Place Shopping Centre | 84,789 | 87,527 | (3.1) | 624 | 617 | 1.1 |
| Peter Pond Mall | 71,857 | 70,615 | 1.8 | 669 | 635 | 5.4 |
| Place d'Orleans ⁽¹⁾ | 94,301 | 96,936 | (2.7) | 461 | 464 | (0.6) |
| Place du Royaume ⁽¹⁾ | 104,257 | 105,982 | (1.6) | 413 | 407 | 1.5 |
| Regent Mall ⁽¹⁾ | 81,109 | 81,410 | (0.4) | 560 | 563 | (0.5) |
| Sherwood Park Mall | 46,079 | 49,122 | (6.2) | 497 | 509 | (2.4) |
| St. Albert Centre | 31,365 | 29,729 | 5.5 | 474 | 486 | (2.5) |
| Stone Road Mall | 112,683 | 109,822 | 2.6 | 621 | 614 | 1.1 |
| Sunridge Mall | 96,237 | 100,791 | (4.5) | 499 | 497 | 0.4 |
| Total⁽²⁾⁽³⁾ | \$1,309,496 | \$1,313,827 | (0.3%) | \$545 | \$542 | 0.6% |

⁽¹⁾ All store sales and same-store sales have been reported as if Primaris owned 100% of Cataraqui Town Centre, Grant Park, Kildonan Place, McAllister Place, Place d'Orleans, Place du Royaume and Regent Mall for the entire rolling 12 months ended December 31, 2017 and 2016.

⁽²⁾ The total same-store sales figures have been presented on a weighted average basis.

⁽³⁾ Excludes Northland Village which is preparing for redevelopment.

STRATEGY UPDATE

H&R is pleased to report that it continued to make progress on its strategic initiatives, improving on three areas of focus: 1) governance, 2) assets, and 3) its investment profile. These improvements add to the significant changes made over the past several years, and are discussed in greater detail in the letter to unitholders accompanying H&R's financial statements and management's discussion and analysis.

Among the more notable conclusions reached in 2017 was a strategic decision to work towards streamlining H&R's property portfolio by narrowing its focus to fewer property types, which led to the plans to sell H&R's U.S. industrial and retail property portfolios. Management expects that narrowing H&R's focus will streamline operations, while also making it easier for investors to understand and appreciate the business, strategy, and opportunity management and the board of trustees see in H&R's units.

In November 2017, H&R announced plans to sell all 79 of its wholly-owned U.S. retail properties and, together with its partners, 12 remaining U.S. industrial properties. During Q4 2017, six U.S. industrial properties were sold for U.S. \$106.1 million, at H&R's ownership interest. The net proceeds from these sales, after mortgage repayments, amounted to approximately U.S. \$79.4 million, which were used to fund Lantower Residential acquisitions.

At December 31, 2017, H&R valued its U.S. retail assets (exclusive of its investment in ECHO) under International Financial Reporting Standards ("IFRS") at U.S. \$752.7 million and its ownership interest of the six remaining U.S. industrial properties at approximately U.S. \$45.2 million. H&R expects to achieve aggregate sales proceeds approximating these values.

Management and the board of trustees of H&R will continue to evaluate all aspects of the business on an ongoing basis, looking for ways to create unitholder value, best position the REIT for long-term success and enhance the profile of H&R among investors. In the pursuit of these objectives, H&R will continue to be guided by its core goal of building a high quality portfolio of real estate in order to deliver strong per unit performance over the long-term.

FINANCIAL AND OPERATING HIGHLIGHTS 2017

Financial Highlights

H&R continued to recycle capital by selling certain investment properties and equity accounted investments between January 1, 2016 and December 31, 2017 for total proceeds of \$1.2 billion and acquiring \$915.1 million in new properties during such period. These acquisitions were primarily in the multi-family segment in the U.S.

- Property operating income decreased by \$23.3 million for the year ended December 31, 2017 compared to the respective 2016 period, primarily due to net property dispositions discussed above.
- Same-Asset property operating income (cash basis) increased by \$3.7 million for the year ended December 31, 2017 compared to the respective 2016 period.
- Net income increased by \$279.1 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to lower deferred income taxes, an increase in net income from equity accounted investments and fair value adjustments on financial instruments partially offset by a decrease in fair value adjustments on real estate assets.
- FFO was \$1.84 per Stapled Unit for the year ended December 31, 2017 compared to \$1.96 per Stapled Unit for the year ended December 31, 2016. The decrease is primarily due to \$1.0 million received in lease settlement payments from Target in 2017 compared to \$20.4 million received in 2016 and the net property dispositions discussed above, partially offset by an \$8.9 million realized gain on sale of investment in Q2 2017.

Although the net property dispositions have reduced overall rent, property operating income, net income before income taxes and FFO, the net proceeds were used to repay debt and has strengthened H&R's balance sheet. As at December 31, 2017, the debt to total asset ratio per the Trusts' Financial Statements was 44.6% compared to 46.2% as at December 31, 2015. The interest coverage ratio was 3.00 for the year ended December 31, 2017 compared to 2.81 for the year ended December 31, 2016.

Operating Highlights

Occupancy as at December 31, 2017 was 95.6% compared to 95.7% as at December 31, 2016. Commercial leases representing only 6.7% of total rentable area will expire during 2018. H&R's average remaining lease term to maturity as at December 31, 2017 was 9.1 years.

SUMMARY OF SIGNIFICANT 2017 ACTIVITY

Developments

H&R continues to make significant progress with its value creating development program.

The development of the 1,871 luxury residential rental units known as "Jackson Park" in Long Island City, NY, in which H&R has a 50% ownership interest, is nearing completion. The project is on budget with approximately \$197.8 million of costs remaining to complete of which will be funded from the construction facility. To date, the first tower has obtained certificates of occupancy for 333 units. The leasing office for Jackson Park opened in November 2017 and lease-up is expected to occur throughout 2018 and 2019. To date, 125 leases have been entered into and 80 units are currently occupied. Part of the amenity space is expected to open in April 2018. First occupancies in the second and third towers are expected to start during Q2 2018. The property was appraised as of December 31, 2017 by a nationally recognized independent firm of appraisers for a value of U.S. \$1.27 billion as compared to total project costs at December 31, 2017 of U.S. \$963.5 million resulting in a 2017 fair value increase of U.S. \$197.4 million (December 31, 2016 - U.S. \$109.7 million). As H&R's investment in Jackson Park is accounted for as an equity investment, this increase in fair value has been recorded as part of net income from equity accounted investments and not as a fair value adjustment on real estate assets. Upon stabilized occupancy of all three towers, the first year's property operating income at H&R's ownership interest is projected to be U.S. \$36.9 million.

In January 2017, H&R acquired a mortgage receivable for U.S. \$34.0 million secured against nine acres of land in Miami, FL. The urban in-fill development site, known as "River Landing", fronts immediately on the Miami River, adjacent to the Health District and in close proximity to downtown Miami, and is zoned for a mixed-use development including approximately 480,000 square feet of retail and office space and over 500 multi-family units. As at December 31, 2017, the mortgage receivable outstanding was U.S. \$67.1 million.

In Q2 2017, the development of two industrial properties in the Airport Road Business Park in Brampton, ON reached substantial completion and were transferred from properties under development to investment properties. Each of these properties were pre-leased for 15 years to Solutions 2 Go Inc. and Sleep Country Canada. The net leasable area of the property leased to Solutions 2 Go Inc. is 215,020 square feet and the tenant's lease commenced in May 2017. The net leasable area of the property leased to Sleep Country Canada is 127,040 square feet and the tenant's lease commenced in September 2017.

H&R has a 31.7% non-managing interest in 38.4 acres of land located in Hercules, CA, adjacent to the San Pablo Bay, northeast of San Francisco, for the future development of multi-family units (“Hercules Project”). This waterfront, multi-phase, master-planned, in-fill mixed-use development surrounds a future intermodal transit centre, including train and ferry service, and is adjacent to an 11 acre waterfront future regional park. The initial investment to purchase the land was approximately U.S. \$10.0 million (at H&R’s ownership interest). As at December 31, 2017, H&R’s investment was U.S. \$12.5 million. Phase 1 of the Hercules Project will consist of 172 multi-family units and construction will commence in May 2018. The total budget for this phase is expected to be U.S. \$78.1 million at the 100% level. Construction financing of approximately U.S. \$50.0 million is expected to be secured in Q1 2018.

In July 2017, H&R acquired a 33.3% non-managing ownership interest in approximately 5.0 acres of land in Austin, TX (“Koenig Project”) for the future development of 391 multi-family units with construction expected to commence mid-2018. This multi-residential development site is close to major technology employers like Apple, IBM, Oracle, and Samsung, as well as the University of Texas at Austin and downtown Austin. As at December 31, 2017, H&R’s investment was approximately U.S. \$5.6 million.

As at December 31, 2017, H&R has a mortgage receivable outstanding of U.S. \$42.8 million secured against an office property currently under construction and against an adjacent 4.8 acres of land located in Dallas’s downtown core (“2217 Bryan St.”). This project includes the re-development of a 93,000 square foot existing historical building into state-of-the-art office space. To date, approximately 63.0% has been pre-leased. The 4.8 acres of excess land is well located in the downtown core, and is expected to be developed into a multi-family property.

Lantower Residential

In April 2017, Lantower Residential acquired 375 multi-family units at 14233 The Lakes Blvd., in Austin, TX (“NXNE”) at a purchase price, excluding transaction costs, of approximately U.S. \$51.9 million or approximately U.S. \$138,400 per unit.

In May 2017, Lantower Residential purchased a property under development at 14301 N. Interstate 35 in Austin, TX (“Ambrosio”) which is located adjacent to NXNE. Ambrosio was substantially completed and transferred to investment properties in November 2017. The property is comprised of 370 units and the total cost was U.S. \$52.8 million or approximately U.S. \$142,000 per unit. NXNE and Ambrosio provide Lantower Residential with a significant presence in the Tech Ridge submarket of Austin.

In September 2017, Lantower Residential sold 12510 South Green Dr. in Houston, TX (“Parc at South Green”) for U.S. \$32.2 million which it had purchased in November 2014 for U.S. \$28.0 million.

In October 2017, Lantower Residential acquired 451 multi-family units at 1810 Sweetbroom Circle in Tampa, FL (“Cypress Creek”) at a purchase price, excluding transaction costs, of approximately U.S. \$78.9 million or approximately U.S. \$174,900 per unit.

In November 2017, Lantower Residential acquired 282 multi-family units at 11660 Westwood Blvd., in Orlando, FL (“Grande Pines”) at a purchase price, excluding transaction costs, of approximately U.S. \$59.5 million or approximately U.S. \$211,000 per unit.

In December 2017, Lantower Residential acquired 450 multi-family units at 10440 Sanderling Shores Dr., in Lutz, FL (“Brandon Crossroads”) at a purchase price, excluding transaction costs, of approximately U.S. \$94.0 million or approximately U.S. \$208,900 per unit.

In December 2017, Lantower Residential acquired 301 multi-family units at 2600 Lake Ridge Rd., Lewisville, TX (“Legacy Lakes”) at a purchase price, excluding transaction costs, of approximately U.S. \$49.7 million or approximately U.S. \$165,000 per unit.

As at December 31, 2017, Lantower Residential had a portfolio of 17 properties in the U.S. comprised of 5,633 multi-family units, with an average age of 7.3 years along with two properties currently under construction (Jackson Park and the Hercules Project) which will, when completed, comprise an additional 990 multi-family units, at H&R’s ownership interest.

Primaris

The enclosed mall portfolio same store sales productivity increased to \$545 per square foot for the 12-month period ending December 31, 2017 an increase from the \$542 per square foot during the prior year. Primaris continues to realize strong tenant demand having completed 164 new lease transactions during 2017, which has driven the occupancy rate to 92.6%, a substantial increase from the 87.4% at the beginning of the year. Including tenants committed, but not yet open and adjusting for the closure of eight Sears’ stores in January 2018, the occupancy rate would be 86.2%.

In January 2017, H&R sold a 50% non-managing interest in two enclosed shopping centres; Catarqui Town Centre in Kingston, ON and Place du Royaume in Chicoutimi, QC for \$211.6 million. The purchaser assumed 50% of the existing financing on the properties of approximately \$126.6 million.

Target:

For the year ended December 31, 2017, H&R spent approximately \$70.3 million in redeveloping the former Target Canada Co. (“Target”) stores. The following table is a summary of H&R’s leasing progress on the former Target space:

| | Square Feet at 100% | Square Feet at H&R’s Ownership Interest | Annual Base Rent at H&R’s Ownership Interest (\$ Millions) |
|---|---------------------|---|--|
| Former Target Canada space | 1,062,676 | 774,035 | \$4.0 |
| Backfill progress: | | | |
| Committed space in occupancy | 549,695 | 392,913 | 6.8 |
| Committed space not yet in occupancy | 91,743 | 49,438 | 0.7 |
| Conditional agreements | 59,872 | 52,217 | 0.9 |
| Advanced discussions | 93,095 | 85,595 | 1.4 |
| Total backfill progress | 794,405 | 580,163 | 9.8 |
| Space currently being marketed | 40,854 | 22,370 | 0.4 |
| Total gross leasable area (“GLA”) upon completion of redevelopment | 835,259 | 602,533 | \$10.2 |
| Expected GLA to be converted to common area | 169,793 | 142,690 | N/A |
| Space for demolition/potential redevelopment | 57,624 | 28,812 | N/A |
| Total | 1,062,676 | 774,035 | |

H&R expects leases for most of the remaining space will be entered into by Q2 2018, with occupancy occurring between Q1 2018 and Q3 2020.

Sears:

Total Sears basic rent, at H&R’s ownership interest, amounted to \$2.3 million which equates to an average net rent of \$3.47 per square foot. At less than 0.4% of annualized gross revenue, management expects that Sears’ departure provides an opportunity to increase net operating income through replacement of an unproductive anchor tenant paying rents well below market rates with tenants that will generate increased rent and traffic to the properties. While disruptive in the short term, management is confident that the replacement of Sears will enhance the profile of these properties and create value for unitholders.

The Trusts’ Internal Reorganization

On October 19, 2017, the Trusts announced a proposed internal reorganization (the “Reorganization”) intended to continue the benefits of the existing Stapled Unit structure that has been in place since 2008. Joint meetings of Unitholders were held on December 7, 2017 to approve the Reorganization. The Unitholders approved the proposed Reorganization, with approximately 99.8% of the Unitholders of each of H&R and Finance Trust, respectively, voting in favour of the Reorganization.

On December 14, 2017, the Trusts received a final order from the Court of Queen’s Bench of Alberta approving the Reorganization. As a result of certain considerations, including the enactment of the U.S. federal income tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 (“U.S. Tax Reform”), H&R has decided not to consummate the Reorganization in its original form as it has concluded that the Stapled Unit structure with H&R Finance Trust is no longer necessary. Accordingly, H&R is in the process of seeking the necessary approvals to implement a modified Reorganization in 2018 with the effect of unwinding the Stapled Unit structure.

Debt and Liquidity Highlights

During 2017, H&R issued the following debentures:

| Senior Debentures | Maturity | Contractual Interest Rate | Principal Amount |
|---|------------------|---------------------------|------------------|
| Series L Senior Debentures ⁽¹⁾ | May 6, 2022 | 2.92% | \$125,000 |
| Series M Senior Debentures | July 23, 2019 | ⁽²⁾ | 150,000 |
| Series N Senior Debentures | January 30, 2024 | 3.37% | 350,000 |
| | | | \$625,000 |

⁽¹⁾ In November 2016, H&R issued \$200.0 million principal amount of 2.92% Series L senior debentures and the total principal amount outstanding is therefore \$325.0 million.

⁽²⁾ Bears interest at a rate equal to 3-month Canadian Dealer Offered Rate plus 123 basis points.

During 2017, H&R redeemed the following debentures:

| Debentures | Maturity/Redemption | Contractual Interest Rate | Principal Amount |
|---------------------------------------|---------------------|---------------------------|------------------|
| Series I Senior Debentures | January 23, 2017 | 2.54% | \$60,000 |
| Series B Senior Debentures | February 3, 2017 | 5.90% | 115,000 |
| 2018 Convertible Debentures (HR.DB.H) | September 21, 2017 | 5.40% | 74,394 |
| | | | \$249,394 |

During 2017, H&R secured 10 new mortgages and increased an existing mortgage adding a total of \$611.5 million of debt at a weighted average interest rate of 3.6% for an average term of 8.6 years and repaid or had purchasers assume 12 mortgages totalling \$579.7 million, which had a weighted average interest rate of 4.4%. The weighted average interest rate on mortgages and debentures payable as at December 31, 2017 was 4.0% with an average term to maturity of 4.5 years.

In March 2017, H&R, through Primaris, extended the maturity date of its \$300.0 million secured operating facility which was originally due in December 2017 to July 2019. As at December 31, 2017, the Trusts had \$42.3 million of cash on hand, \$313.4 million available under its bank credit facilities and an unencumbered property pool of approximately \$3.6 billion. In January 2018, H&R obtained an additional \$200.0 million unsecured revolving operating facility maturing in January 2023.

SECTION III

FINANCIAL POSITION

| (in thousands of Canadian dollars) | December 31, 2017 | December 31, 2016 |
|--|------------------------------|----------------------|
| Assets | | |
| Real estate assets | | |
| Investment properties | \$13,074,123 | \$12,564,144 |
| Properties under development | 83,132 | 118,268 |
| | 13,157,255 | 12,682,412 |
| Equity accounted investments | 1,125,135 | 1,051,187 |
| Assets classified as held for sale | - | 211,550 |
| Other assets | 234,189 | 161,842 |
| Cash and cash equivalents | 42,284 | 48,021 |
| | \$14,558,863 | \$14,155,012 |
| Liabilities and Unitholders' Equity | | |
| Liabilities | | |
| Mortgages payable | \$3,958,631 | \$4,001,451 |
| Debentures payable | 1,852,790 | 1,491,591 |
| Exchangeable units | 341,321 | 370,533 |
| Deferred tax liability | 325,131 | 386,775 |
| Liabilities classified as held for sale | - | 126,815 |
| Bank indebtedness | 682,196 | 647,772 |
| Accounts payable and accrued liabilities | 219,031 | 217,425 |
| | 7,379,100 | 7,242,362 |
| Unitholders' equity | 7,179,763 | 6,912,650 |
| | \$14,558,863 | \$14,155,012 |

ASSETS

Real Estate Assets:

2017 Acquisitions:

| Property | Year Built | Segment | Date Acquired | Number of Units | Purchase Price (\$ Millions) ⁽¹⁾ | Ownership Interest Acquired |
|---|------------|--------------|---------------|-----------------|---|-----------------------------|
| 14233 The Lakes Blvd., Austin, TX | 2016 | Multi-family | Apr 7, 2017 | 375 | \$69.5 | 100% |
| 14301 N. Interstate Hwy. 35, Austin, TX | 2017 | Multi-family | May 26, 2017 | 370 | 71.3 | 100% |
| 1810 Sweetbroom Circle, Lutz, FL | 2010 | Multi-family | Oct 10, 2017 | 451 | 98.6 | 100% |
| 11660 Westwood Blvd., Orlando, FL | 2017 | Multi-family | Nov 15, 2017 | 282 | 76.2 | 100% |
| 10440 Sanderling Shores Dr., Tampa, FL | 2016 | Multi-family | Dec 11, 2017 | 450 | 121.3 | 100% |
| 2600 Lake Ridge Rd., Lewisville, TX | 2016 | Multi-family | Dec 12, 2017 | 301 | 64.1 | 100% |
| Total | | | | 2,229 | \$501.0 | |

⁽¹⁾ U.S. acquisitions have been translated to Canadian dollars at the exchange rate as at the date acquired.

2016 Acquisitions:

| Property | Year Built | Segment | Date Acquired | Number of Units | Purchase Price (\$ Millions) ⁽²⁾ | Ownership Interest Acquired |
|--|------------|--------------|---------------|-----------------|---|-----------------------------|
| 283009 Logistics Dr., Calgary, AB ⁽¹⁾ | 2014 | Industrial | Feb 23, 2016 | N/A | \$15.5 | 50% |
| 3767 Southwest Durham Dr., Durham, NC | 2014 | Multi-family | Jun 22, 2016 | 322 | 76.8 | 100% |
| 4025 Huffines Blvd., Carrollton, TX | 2012 | Multi-family | Aug 15, 2016 | 312 | 59.9 | 100% |
| 4504 W. Spruce St., Tampa, FL | 2014 | Multi-family | Oct 19, 2016 | 300 | 90.6 | 100% |
| 327 W. Sunset Rd., San Antonio, TX | 2015 | Multi-family | Nov 30, 2016 | 312 | 76.2 | 100% |
| Total | | | | 1,246 | \$319.0 | |

⁽¹⁾ Purchase price is stated at H&R's ownership interest. The square footage at H&R's ownership interest is 132,401.

⁽²⁾ U.S. acquisitions have been translated to Canadian dollars at the exchange rate as at the date acquired.

2017 Dispositions:

| Property | Segment | Date Sold | Square Feet | Selling Price (\$ Millions) ⁽⁴⁾ | Ownership Interest Sold |
|---|--------------|--------------|------------------|--|-------------------------|
| Place du Royaume, Chicoutimi, QC ⁽¹⁾⁽²⁾ | Primaris | Jan 16, 2017 | 301,859 | \$109.0 | 50% |
| Cataraqui Town Centre, Kingston, ON ⁽¹⁾⁽²⁾ | Primaris | Jan 16, 2017 | 310,311 | 102.6 | 50% |
| 914 E. North Ave., Belton, MO | Retail | Jan 27, 2017 | 88,248 | 13.9 | 100% |
| 2940 N. Broadway, Anderson, IN | Retail | Mar 31, 2017 | 39,877 | 2.7 | 100% |
| 8766 E. 96th St., Fishers, IN | Retail | Mar 31, 2017 | 80,960 | 5.3 | 100% |
| 2800 Skymark Ave., Mississauga, ON ⁽³⁾ | Office | Q2-Q3 2017 | 12,202 | 1.6 | 100% |
| 189/203 Queen St. N., Tilbury, ON ⁽¹⁾ | Industrial | Aug 21, 2017 | 85,068 | 3.8 | 50% |
| 12510 South Green Dr., Houston, TX ⁽⁵⁾ | Multi-family | Sep 27, 2017 | 323,568 | 39.9 | 100% |
| Total | | | 1,242,093 | \$278.8 | |

⁽¹⁾ Square feet and selling price are based on the ownership interest disposed.

⁽²⁾ H&R retained an ownership interest of 50% in these properties.

⁽³⁾ As at December 31, 2017, all condominium units have been sold.

⁽⁴⁾ U.S. dispositions have been translated to Canadian dollars at the exchange rate as at the date sold.

⁽⁵⁾ Property consisted of 428 units.

2016 Dispositions:

| Property | Segment | Date Sold | Square Feet | Selling Price (\$ Millions) ⁽³⁾ | Ownership Interest Sold |
|---|------------|--------------|------------------|--|-------------------------|
| 2800 Skymark Ave., Mississauga, ON ⁽¹⁾ | Office | Q1-Q4 2016 | 22,940 | \$3.2 | 100% |
| 1929 N.E. Pine Island Rd., Cape Coral, FL | H&R Retail | Mar 28, 2016 | 119,598 | 24.1 | 100% |
| 733 Pleasant Hill Rd., Lilburn, GA | H&R Retail | Mar 30, 2016 | 132,847 | 6.0 | 100% |
| 1 Moyal Ct., Vaughan, ON ⁽²⁾ | Industrial | Apr 7, 2016 | 26,396 | 3.0 | 50% |
| 150 New Jersey State Hwy Route 73, Voorhees, NJ | H&R Retail | Apr 11, 2016 | 115,396 | 24.8 | 100% |
| 3712 Call Field Rd., Wichita Falls, TX | H&R Retail | May 19, 2016 | 108,178 | 14.7 | 100% |
| 20600 Clark-Graham Ave., Montreal, QC ⁽²⁾ | Industrial | Aug 31, 2016 | 69,867 | 4.2 | 50% |
| 110 S. Southwest Loop #323, Tyler, TX | H&R Retail | Sep 26, 2016 | 14,820 | 11.2 | 100% |
| 450-1st St. S.W., (TransCanada Tower) Calgary, AB ⁽²⁾⁽⁴⁾ | Office | Nov 17, 2016 | 465,594 | 257.4 | 50% |
| Total | | | 1,075,636 | \$348.6 | |

⁽¹⁾ Sold as separate condominium units.

⁽²⁾ Square feet and selling price are based on the ownership interest disposed.

⁽³⁾ U.S. dispositions have been translated to Canadian dollars at the exchange rate as at the date sold.

⁽⁴⁾ H&R retained an ownership interest of 50% in this property.

Change in Investment Properties:

The following table shows the change in investment properties from January 1, 2017 to December 31, 2017:

| (in thousands of Canadian dollars) | Trusts' Financial Statements | Plus: equity accounted investments | Trusts' proportionate share⁽¹⁾ |
|--|-------------------------------------|---|--|
| Opening balance, beginning of year | \$12,564,144 | \$1,046,539 | \$13,610,683 |
| Acquisitions, including transaction costs | 430,537 | 60,315 | 490,852 |
| Dispositions | (70,062) | (146,197) | (216,259) |
| Transfer from equity accounted investment | 62,500 | (62,500) | - |
| Operating capital | | | |
| Capital expenditures | 51,845 | 11,120 | 62,965 |
| Leasing expenses and tenant inducements | 28,722 | 2,079 | 30,801 |
| Redevelopment (including capitalized interest) | 113,212 | 294 | 113,506 |
| Amortization of tenant inducements, straight-line rents and blend and extend rents included in revenue | (1,478) | 282 | (1,196) |
| Transfer of properties under development that have reached substantial completion to investment properties | 116,525 | 8,079 | 124,604 |
| Fair value adjustment on real estate assets | 3,038 | (14,963) | (11,925) |
| Change in foreign exchange | (224,860) | (58,617) | (283,477) |
| Closing balance, end of year | \$13,074,123 | \$846,431 | \$13,920,554 |

⁽¹⁾ The Trusts' proportionate share is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

Investment Properties by Segment and Region:

The following tables disclose the fair values of the investment properties by operating segment and geographic location, excluding assets held for sale:

| Segment (millions) | December 31, 2017 | | | December 31, 2016 ⁽¹⁾ |
|----------------------|------------------------------|------------------------------------|--|----------------------------------|
| | Trusts' Financial Statements | Plus: equity accounted investments | Trusts' proportionate share ⁽²⁾ | Trusts' Financial Statements |
| Office | \$6,562 | \$ - | \$6,562 | \$6,433 |
| Primaris | 2,946 | - | 2,946 | 2,943 |
| H&R Retail | 1,400 | - | 1,400 | 1,547 |
| ECHO | - | 790 | 790 | - |
| Industrial | 979 | 57 | 1,036 | 886 |
| Lantower Residential | 1,187 | - | 1,187 | 755 |
| Total | \$13,074 | \$847 | \$13,921 | \$12,564 |

(1) Refer to note 3 of the Trusts' Financial Statements for the assumptions and methods used in measuring the fair value of the portfolio.

(2) The Trusts' proportionate share is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

| Geographic Location (millions) | December 31, 2017 | | | December 31, 2016 ⁽¹⁾ |
|--------------------------------|------------------------------|------------------------------------|--|----------------------------------|
| | Trusts' Financial Statements | Plus: equity accounted investments | Trusts' proportionate share ⁽²⁾ | Trusts' Financial Statements |
| Ontario | \$4,378 | \$ - | \$4,378 | \$4,144 |
| Alberta | 3,540 | - | 3,540 | 3,476 |
| Other | 1,344 | - | 1,344 | 1,323 |
| Canada | \$9,262 | - | 9,262 | 8,943 |
| United States | 3,812 | 847 | 4,659 | 3,621 |
| Total | \$13,074 | \$847 | \$13,921 | \$12,564 |

(1) Refer to note 3 of the Trusts' Financial Statements for the assumptions and methods used in measuring the fair value of the portfolio.

(2) The Trusts' proportionate share is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

H&R has utilized the following capitalization rates in estimating the fair value of the investment properties. The capitalization rates disclosed below are reported by segment and geographic location at the Trusts' proportionate share which differs from the Trusts' Financial Statements.

| Weighted Average Overall Capitalization Rates | December 31, 2017 | | | | | | |
|---|-------------------|----------|------------|-------|------------|-------------|-------|
| | Office | Primaris | H&R Retail | ECHO | Industrial | Residential | Total |
| Canada | 5.58% | 5.54% | 6.38% | - | 5.85% | - | 5.63% |
| United States | 5.36% | - | 7.36% | 6.78% | 8.06% | 5.12% | 5.98% |

| Weighted Average Overall Capitalization Rates | December 31, 2016 | | | | | | |
|---|-------------------|----------|------------|-------|------------|-------------|-------|
| | Office | Primaris | H&R Retail | ECHO | Industrial | Residential | Total |
| Canada | 5.77% | 5.45% | 6.55% | - | 6.20% | - | 5.75% |
| United States | 5.39% | - | 7.16% | 6.83% | 6.69% | 5.33% | 6.11% |

Properties under Development

Caledon Industrial Lands

H&R owns 144 acres of land held for development in Caledon, ON, which is expected to accommodate up to 2.7 million buildable square feet of industrial space. This land is located adjacent to Highway 410 between Heartlake Road and Dixie Road. As at December 31, 2017, the carrying value of this property under development was \$83.1 million.

Development of Airport Road Project

In Q2 2017, the development of two industrial properties in the Airport Road Business Park in Brampton, ON reached substantial completion and were transferred from properties under development to investment properties. Each of these properties were pre-leased for 15 years to Solutions 2 Go Inc. and Sleep Country Canada. The net leasable area of the property leased to Solutions 2 Go Inc. is 215,020 square feet and the tenant's lease commenced in May 2017. The net leasable area of the property leased to Sleep Country Canada is 127,040 square feet and the tenant's lease commenced in September 2017.

Ambrosio

In Q2 2017, H&R purchased a multi-family property under development in Austin, TX known as "Ambrosio". This development was substantially completed and transferred to investment properties in Q4 2017. The property is comprised of 370 multi-family units and the total cost was U.S. \$52.8 million. Ambrosio is located adjacent to H&R's NXNE property, which will provide H&R with a significant presence in the Tech Ridge submarket of Austin.

Equity Accounted Investments

| (in thousands of Canadian dollars) | December 31, 2017 | | | | | | | December 31, 2016 ⁽²⁾ |
|------------------------------------|-------------------|--------------|--------------------------------|------------------|----------------|-----------------------------|----------------------|----------------------------------|
| | ECHO | Jackson Park | Six U.S. Industrial Properties | Hercules Project | Koenig Project | Scotia Plaza ⁽¹⁾ | Total ⁽²⁾ | |
| Investment properties | \$789,419 | \$ - | \$57,012 | \$ - | \$ - | \$ - | \$846,431 | \$1,046,539 |
| Properties under development | 10,345 | 783,117 | - | 15,410 | 6,600 | - | 815,472 | 510,527 |
| Other assets | 14,241 | 17,261 | 51,652 | 62 | 95 | 105 | 83,416 | 41,000 |
| Cash and cash equivalents | 7,545 | 3,955 | 51,771 | 268 | 399 | 882 | 64,820 | 34,303 |
| Mortgages payable | (180,253) | - | (18,297) | - | - | - | (198,550) | (328,812) |
| Bank indebtedness | (166,930) | (248,105) | - | - | - | - | (415,035) | (181,250) |
| Other liabilities | (37,061) | (32,306) | (635) | (1) | - | (1,416) | (71,419) | (71,120) |
| Equity accounted investments | \$437,306 | \$523,922 | \$141,503 | \$15,739 | \$7,094 | (\$429) | \$1,125,135 | \$1,051,187 |

(1) Scotia Plaza includes 100 Yonge.

(2) Each of these line items represent the Trusts' proportionate share of equity accounted investments which are reconciled to the total equity accounted investments per the Trusts' Financial Statements. This is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

ECHO

H&R owns a 33.6% interest in ECHO, a privately held real estate and development company which focuses on developing and owning a core portfolio of grocery anchored shopping centres in the United States. ECHO reports its financial results to H&R one month in arrears. The above amounts include ECHO's financial information as at November 30, 2017 and November 30, 2016, respectively.

During the twelve months ended November 30, 2017, ECHO acquired 11 investment properties and three land parcels totalling 176,500 square feet for an aggregate purchase price of U.S. \$41.4 million, at H&R's ownership interest. Major tenants at these properties include Acme Supermarket, Giant Foods, Redner's Supermarket, Publix Supermarket and Harris Teeter. During this period, Echo sold an investment property for gross proceeds of U.S. \$2.5 million, at H&R's ownership interest.

During the twelve months ended November 30, 2016, ECHO acquired four investment properties, four properties under development and two land parcels totaling 94,872 square feet for an aggregate purchase price of U.S. \$16.4 million, at H&R's ownership interest. Major tenants at these properties include Giant Eagle, Inc. and Safeway Inc. During this period ECHO sold an investment property for gross proceeds of U.S. \$1.7 million, at H&R's ownership interest.

Long Island City Project-Jackson Park

The development of the 1,871 luxury residential rental units known as “Jackson Park” in Long Island City, NY, in which H&R has a 50% ownership interest, is nearing completion. The project is on budget with approximately \$197.8 million of costs remaining to complete of which will be funded from the construction facility. To date, the first tower has obtained certificates of occupancy for 333 units. The leasing office for Jackson Park opened in November 2017 and lease-up is expected to occur throughout 2018 and 2019. To date, 125 leases have been entered into and 80 units are currently occupied. Part of the amenity space is expected to open in April 2018. First occupancies in the second and third towers are expected to start during Q2 2018. The property was appraised as of December 31, 2017 by a nationally recognized independent firm of appraisers for a value of U.S. \$1.27 billion as compared to total project costs at December 31, 2017 of U.S. \$963.5 million resulting in a 2017 fair value increase of U.S. \$197.4 million (December 31, 2016 - U.S. \$109.7 million). As H&R’s investment in Jackson Park is accounted for as an equity investment, this increase in fair value has been recorded as part of net income from equity accounted investments and not as a fair value adjustment on real estate assets. Upon stabilized occupancy of all three towers, the first year’s property operating income at H&R’s ownership interest is projected to be U.S. \$36.9 million.

Six U.S. Industrial Properties

As at December 31, 2017, H&R owns a 50.5% interest in six industrial properties through a joint venture with its partners, all of which are located in the United States (December 31, 2016 - 15 properties). During 2017, H&R sold its 50.5% ownership interest in the following properties:

| Property ⁽¹⁾⁽²⁾ | Segment | Date Sold | Square Feet | Selling Price (\$ Millions) | Ownership Interest Sold |
|--|------------|--------------|------------------|-----------------------------|-------------------------|
| 11 Cermak Blvd., Saint Peters, MO | Industrial | Aug 21, 2017 | 71,710 | \$5.9 | 50.5% |
| 827 Graham Dr., Fremont, OH | Industrial | Aug 21, 2017 | 43,634 | 2.9 | 50.5% |
| 15573 Oakwood Dr., Romulus, MI | Industrial | Aug 21, 2017 | 50,740 | 4.2 | 50.5% |
| 12090 Sage Point Ct., Reno, NV | Industrial | Nov 30, 2017 | 348,450 | 18.7 | 50.5% |
| 930 Sherwin Pkwy., Buford, GA | Industrial | Dec 14, 2017 | 231,679 | 15.8 | 50.5% |
| One Nestle Crt., McDonough, GA | Industrial | Dec 14, 2017 | 395,195 | 25.9 | 50.5% |
| 1915-B Fairview Dr., Dekalb, IL | Industrial | Dec 14, 2017 | 434,774 | 35.1 | 50.5% |
| 13600 Independence Pkwy., Fort Worth, TX | Industrial | Dec 14, 2017 | 264,747 | 25.9 | 50.5% |
| 950 Stelzer Rd., Columbus, OH | Industrial | Dec 14, 2017 | 242,785 | 14.5 | 50.5% |
| Total | | | 2,083,714 | \$148.9 | |

⁽¹⁾ Square feet and selling price are based on the ownership interest disposed.

⁽²⁾ U.S. dispositions have been translated to Canadian dollars at the exchange rate as at the date sold.

As at December 31, 2017, this joint venture had cash on hand of \$51.8 million and restricted cash of \$51.5 million which is primarily due to Section 1031 exchanges and U.S. tax planning relating to the nine properties sold during 2017. In January 2018, these funds were disbursed to the respective partners.

In 2016, H&R sold its 50.5% ownership interest in one property located in Grove City, OH for \$3.7 million.

Hercules Project

H&R has a 31.7% non-managing interest in 38.4 acres of land located in Hercules, CA, adjacent to the San Pablo Bay, northeast of San Francisco, for the future development of multi-family units (“Hercules Project”). This waterfront, multi-phase, master-planned, in-fill mixed-use development surrounds a future intermodal transit centre, including train and ferry service, and is adjacent to an 11 acre waterfront future regional park. The initial investment to purchase the land was approximately U.S. \$10.0 million (at H&R’s ownership interest). As at December 31, 2017, H&R’s investment was U.S. \$12.5 million. Phase 1 of the Hercules Project will consist of 172 multi-family units and construction will commence in May 2018. The total budget for this phase is expected to be U.S. \$78.1 million at the 100% level. Construction financing of approximately U.S. \$50.0 million is expected to be secured in Q1 2018.

Koenig Project

In July 2017, H&R acquired a 33.3% non-managing ownership interest in approximately 5.0 acres of land in Austin, TX (“Koenig Project”) for the future development of 391 multi-family units with construction expected to commence mid-2018. This multi-residential development site is close to major technology employers like Apple, IBM, Oracle, and Samsung, as well as the University of Texas at Austin and downtown Austin. As at December 31, 2017, H&R’s investment was approximately U.S. \$5.6 million.

F1RST Tower (formerly Telus Tower)

On January 1, 2017, H&R and its partner, Dream Office REIT, restructured their ownership agreement in F1RST Tower which resulted in the dissolution of the partnership and the creation of a co-ownership arrangement. This resulted in a change in accounting presentation whereby this property, which was previously treated as an equity accounted investment, is now being proportionately consolidated in the Trusts' Financial Statements.

Scotia Plaza and 100 Yonge

On June 30, 2016, H&R sold its 33.3% freehold and leasehold interests in Scotia Plaza and 100 Yonge for approximately \$438.3 million. The purchaser assumed H&R's share of the existing financing on the properties. H&R recorded a gain on sale, net of related costs, of \$15.0 million.

Assets and Liabilities Classified as Held for Sale

As at December 31, 2017, there were no assets classified as held for sale. As at December 31, 2016, H&R had a 50% ownership interest in two Primaris properties with a fair value of \$211.6 million and liabilities of \$126.8 million classified as held for sale. In January 2017, these assets were sold for \$211.6 million and the purchaser assumed 50.0% of the existing financing on the properties of approximately \$126.6 million.

Other Assets

| (in thousands of Canadian dollars) | December 31, 2017 | December 31, 2016 |
|---|------------------------------|----------------------|
| Mortgages receivable | \$153,211 | \$43,817 |
| Prepaid expenses and sundry assets | 33,554 | 92,975 |
| Restricted cash | 25,311 | 11,275 |
| Accounts receivable | 15,739 | 12,999 |
| Derivative instruments | 6,374 | 776 |
| | \$234,189 | \$161,842 |

Mortgages receivable increased by \$109.4 million to \$153.2 million as at December 31, 2017 primarily due to the new River Landing mortgage receivable which had a balance outstanding of \$84.6 million as at December 31, 2017 and an increase of \$19.8 million relating to 2217 Bryan St. which had a balance outstanding of \$53.9 million as at December 31, 2017.

Prepaid expenses and sundry assets decreased by \$59.4 million to \$33.6 million as at December 31, 2017 primarily due to the sale of an investment previously classified as held for trading.

Restricted cash increased by \$14.0 million to \$25.3 million as at December 31, 2017 primarily due to \$13.3 million held in escrow from the sale of a U.S. multi-family property in Q3 2017 due to a Section 1031 property exchange.

LIABILITIES AND UNITHOLDERS' EQUITY

| | December 31, 2017 | December 31, 2016 |
|---|----------------------|-------------------|
| Debt to total assets per the Trusts' Financial Statements ⁽¹⁾ | 44.6% ⁽²⁾ | 44.3% |
| Debt to total assets at the Trusts' proportionate share ⁽¹⁾⁽³⁾ | 46.6% ⁽²⁾ | 46.0% |
| Unencumbered assets ⁽⁴⁾ (in thousands of Canadian dollars) | \$3,614,735 | \$2,968,480 |
| Unsecured debt ⁽⁴⁾ (in thousands of Canadian dollars) | \$2,144,992 | \$1,684,611 |
| Unencumbered asset to unsecured debt coverage ratio ⁽⁴⁾ | 1.69 | 1.76 |
| Interest coverage ratio ⁽³⁾ | 3.00 | 2.81 |
| Weighted average interest rate of outstanding debt ⁽⁵⁾ | 4.0% | 4.2% |
| Weighted average term to maturity of outstanding debt (in years) ⁽⁵⁾ | 4.5 | 4.6 |

⁽¹⁾ Debt includes mortgages payable, debentures payable and bank indebtedness.

⁽²⁾ H&R had \$115.1 million in restricted cash relating to Section 1031 U.S. property exchanges, at the Trusts' proportionate share. These funds were released in January 2018 and were used to repay bank indebtedness. Debt to total assets per the Trusts' Financial Statements and at the Trusts' proportionate share would have been 44.2% and 46.2%, respectively, as at December 31, 2017 if these funds were available in 2017.

⁽³⁾ These are non-GAAP measures. See the "Non-GAAP Financial Measures" section of this MD&A.

⁽⁴⁾ Unencumbered assets are investment properties and properties under development without encumbrances for mortgages or bank indebtedness. Unsecured debt includes senior debentures and H&R's unsecured bank facilities.

⁽⁵⁾ Outstanding debt includes mortgages and debentures payable.

Mortgages Payable

The following table shows the change in mortgages payable from January 1, 2017 to December 31, 2017:

| <i>(in thousands of Canadian dollars)</i> | Trusts' Financial Statements | Plus: Equity accounted investments | Trusts' proportionate share ⁽¹⁾ |
|--|------------------------------|------------------------------------|--|
| Opening balance, beginning of year | \$4,001,451 | \$328,812 | \$4,330,263 |
| Principal repayments: | | | |
| Scheduled amortization on mortgages | (133,330) | (20,837) | (154,167) |
| Mortgage repayments | (452,329) | (52,059) | (504,388) |
| New mortgages | 588,094 | - | 588,094 |
| Transfer from equity accounted investment | 39,854 | (39,854) | - |
| Effective interest rate accretion on mortgages | (3,119) | (271) | (3,390) |
| Change in foreign exchange rates | (81,990) | (17,241) | (99,231) |
| Closing balance, end of year | \$3,958,631 | \$198,550 | \$4,157,181 |

⁽¹⁾ The Trusts' proportionate share is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

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The following table shows H&R's mortgage maturity profile as at December 31, 2017:

| MORTGAGES PAYABLE | Periodic Amortized Principal (\$000's) | Principal on Maturity (\$000's) | Total Principal (\$000's) | % of Total Principal | Weighted Average Interest Rate on Maturity |
|---|--|---------------------------------|---------------------------|----------------------|--|
| 2018 | \$129,488 | \$135,308 | \$264,796 | 6.7 | 5.0% |
| 2019 | 137,477 | 122,408 | 259,885 | 6.6 | 3.7% |
| 2020 | 130,949 | 355,378 | 486,327 | 12.3 | 4.4% |
| 2021 | 113,244 | 837,610 | 950,854 | 24.0 | 3.9% |
| 2022 | 70,276 | 589,839 | 660,115 | 16.6 | 4.0% |
| Thereafter | | | 1,343,463 | 33.8 | |
| | | | 3,965,440 | 100% | |
| Financing costs and mark-to-market adjustments arising on acquisitions ⁽¹⁾ | | | (6,809) | | |
| Total | | | \$3,958,631 | | |

⁽¹⁾ Mark-to-market adjustment represents the difference between the actual mortgages assumed on property acquisitions and the fair value of the mortgages at the date of purchase and is recognized in finance costs over the life of the applicable mortgage using the effective interest rate method. Financing costs are deducted from the Trusts' mortgages payable balances and are recognized in finance costs over the life of the applicable mortgage.

The mortgages outstanding as at December 31, 2017 bear interest at a weighted average rate of 4.3% (December 31, 2016 - 4.4%) and mature between 2018 and 2033. The weighted average term to maturity of the Trusts' mortgages is 5.4 years (December 31, 2016 - 5.5 years). For a further discussion of liquidity please see "Funding of Future Commitments". For a further discussion of interest rate risk, please see "Risks and Uncertainties".

Debentures Payable

The following table shows the change in debentures payable from January 1, 2017 to December 31, 2017:

(in thousands of Canadian dollars)

| | |
|--|--------------------|
| Opening balance, beginning of year | \$ 1,491,591 |
| Debenture issuances: | |
| Series L Senior Debentures | 122,445 |
| Series M Senior Debentures | 149,461 |
| Series N Senior Debentures | 347,393 |
| Debenture redemptions: | |
| Series I Senior Debentures | (60,000) |
| Series B Senior Debentures | (115,000) |
| 2018 Convertible Debentures (HR.DB.H) | (74,394) |
| Conversion - 2020 Convertible Debentures | (2) |
| Gain on change in fair value | (1,362) |
| Change due to foreign exchange rates | (10,000) |
| Accretion adjustment | 2,658 |
| Closing balance, end of year | \$1,852,790 |

H&R has elected to measure the outstanding convertible debentures at fair value and uses the quoted prices on the TSX to determine the fair value of the convertible debentures. The fluctuation in fair value between each period is recorded as a gain (loss) on change in fair value.

Exchangeable Units

Certain of H&R's subsidiaries have exchangeable units outstanding which are puttable instruments where H&R has a contractual obligation to issue Stapled Units to participating vendors upon redemption. These puttable instruments are classified as a liability under IFRS and are measured at fair value through net income.

At the end of each period the fair value is determined by using the quoted prices of Stapled Units on the TSX as the exchangeable units are exchangeable into Stapled Units at the option of the holder. Holders of all exchangeable units are entitled to receive the economic equivalent of distributions on a per unit amount equal to a per Stapled Unit amount provided to holders of Stapled Units.

During the year ended December 31, 2017, 584,386 exchangeable units were exchanged for Stapled Units (December 31, 2016 - 100,000).

The following number of exchangeable units are issued and outstanding:

| | Number of Exchangeable Units | Quoted Price of Stapled Units | Amounts per the Trusts' Financial Statements (\$000's) |
|--------------------------------|------------------------------|-------------------------------|--|
| As at December 31, 2017 | 15,979,430 | \$21.36 | \$341,321 |
| As at December 31, 2016 | 16,563,816 | \$22.37 | \$370,533 |

A subsidiary of H&R also holds 0.4 million Stapled Units to mirror certain of these exchangeable units. Therefore, when the approximately 0.4 million exchangeable units are exchanged for Stapled Units, the number of outstanding Stapled Units will only increase by 15.5 million. These 0.4 million exchangeable units have been excluded from the weighting of exchangeable units used to calculate FFO and AFFO per unit amounts as they are already included in the total Stapled Units outstanding.

Deferred Tax Liability

H&R has certain subsidiaries in the United States that are subject to tax on their taxable income at a combined federal and state tax rate of approximately 37.5% in 2017 (December 31, 2016 - 37.5%). As a result of U.S. Tax Reform, deferred income taxes as at December 31, 2017 have been measured based upon the newly enacted federal income tax rate. The income tax recovery for the year ended December 31, 2017 reflects the impact of U.S. Tax Reform resulting from the reduction in the federal tax rate from 35% to 21% in 2018 (24% including state tax) and a reduction in certain deferred tax assets related to deferred interest deductions.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

| (in millions of Canadian dollars) | December 31, 2017 | December 31, 2016 |
|--|-------------------|-------------------|
| Deferred tax assets: | | |
| Net operating losses | \$6.9 | \$17.2 |
| Deferred interest deductions | - | \$62.0 |
| Accounts payable and accrued liabilities | 1.4 | 2.3 |
| Other assets | 2.3 | 1.8 |
| | 10.6 | 83.3 |
| Deferred liabilities: | | |
| Investment properties | 256.5 | 404.9 |
| Equity accounted investments | 79.2 | 65.2 |
| | 335.7 | 470.1 |
| Deferred tax liability | (\$325.1) | (\$386.8) |

The deferred tax liability relating to the investment properties is derived on the basis that the U.S. investment properties will be sold at their current fair value. The tax liability will only be realized upon an actual disposition. Deferred tax liability decreased by \$61.7 million from \$386.8 million as at December

31, 2016 to \$325.1 million as at December 31, 2017 primarily due to the enactment of U.S. Tax Reform on December 22, 2017. Refer to the discussion under the heading “U.S. Tax Reform” in the “Risks and Uncertainties” section of this MD&A for further details on the implications to H&R.

Unitholders' Equity

Unitholders' equity increased by \$267.1 million from \$6,912.7 million as at December 31, 2016 to \$7,179.8 million as at December 31, 2017. The increase is primarily due to net income, proceeds from the issuance of Stapled Units under the DRIP and Unit Option Plan and exchangeable units converted into Stapled Units, partially offset by distributions paid to unitholders and other comprehensive loss.

Other comprehensive loss consists of the unrealized loss on translation of U.S. denominated foreign operations and the transfer of realized losses on cash flow hedges to net income. Fluctuations in other comprehensive loss is primarily due to changes in foreign exchange rates.

Normal Course Issuer Bid (“NCIB”)

On August 8, 2017, the Trusts received approval from the TSX for the renewal of their NCIB, allowing the Trusts to purchase for cancellation up to a maximum of 5,000,000 Stapled Units on the open market until the earlier of August 14, 2018 or the date on which the Trusts have purchased the maximum number of Stapled Units permitted under the NCIB. During the year ended December 31, 2017, the Trusts purchased and cancelled 755,420 Stapled Units at a weighted average price of \$21.10 per Stapled Unit, for a total cost of \$15.9 million. During the year ended December 31, 2016, the Trusts purchased and cancelled 141,800 Stapled Units at a weighted average price of \$19.28 per Stapled Unit, for a total cost of \$2.7 million.

Subsequent to December 31, 2017, the Trusts purchased and cancelled 2,945,120 Stapled Units at a weighted average price of \$21.00 per unit, for a total cost of \$61.8 million.

RESULTS OF OPERATIONS

| (in thousands of Canadian dollars) | Three months ended December 31 | | Year ended December 31 | |
|--|--------------------------------|-----------|------------------------|-------------|
| | 2017 | 2016 | 2017 | 2016 |
| Property operating income: | | | | |
| Rentals from investment properties | \$298,042 | \$305,500 | \$1,168,454 | \$1,196,011 |
| Property operating costs | (98,628) | (103,134) | (427,013) | (431,271) |
| | 199,414 | 202,366 | 741,441 | 764,740 |
| Net income from equity accounted investments | 118,337 | 82,176 | 167,407 | 48,341 |
| Other income | 1,040 | 1,454 | 1,040 | 20,353 |
| Finance costs - operations | (69,003) | (69,861) | (270,358) | (287,325) |
| Finance income | 1,407 | 925 | 4,999 | 4,715 |
| Trust expenses | (4,383) | (7,014) | (18,111) | (29,852) |
| Fair value adjustments on financial instruments | 9,553 | 6,198 | 27,049 | (33,830) |
| Fair value adjustments on real estate assets | 3,984 | (32,488) | 1,796 | 133,738 |
| Loss on sale of real estate assets | (70) | (7,816) | (7,729) | (8,167) |
| Gain (loss) on foreign exchange | 2,263 | 6,695 | (17,903) | (8,944) |
| Transaction costs | - | - | - | (13,483) |
| Net income before income taxes | 262,542 | 182,635 | 629,631 | 590,286 |
| Income tax recovery (expense) | 62,671 | (42,019) | 38,239 | (201,541) |
| Net income | 325,213 | 140,616 | 667,870 | 388,745 |
| Other comprehensive income (loss): | | | | |
| Items that are or may be reclassified subsequently to net income | | | | |
| Unrealized gain (loss) on translation of U.S. denominated foreign operations | 10,245 | 40,363 | (131,302) | (38,397) |
| Transfer of realized loss on cash flow hedges to net income | 8 | 8 | 30 | 30 |
| | 10,253 | 40,371 | (131,272) | (38,367) |
| Total comprehensive income attributable to unitholders | \$335,466 | \$180,987 | \$536,598 | \$350,378 |

Net income before income taxes increased by \$79.9 million for the three months ended December 31, 2017 compared to the three months ended December 31, 2016 primarily due to an increase in fair value adjustments on real estate assets and net income from equity accounted investments.

Net income before income taxes increased by \$39.3 million for the year ended December 31, 2017 compared to the year ended December 31, 2016 primarily due to an increase in net income from equity accounted investments and fair value adjustments on financial instruments partially offset by a decrease in fair value adjustments on real estate assets.

Income tax recovery increased by \$104.7 million and \$239.8 million for the three months and year ended December 31, 2017, respectively, compared to the respective 2016 periods primarily due to the enactment of U.S. Tax Reform on December 22, 2017 which is further described in the “Risks and Uncertainties” section of this MD&A and fair value increases in 2016 to multiple properties, including Two Gotham Center in Long Island City, NY and Hess Tower in Houston, TX which were externally appraised.

PROPERTY OPERATING INCOME

Property operating income consists of rentals from investment properties less property operating costs. Management believes that property operating income is a useful measure for investors in assessing the performance of H&R’s properties before financing costs and other sources of income and expenditures which are not directly related to the day-to-day operations of a property. Property operating income (cash basis) adjusts property operating income to exclude straight-lining of contractual rent and realty taxes accounted for under IFRIC 21. This non-GAAP measure adjusts property operating income for non-cash items which allows investors to better understand H&R’s operating performance and is a key input in determining the value of the portfolio. Property operating income (cash basis) at the Trusts’ proportionate share adjusts property operating income to exclude straight-lining of contractual rent and realty taxes accounted for under IFRIC 21, and also adjusts property operating income to include the Trusts’ proportionate share of property operating income (cash basis) from equity accounted investments. Management believes this non-GAAP measure is important for investors as it is consistent with how the Trusts’ review and assess operating performance of their entire portfolio. “Same-Asset” refers to those properties owned by H&R for the entire two-year period ended December 31, 2017. “Transactions” refers to property operating income earned related to properties acquired, disposed of or transferred from properties under development to investment properties during the two-year period ended December 31, 2017.

| (in thousands of Canadian dollars) | Three months ended December 31, 2017 | | | Three months ended December 31, 2016 | | |
|---|--------------------------------------|--------------|-----------|--------------------------------------|--------------|-----------|
| | Same-Asset | Transactions | Total | Same-Asset | Transactions | Total |
| Rentals | \$281,202 | \$16,840 | \$298,042 | \$288,553 | \$16,947 | \$305,500 |
| Property operating costs | (92,733) | (5,895) | (98,628) | (96,482) | (6,652) | (103,134) |
| Property operating income | 188,469 | 10,945 | 199,414 | 192,071 | 10,295 | 202,366 |
| Straight-lining of contractual rent | 1,095 | (201) | 894 | (1,061) | 245 | (816) |
| Realty taxes in accordance with IFRIC 21 | (8,914) | (1,783) | (10,697) | (8,719) | (855) | (9,574) |
| Property operating income (cash basis) ⁽¹⁾ | 180,650 | 8,961 | 189,611 | 182,291 | 9,685 | 191,976 |
| Property operating income (cash basis) from equity accounted investments ⁽¹⁾ | 11,876 | 2,595 | 14,471 | 12,804 | 3,926 | 16,730 |
| Property operating income (cash basis) at the Trusts' proportionate share ⁽¹⁾⁽²⁾ | \$192,526 | \$11,556 | \$204,082 | \$195,095 | \$13,611 | \$208,706 |

⁽¹⁾ Property operating income (cash basis) is a non-GAAP measure defined in the “Non-GAAP Financial Measures” section of this MD&A.

⁽²⁾ The Trusts’ proportionate share is a non-GAAP measure defined in the “Non-GAAP Financial Measures” section of this MD&A.

Total property operating income decreased by \$3.0 million for the three months ended December 31, 2017 compared to the three months ended December 31, 2016, primarily due to the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32).

Same-Asset property operating income (cash basis) decreased by \$1.6 million for the three months ended December 31, 2017 compared to the three months ended December 31, 2016, primarily due to the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32).

Property operating income (cash basis) from Transactions decreased by \$0.7 million for the three months ended December 31, 2017 compared to the three months ended December 31, 2016, primarily due to properties sold during the last two years. For a list of properties purchased and sold, please refer to pages 15 and 16 of this MD&A.

Refer to the “Segmented Information” section of this MD&A for further details on Same-Asset property operating income (cash basis), disclosed at the Trusts’ proportionate share.

| (in thousands of Canadian dollars) | Year ended December 31, 2017 | | | Year ended December 31, 2016 | | |
|---|------------------------------|--------------|-------------|------------------------------|--------------|-------------|
| | Same-Asset | Transactions | Total | Same-Asset | Transactions | Total |
| Rentals | \$1,113,300 | \$55,154 | \$1,168,454 | \$1,126,244 | \$69,767 | \$1,196,011 |
| Property operating costs | (400,083) | (26,930) | (427,013) | (403,537) | (27,734) | (431,271) |
| Property operating income | 713,217 | 28,224 | 741,441 | 722,707 | 42,033 | 764,740 |
| Straight-lining of contractual rent | 7,355 | (537) | 6,818 | (5,828) | 1,047 | (4,781) |
| Property operating income (cash basis) ⁽¹⁾ | 720,572 | 27,687 | 748,259 | 716,879 | 43,080 | 759,959 |
| Property operating income (cash basis) from equity accounted investments ⁽¹⁾ | 54,705 | 13,895 | 68,600 | 50,163 | 30,156 | 80,319 |
| Property operating income (cash basis) at the Trusts’ proportionate share ⁽¹⁾⁽²⁾ | \$775,277 | \$41,582 | \$816,859 | \$767,042 | \$73,236 | \$840,278 |

⁽¹⁾ Property operating income (cash basis) is a non-GAAP measure defined in the “Non-GAAP Financial Measures” section of this MD&A.

⁽²⁾ The Trusts’ proportionate share is a non-GAAP measure defined in the “Non-GAAP Financial Measures” section of this MD&A.

Total property operating income decreased by \$23.3 million for the year ended December 31, 2017 compared to the year ended December 31, 2016, primarily due to properties sold during the last two years. For a list of properties sold, refer to pages 15 and 16 of this MD&A.

Same-Asset property operating income (cash basis) increased by \$3.7 million for the year ended December 31, 2017 compared to the year ended December 31, 2016, primarily due to contractual rental escalations at H&R’s office properties, partially offset by the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the year ended December 31, 2017 was \$1.30 (December 31, 2016 - \$1.32).

Property operating income (cash basis) from Transactions decreased by \$15.4 million for the year ended December 31, 2017 compared to the year ended December 31, 2016, primarily due to properties sold during the last two years. For a list of properties purchased and sold, please refer to pages 15 and 16 of this MD&A.

Refer to the “Segmented Information” section of this MD&A for further details on Same-Asset property operating income (cash basis), disclosed at the Trusts’ proportionate share.

SEGMENTED INFORMATION

H&R’s strategy to mitigate risk includes diversification both by asset class and geographic location.

Operating Segments:

The Trusts have six reportable operating segments (Office, which also includes the Trusts’ head office and Finance Trust), Primaris, H&R Retail, ECHO, Industrial and Residential (operating as Lantower Residential)), in two geographic locations (Canada and the United States). The operating segments derive their revenue primarily from rental income from leases. The segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker, determined to be the Chief Executive Officer (“CEO”) of the Trusts. The CEO measures and evaluates the performance of the Trusts based on property operating income and on a proportionately consolidated basis for the Trusts’ equity accounted investments. Further disclosure of segmented information for property operating income can be found in the Trusts’ Financial Statements.

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| (in thousands of Canadian dollars) | Property operating income | | | | Occupancy | |
|------------------------------------|--------------------------------|-----------|------------------------|-----------|-------------------|-------|
| | Three months ended December 31 | | Year ended December 31 | | As at December 31 | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Office ⁽¹⁾ | \$101,370 | \$101,899 | \$390,366 | \$397,314 | 97.0% | 96.9% |
| Primaris | 41,814 | 44,977 | 157,264 | 170,908 | 92.6% | 87.4% |
| H&R Retail | 27,290 | 29,527 | 95,784 | 112,463 | 97.4% | 98.6% |
| Industrial | 14,351 | 13,949 | 57,375 | 55,548 | 98.2% | 99.7% |
| Lantower Residential | 14,589 | 12,014 | 40,652 | 28,507 | 90.0% | 93.1% |
| The Trusts' Financial Statements | 199,414 | 202,366 | 741,441 | 764,740 | 95.6% | 95.4% |

⁽¹⁾ Includes the Trusts' head office.

Property Operating Income per the Trusts' Financial Statements decreased by \$3.0 million for the three months ended December 31, 2017 compared to the respective 2016 period primarily due to the strengthening of the Canadian dollar compared to the U.S dollar. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32).

Property Operating Income per the Trusts' Financial Statements decreased by \$23.3 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to properties sold across all segments throughout 2016 & 2017.

The following segmented information has been presented at the Trusts' proportionate share. The Trusts' proportionate share is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

| (in thousands of Canadian dollars) | Same-Asset property operating income (cash basis) ⁽¹⁾ | | | | Occupancy (same asset) | |
|--|--|-----------|------------------------|-----------|------------------------|-------|
| | Three months ended December 31 | | Year ended December 31 | | As at December 31 | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Office ⁽²⁾ | \$95,549 | \$94,206 | \$383,507 | \$376,815 | 98.3% | 98.3% |
| Primaris | 41,461 | 41,731 | 155,696 | 157,749 | 92.6% | 87.4% |
| H&R Retail | 25,027 | 26,570 | 104,193 | 105,880 | 97.4% | 98.6% |
| ECHO | 10,720 | 11,577 | 49,893 | 45,265 | 93.8% | 94.2% |
| Industrial | 14,899 | 15,206 | 60,861 | 60,092 | 98.3% | 99.7% |
| Lantower Residential | 4,870 | 5,805 | 21,127 | 21,241 | 93.9% | 94.5% |
| The Trusts' proportionate share (page 25-26) | \$192,526 | \$195,095 | \$775,277 | \$767,042 | 96.5% | 96.1% |

⁽¹⁾ Same-Asset property operating income (cash basis) is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

⁽²⁾ Includes the Trusts' head office.

Same-Asset property operating income (cash basis) from the Office segment increased by \$1.3 million and \$6.7 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods primarily due to contractual rental escalations.

Same-Asset property operating income (cash basis) from the Primaris segment decreased by \$0.3 million and \$2.1 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods primarily due to the closing of several large format stores including Future Shop and Safeway previously at Garden City Square, along with several smaller tenant bankruptcies/restructurings. Included in Same-Asset property operating income (cash basis) for the three months and year ended December 31, 2017 is \$1.6 million (Q4 2016 - \$0.2 million) and \$3.3 million (December 31, 2016 - \$0.4 million), respectively, relating to rent from the former Target space.

Same-Asset property operating (cash basis) income from the H&R Retail segment decreased by \$1.5 million and \$1.7 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods primarily due to the strengthening of the Canadian dollar compared to the U.S dollar and Marsh Supermarkets, a former tenant at seven of H&R's properties, filing for Chapter 11 bankruptcy protection in May 2017. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32). The average exchange rate for the year ended December 31, 2017 was \$1.30 for each U.S. \$1.00 (December 31, 2016 - \$1.32).

Same-Asset property operating income (cash basis) from the ECHO segment increased by \$4.6 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to ECHO receiving lease termination payments of \$5.5 million at H&R's ownership interest.

Same-Asset property operating income (cash basis) from the Lantower Residential segment decreased by \$0.9 million and \$0.1 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods primarily due to one-time start-up costs relating to the internalization of Lantower Residential's property management of \$0.5 million and \$0.8 million for the three months and year ended December 31, 2017

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and the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32). The average exchange rate for the year ended December 31, 2017 was \$1.30 for each U.S. \$1.00 (December 31, 2016 - \$1.32).

Geographic Locations:

The Trusts operate in two geographic locations: Canada and the United States.

| (in thousands of Canadian dollars) | Same-Asset property operating income (cash basis) ⁽¹⁾ | | | | Occupancy (same asset) | |
|--|--|-----------|------------------------|-----------|------------------------|-------|
| | Three months ended December 31 | | Year ended December 31 | | As at December 31 | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Ontario ⁽²⁾ | \$63,694 | \$61,837 | \$249,821 | \$243,719 | 96.2% | 96.8% |
| Alberta | 51,075 | 51,139 | 201,028 | 200,939 | 97.4% | 93.2% |
| Other Canada | 20,715 | 21,373 | 80,294 | 80,497 | 95.9% | 95.9% |
| Total – Canada | 135,484 | 134,349 | 531,143 | 525,155 | 96.5% | 95.5% |
| United States ⁽²⁾ | 57,042 | 60,746 | 244,134 | 241,887 | 96.6% | 97.4% |
| The Trusts' proportionate share (page 25-26) | \$192,526 | \$195,095 | \$775,277 | \$767,042 | 96.5% | 96.1% |

⁽¹⁾ Same-Asset property operating income (cash basis) is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

⁽²⁾ Property operating income relating to corporate entities has been included in Ontario for Canadian properties and the United States for U.S. properties.

Same-Asset property operating income (cash basis) from Canada increased by \$1.1 million and \$6.0 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods, primarily due to contractual rental escalations at H&R's Toronto and Calgary office properties.

Same-Asset property operating income (cash basis) from the U.S. decreased by \$3.7 million for the three months ended December 31, 2017 compared to the respective 2016 period primarily due to the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the three months ended December 31, 2017 was \$1.27 for each U.S. \$1.00 (Q4 2016 - \$1.32).

Same-Asset property operating income (cash basis) from the U.S. increased by \$2.2 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to ECHO receiving lease termination payments of \$5.5 million, at H&R's ownership interest in Q3 2017, partially offset by the strengthening of the Canadian dollar compared to the U.S. dollar. The average exchange rate for the year ended December 31, 2017 was \$1.30 for each U.S. \$1.00 (December 31, 2016 - \$1.32).

The Trusts have provided the table below to disclose the United States region in U.S. dollars to eliminate the effect of fluctuations in foreign exchange. The table below discloses Same-Asset property operating income (cash basis) at the Trusts' proportionate share by operating segment, which is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A:

| United States: (in thousands of U.S. dollars) | Same-Asset property operating income (cash basis) ⁽¹⁾ | | | | Occupancy (same asset) | |
|--|--|----------|------------------------|-----------|------------------------|--------|
| | Three months ended December 31 | | Year ended December 31 | | As at December 31 | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Office ⁽²⁾ | \$17,905 | \$17,470 | \$72,194 | \$71,336 | 100.0% | 100.0% |
| H&R Retail | 13,843 | 14,452 | 57,269 | 57,818 | 97.4% | 99.0% |
| ECHO | 8,476 | 8,770 | 38,379 | 34,292 | 93.8% | 94.2% |
| Industrial | 911 | 930 | 3,701 | 3,710 | 100.0% | 100.0% |
| Lantower Residential | 3,842 | 4,398 | 16,252 | 16,092 | 93.9% | 94.5% |
| U.S. total in U.S. dollars | \$44,977 | \$46,020 | \$187,795 | \$183,248 | 96.6% | 97.4% |

⁽¹⁾ Same-Asset property operating income (cash basis) is a non-GAAP measure defined in the "Non-GAAP Financial Measures" section of this MD&A.

⁽²⁾ Includes the Trusts' head office.

Same-Asset property operating income (cash basis) from the U.S. region decreased by U.S. \$1.0 million for the three months ended December 31, 2017 compared to the respective 2016 period primarily due to Marsh Supermarkets, a former tenant at seven of H&R's properties, filing for Chapter 11 bankruptcy protection in May 2017, and one-time start-up costs of U.S. \$0.4 million, relating to the internalization of Lantower Residential's property management. This was partially offset by contractual rent escalations across H&R's U.S. Office properties.

Same-Asset property operating income (cash basis) from the U.S. region increased by \$4.5 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to lease termination payments received by ECHO and contractual rent escalations across H&R's U.S. Office properties. This was partially offset by Marsh Supermarkets, a former tenant at seven of H&R's properties, filing for Chapter 11 bankruptcy protection in May 2017, and one-time start-up costs of U.S. \$0.6 million, relating to the internalization of Lantower Residential's property management.

NET INCOME, FFO AND AFFO FROM EQUITY ACCOUNTED INVESTMENTS⁽¹⁾

The following table provides a breakdown of H&R's net income from equity accounted investments which is further reconciled to FFO and AFFO from equity accounted investments:

| (in thousands of Canadian dollars) | Three Months Ended December 31 | | Year ended December 31 | |
|--|--------------------------------|-----------------|------------------------|-----------------|
| | 2017 | 2016 | 2017 | 2016 |
| Rentals from investment properties | \$20,642 | \$22,351 | 88,458 | \$114,157 |
| Property operating costs | (4,576) | (4,008) | (18,413) | (33,061) |
| | 16,066 | 18,343 | 70,045 | 81,096 |
| Net income from equity accounted investments | 81 | 111 | 587 | 528 |
| Finance cost - operations | (4,332) | (4,511) | (18,807) | (22,341) |
| Finance income | 109 | (18) | 403 | 461 |
| Trust expenses | (565) | (382) | (2,291) | (1,611) |
| Fair value adjustments on financial instruments | 3,402 | 9,588 | 4,222 | (1,039) |
| Fair value adjustment on real estate assets | 103,834 | 59,931 | 114,996 | (22,489) |
| Gain (loss) on sale of real estate assets | 89 | (571) | (677) | 14,484 |
| Income tax expense | (61) | (145) | (185) | (290) |
| Non-controlling interest | (286) | (170) | (886) | (458) |
| Net income from equity accounted investments | 118,337 | 82,176 | 167,407 | 48,341 |
| Realty taxes in accordance with IFRIC 21 | (1,306) | (1,306) | - | - |
| Fair value adjustments on real estate assets and financial instruments | (107,236) | (69,519) | (119,218) | 23,528 |
| (Gain) loss on sale of real estate assets | (89) | 571 | 677 | (14,484) |
| Deferred income taxes expense | - | 153 | - | 153 |
| Incremental leasing costs | 63 | - | 203 | - |
| Notional interest capitalization ⁽²⁾ | 3,342 | 3,724 | 13,799 | 13,994 |
| FFO from equity accounted investments | 13,111 | 15,799 | 62,868 | 71,532 |
| Straight-lining of contractual rent | (289) | (307) | (1,445) | (777) |
| Capital expenditures | (3,016) | (2,744) | (11,120) | (12,307) |
| Leasing expenses and tenant inducements | (1,787) | (318) | (2,079) | (6,986) |
| Incremental leasing costs | (63) | - | (203) | - |
| AFFO from equity accounted investments | \$7,956 | \$12,430 | \$48,021 | \$51,462 |

⁽¹⁾ Each of these line items represent the Trusts' proportionate share of equity accounted investments which are reconciled to net income from equity accounted investments per the Trusts' Financial Statements, which is further reconciled to FFO and AFFO from equity accounted investments. These are non-GAAP measures defined in the "Non-GAAP Financial Measures" section of this MD&A.

⁽²⁾ Represents an adjustment to add general or indirect interest incurred in respect of properties under development held in and through equity accounted investments.

Net income from equity accounted investments for the three months and year ended December 31, 2017 compared to the respective 2016 periods increased by \$36.2 million and \$119.1 million, respectively, primarily due to the fair value adjustments on real estate assets. In Q4 2017, the value of Jackson Park increased by U.S. \$98.7 million at H&R's ownership interest which was supported by an independent third party appraisal. For the year ended December 31, 2017 compared to the respective 2016 period, the above noted increase was partially offset by the sale of Scotia Plaza and 100 Yonge in June 2016.

FFO from equity accounted investments for the three months ended December 31, 2017 compared to the respective 2016 period decreased by \$2.7 million primarily due to the sale of nine U.S. industrial properties throughout 2017 and \$0.7 million of marketing expenses incurred in Q4 2017 relating to Jackson Park.

FFO from equity accounted investments for the year ended December 31, 2017 compared to the respective 2016 period decreased by \$8.7 million primarily due to the decreases explained above as well as the sale of Scotia Plaza and 100 Yonge in 2016 and the change in the legal structure of F1RST Tower resulting in the property now being accounted for as a proportionately consolidated investment property in the Trusts' Financial Statements effective January 1, 2017. This was partially offset by ECHO receiving lease termination payments of \$5.5 million at H&R's ownership interest from four tenants who terminated their leases in Q3 2017.

OTHER INCOME AND EXPENSE ITEMS

The other income and expense items section of this MD&A provides management's commentary on the Results of Operations per the Trusts' Financial Statements.

| Other Income (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|---------|---------|------------------------|----------|------------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Other income | \$1,040 | \$1,454 | (\$414) | \$1,040 | \$20,353 | (\$19,313) |

On January 15, 2015, Target Corporation announced plans to discontinue operating stores in Canada through its subsidiary, Target. As at December 31, 2016, Primaris had an interest in nine malls where Target was a tenant: a 50% interest in four of these malls and a 100% interest in the other five malls. Three of the leases were guaranteed by Target Corporation, the U.S. parent of Target. In March 2016, Primaris entered into binding agreements with Target and Target Corporation concluding the terms of settlement relating to the leases that were disclaimed pursuant to the *Companies' Creditors Arrangement Act*. The binding agreements were approved by the courts in June 2016. Distributions in respect of the settlement proceeds in the amount of \$1.0 million was received in 2017 (December 31, 2016 - \$20.4 million).

| Finance Costs (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|------------|---------|------------------------|-------------|----------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Finance costs – operations: | | | | | | |
| Contractual interest on mortgages payable | (\$43,083) | (\$46,964) | \$3,881 | (\$174,492) | (\$196,228) | \$21,736 |
| Contractual interest on debentures payable | (16,095) | (14,543) | (1,552) | (62,565) | (60,019) | (2,546) |
| Effective interest rate accretion | (920) | 401 | (1,321) | (1,808) | 2,595 | (4,403) |
| Bank interest and charges | (3,588) | (4,023) | 435 | (11,877) | (13,302) | 1,425 |
| Exchangeable unit distributions | (5,464) | (5,630) | 166 | (22,254) | (22,480) | 226 |
| | (69,150) | (70,759) | 1,609 | (272,996) | (289,434) | 16,438 |
| Capitalized interest | 147 | 898 | (751) | 2,638 | 2,109 | 529 |
| | (69,003) | (69,861) | 858 | (270,358) | (287,325) | 16,967 |
| Finance income | 1,407 | 925 | 482 | 4,999 | 4,715 | 284 |
| Fair value adjustments on financial instruments | 9,553 | 6,198 | 3,355 | 27,049 | (33,830) | 60,879 |
| | (\$58,043) | (\$62,738) | \$4,695 | (\$238,310) | (\$316,440) | \$78,130 |

The decrease in contractual interest on mortgages payable of \$3.9 million and \$21.7 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods is primarily due to the repayment of mortgages upon maturity or assumption of mortgages on sale.

The increase in contractual interest on debentures payable of \$1.6 million and \$2.5 million, respectively, for the three months and year ended December 31, 2017 compared to the respective 2016 periods is primarily due to the issuance of an aggregate of \$825.0 million of Senior Debentures since November 2016. This was offset by the repayment of an aggregate of \$504.4 million of senior and convertible debentures since July 2016.

The increase in fair value adjustments on financial instruments of \$60.9 million for the year ended December 31, 2017 compared to the respective 2016 period is primarily due to the gain (loss) on fair value of exchangeable units whereby at the end of each period, the fair value is determined using the quoted prices of Stapled Units on the TSX, as the exchangeable units are exchangeable into Stapled Units at the option of the holder. For the year ended December 31, 2017, the change in fair value is based on the quoted price of Stapled Units which was \$21.36 as at December 31, 2017 (December 31, 2016 - \$22.37). For the year ended December 31, 2016, the change in fair value is based on the quoted price of Stapled Units which was \$22.37 as at December 31, 2016 (December 31, 2015 - \$20.05). In addition, during the year ended December 31, 2017, H&R realized a gain of \$8.8 million (December 31, 2016 - nil) on the sale of an investment previously classified as held for trading.

| Trust Expenses (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|---------|------------------------|------------|-----------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Other expenses | (\$3,700) | (\$3,249) | (\$451) | (\$13,242) | (\$11,936) | (\$1,306) |
| Unit-based compensation | (683) | (3,765) | 3,082 | (4,869) | (17,916) | 13,047 |
| Trust expenses | (\$4,383) | (\$7,014) | \$2,631 | (\$18,111) | (\$29,852) | \$11,741 |

Other expenses are primarily comprised of salaries, professional fees, trustee fees and corporate overhead expenses. Other expenses increased by \$0.5 million for the three months ended December 31, 2017 compared to the respective 2016 period primarily due reorganization costs relating to the proposed Reorganization. Other expenses increased by \$1.3 million for the year ended December 31, 2017 compared to the respective 2016 period primarily due to reorganization costs relating to the proposed Reorganization and an increase in salaries and corporate expenses relating to Lantower Residential.

Unit-based compensation is comprised of the following two compensation plans: the Unit Option Plan and the Incentive Unit Plan. Both plans are considered to be cash-settled under IFRS 2, *Share-based Payments* and as a result, are measured at each reporting period and settlement date at their fair value as defined by IFRS 2 based on the quoted prices of Stapled Units on the TSX. The fair value adjustment to unit-based compensation was \$0.3 million and (\$2.5 million), respectively, for the three months ended December 31, 2017 and 2016 and (\$1.3 million) and (\$12.7 million), respectively, for the year ended December 31, 2017 and 2016.

| Fair Value Adjustments on Real Estate Assets (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|------------|----------|------------------------|-----------|-------------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Fair value adjustments on real estate assets | \$3,984 | (\$32,488) | \$36,472 | \$1,796 | \$133,738 | (\$131,942) |

H&R records its real estate assets at fair value. Fair value adjustments on real estate assets are determined based on the movement of various parameters, including changes in capitalization rates, discount rates and future cash flow projections. Changes in fair value can also occur due to the following factors: (i) realty taxes in accordance with IFRIC 21, (ii) capital and tenant expenditures, (iii) redevelopment costs and (iv) straight-lining of contractual rent.

Fair value adjustment on real estate assets for the year ended December 31, 2016 of \$133.7 million was primarily due to fair value increases in two office properties, Two Gotham Center in Long Island City, NY and Hess Tower in Houston, TX. Independent third party appraisals were obtained for these properties in Q2 2016. This was partially offset by fair value decreases to H&R's Alberta office portfolio as a result of the overall weakening of the Alberta economy.

| Loss on Sale of Real Estate Assets (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|---------|------------------------|-----------|--------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Loss on sale of real estate assets | (\$70) | (\$7,816) | \$7,746 | (\$7,729) | (\$8,167) | \$438 |

During the year ended December 31, 2017, H&R sold three retail properties, a 50% ownership interest in two Primaris properties, a 50% ownership interest in one industrial property, one multi-family residential property and one office property and recognized a loss on sale of real estate assets of \$7.7 million. The loss on sale of real estate assets includes mark-to-market adjustments on the purchasers' assumption of mortgage of \$3.5 million.

During the year ended December 31, 2016, H&R sold five retail properties, a 50% ownership interest in two industrial properties, a 50% non-managing ownership interest in an office property and a portion of an office property (sold as separate condominium units) and recognized a loss on sale of real estate assets of \$8.2 million. This was primarily due to the sale of a 50% non-managing ownership interest in TransCanada Tower in November 2016.

For a list of properties sold in 2017 and 2016, please refer to pages 15 and 16 in this MD&A.

Gain (loss) on Foreign Exchange

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|---------|-----------|------------------------|-----------|-----------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Gain (loss) on foreign exchange | \$2,263 | \$6,695 | (\$4,432) | (\$17,903) | (\$8,944) | (\$8,959) |

The amounts in the table above were recorded by Finance Trust due to the translation of the U.S. Holdco Notes into Canadian dollars. The U.S. Holdco Notes are eliminated in the Trusts' Financial Statements however, the related foreign exchange difference is not eliminated on combination as it flows through net income of Finance Trust and other comprehensive income of H&R as U.S. Holdco is a subsidiary of H&R and forms part of its net investment in the United States. U.S. Holdco is not a subsidiary of Finance Trust. The exchange rate as at December 31, 2017 was \$1.26 for each U.S. \$1.00 (September 30, 2017 - \$1.25, December 31, 2016 - \$1.34). The exchange rate as at December 31, 2016 was \$1.34 for each U.S. \$1.00 (September 30, 2016 - \$1.31, December 31, 2015 - \$1.38).

Transaction Costs

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|------|--------|------------------------|------------|----------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Transaction costs | \$ - | \$ - | \$ - | \$ - | (\$13,483) | \$13,483 |

On February 18, 2016, the Ontario Ministry of Finance (the "Ministry") announced retroactive amendments to the regulations under the *Land Transfer Act* (Ontario) that impact the availability of an exemption from Ontario land transfer tax for certain transactions involving trusts (including real estate investment trusts) and partnerships. On March 24, 2016, the Ministry announced relieving measures that limited the reassessment period to dispositions that occurred on or after February 18, 2012 and provided a voluntary disclosure program (including interest and penalty relief) that expired on June 30, 2017. The voluntary disclosure program was further extended to August 31, 2017. H&R has complied with the retroactive amendments.

Income Tax Recovery (Expense)

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|------------|-----------|------------------------|-------------|-----------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Income tax computed at the Canadian statutory rate of nil applicable to H&R for 2017 and 2016 | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Current U.S. income taxes | (376) | (997) | 621 | (1,538) | (1,950) | 412 |
| Deferred income taxes applicable to U.S. Holdco: | | | | | | |
| Impact of U.S. Tax Reform | 87,970 | - | 87,970 | 87,970 | - | 87,970 |
| Other | (24,923) | (41,022) | 16,099 | (48,193) | (199,591) | 151,398 |
| | 63,047 | (41,022) | 104,069 | 39,777 | (199,591) | 239,368 |
| Income tax recovery (expense) | \$62,671 | (\$42,019) | \$104,690 | \$38,239 | (\$201,541) | \$239,780 |

H&R is generally subject to tax in Canada under the Tax Act with respect to its taxable income each year, except to the extent such taxable income is paid or made payable to unitholders and deducted by H&R for tax purposes. H&R's current income tax expense is primarily due to U.S. state taxes.

H&R's deferred income tax expense is recorded in respect of U.S. Holdco and arose due to taxable temporary differences between the tax and accounting bases of assets and liabilities net of the benefit of unused tax credits, deferred interest deductions and losses that are available to be carried forward to future tax years to the extent that it is probable that the unused tax credits, deferred interest deductions and losses can be realized. Deferred income taxes recovery increased by \$104.1 million and \$239.4 million for the three months and year ended December 31, 2017 compared to the respective 2016 periods, primarily due to the enactment of U.S. Tax Reform on December 22, 2017 which is further described in the "Risks and Uncertainties" section of this MD&A and fair value increases in 2016 to multiple properties, including Two Gotham Center in Long Island City, NY and Hess Tower in Houston, TX which were externally appraised.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply when the assets are realized or the liabilities are settled, based on the tax laws that have been enacted or substantively enacted at the statement of financial position date. Deferred income tax relating to items recognized in equity will also be recognized in equity.

As at December 31, 2017, H&R had net deferred tax liabilities of \$325.1 million (December 31, 2016 - \$386.8 million) primarily related to taxable temporary differences between the tax and accounting bases of U.S. investment properties.

FUNDS FROM OPERATIONS AND ADJUSTED FUNDS FROM OPERATIONS

The Trusts' present their combined FFO and AFFO calculations in accordance with REALpac's February 2017 *White Paper on Funds From Operations and Adjusted Funds From Operations for IFRS*. FFO and AFFO are non-GAAP measures defined in the "Non-GAAP Financial Measures" section of this MD&A.

FFO AND AFFO

| (in thousands of Canadian dollars except per unit amounts) | Three Months Ended December 31 | | Year ended December 31 | |
|---|--------------------------------|------------------|------------------------|------------------|
| | 2017 | 2016 | 2017 | 2016 |
| Net income per the Trusts' Financial Statements | \$325,213 | \$140,616 | \$667,870 | \$388,745 |
| Realty taxes in accordance with IFRIC 21 | (10,697) | (9,574) | - | - |
| FFO adjustments from equity accounted investments (page 30) | (105,226) | (66,377) | (104,539) | 23,191 |
| Exchangeable unit distributions | 5,464 | 5,630 | 22,254 | 22,480 |
| Fair value adjustments on real estate assets and financial instruments ⁽¹⁾ | (13,537) | 26,290 | (19,910) | (99,908) |
| Fair value adjustment to unit-based compensation | (317) | 2,450 | 1,307 | 12,652 |
| Loss on sale of real estate assets | 70 | 7,816 | 7,729 | 8,167 |
| (Gain) loss on foreign exchange | (2,263) | (6,695) | 17,903 | 8,944 |
| Transaction costs | - | - | - | 13,483 |
| Deferred income taxes applicable to U.S. Holdco | (63,047) | 41,022 | (39,777) | 199,591 |
| Incremental leasing costs | 1,787 | 1,721 | 7,253 | 6,956 |
| FFO | \$137,447 | \$142,899 | \$560,090 | \$584,301 |
| Straight-lining of contractual rent | 894 | (816) | 6,818 | (4,781) |
| Capital expenditures | (14,874) | (17,795) | (51,845) | (58,924) |
| Leasing expenses and tenant inducements | (9,394) | (7,038) | (28,722) | (34,682) |
| Incremental leasing costs | (1,787) | (1,721) | (7,253) | (6,956) |
| AFFO adjustments from equity accounted investments (page 30) | (5,155) | (3,369) | (14,847) | (20,070) |
| AFFO | \$107,131 | \$112,160 | \$464,241 | \$458,888 |
| Weighted average number of Stapled Units (in thousands of basic Stapled Units adjusted for conversion of exchangeable Stapled Units) ⁽²⁾ | 306,629 | 300,482 | 304,462 | 298,404 |
| Diluted weighted average number of Stapled Units (in thousands of Stapled Units) for the calculation of FFO ⁽²⁾⁽³⁾⁽⁴⁾⁽⁵⁾⁽⁶⁾ | 311,836 | 312,142 | 312,433 | 310,072 |
| Diluted weighted average number of Stapled Units (in thousands of Stapled Units) for the calculation of AFFO ⁽²⁾⁽³⁾⁽⁵⁾⁽⁶⁾ | 307,595 | 312,142 | 312,433 | 310,072 |
| FFO per basic Stapled Unit (adjusted for conversion of exchangeable units) | \$0.45 | \$0.48 | \$1.84 | \$1.96 |
| FFO per diluted Stapled Unit | \$0.45 | \$0.47 | \$1.82 | \$1.93 |
| AFFO per basic Stapled Unit (adjusted for conversion of exchangeable units) | \$0.35 | \$0.37 | \$1.52 | \$1.54 |
| AFFO per diluted Stapled Unit | \$0.35 | \$0.37 | \$1.51 | \$1.52 |
| Distributions per Stapled Unit | \$0.35 | \$0.34 | \$1.38 | \$1.35 |
| Payout ratio per Stapled Unit as a % of FFO | 77.8% | 70.8% | 75.0% | 68.9% |

⁽¹⁾ During the year ended December 31, 2017, H&R realized a gain of U.S. \$8.9 million (December 31, 2016 – nil) on the sale of an investment previously classified as held for trading which has not been added back above.

⁽²⁾ For the three months ended December 31, 2017 and 2016, included in the weighted average and diluted weighted average number of Stapled Units are exchangeable units of 15,546,256 and 16,130,642 respectively. For the year ended December 31, 2017 and 2016, included in the weighted average and diluted weighted average number of Stapled Units are exchangeable units of 15,674,341 and 16,188,019, respectively.

⁽³⁾ For the three months ended December 31, 2017 and 2016, 966,301 Stapled Units and 1,493,059 Stapled Units, respectively, are included in the determination of diluted FFO and AFFO with respect to H&R's Unit Option Plan and Incentive Unit Plan. For the years ended December 31, 2017 and 2016, 1,555,465 Stapled Units and 1,501,069 Stapled Units, respectively, are included in the determination of diluted FFO and AFFO with respect to H&R's Unit Option Plan and Incentive Unit Plan.

⁽⁴⁾ The 2020 convertible debentures are dilutive for the three months ended December 31, 2017. Therefore, debenture interest of \$1.5 million is added to FFO and 4,240,511 Stapled Units are included in the diluted weighted average number of Stapled Units outstanding for this period.

⁽⁵⁾ The 2018 and 2020 convertible debentures are dilutive for the year ended December 31, 2017. Therefore, debenture interest of \$8.8 million is added to FFO and AFFO and 6,416,361 Stapled Units is included in the diluted weighted average number of Stapled Units outstanding for these periods.

⁽⁶⁾ The 2016, 2018 and 2020 convertible debentures are dilutive for the three months and year ended December 31, 2016. Therefore, debenture interest of \$3.3 million and \$13.3 million, respectively, are added to FFO and AFFO and 10,167,061 Stapled Units and 10,167,115 Stapled Units, respectively, are included in the diluted weighted average number of Stapled Units outstanding for these periods.

H&R REIT AND H&R FINANCE TRUST - MD&A – DECEMBER 31, 2017

Included in FFO at the Trusts' proportionate share are the following items which can be a source of variances between periods:

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|----------------|------------------|------------------------|-----------------|-------------------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Lease termination payments | \$4 | \$91 | (\$87) | \$5,989 | \$5,855 | \$134 |
| Mortgage prepayment penalties | (404) | - | (404) | (952) | - | (952) |
| Jackson Park marketing expenses | (708) | - | (708) | (708) | - | (708) |
| Adjustment to straight-lining of contractual rent | (252) | - | (252) | (5,892) | (2,535) | (3,357) |
| Other income | 1,040 | 1,454 | (414) | 1,040 | 20,353 | (19,313) |
| Realized gain on sale of investment | - | - | - | 8,935 | - | 8,935 |
| | (\$320) | \$1,545 | (\$1,865) | \$8,412 | \$23,673 | (\$15,261) |

Excluding the above items, FFO would have been \$137.8 million for the three months ended December 31, 2017 (Q4 2016 - \$141.4 million) and \$0.45 per basic Stapled Unit (Q4 2016 - \$0.47 per basic Stapled Unit). For the year ended December 31, 2017, FFO would have been \$551.7 million (Q4 2016 - \$560.6 million) and \$1.81 per basic Stapled Unit (Q4 2016 - \$1.88 per basic Stapled Unit).

Included in AFFO at the Trusts' proportionate share are the following items which can be a source of variances between periods:

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-------------------|------------------|------------------------|-------------------|----------------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Lease termination payments | \$4 | \$91 | (\$87) | \$5,989 | \$5,855 | \$134 |
| Mortgage prepayment penalties | (404) | - | (404) | (952) | - | (952) |
| Jackson Park marketing expenses | (708) | - | (708) | (708) | - | (708) |
| Other income | 1,040 | 1,454 | (414) | 1,040 | 20,353 | (19,313) |
| Realized gain on sale of investment | - | - | - | 8,935 | - | 8,935 |
| Capital expenditures | (17,890) | (20,539) | 2,649 | (62,965) | (71,231) | 8,266 |
| Leasing expenses and tenant inducements | (11,181) | (7,356) | (3,825) | (30,801) | (41,668) | 10,867 |
| Additional current year capital expenditure recoveries net of capital expenditures | 632 | 341 | 291 | 2,297 | 1,962 | 335 |
| | (\$28,507) | (\$26,009) | (\$2,498) | (\$77,165) | (\$84,729) | \$7,564 |

Excluding the above items, AFFO would have been \$135.6 million for the three months ended December 31, 2017 (Q4 2016 - \$138.2 million) and \$0.44 per basic Stapled Unit (Q4 2016 - \$0.46 per basic Stapled Unit). For the year ended December 31, 2017, AFFO would have been \$541.4 million (Q4 2016 - \$543.6 million) and \$1.78 per basic Stapled Unit (Q4 2016 - \$1.82 per basic Stapled Unit).

H&R REIT AND H&R FINANCE TRUST - MD&A – DECEMBER 31, 2017

The following is a breakdown of H&R's capital and tenant expenditures by operating segment:

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|---|--------------------------------|----------|-----------|------------------------|----------|------------|
| | 2017 | 2016 | Change | 2017 | 2016 | Change |
| Office: | | | | | | |
| Capital expenditures | \$10,307 | \$11,595 | (\$1,288) | \$33,675 | \$48,517 | (\$14,842) |
| Leasing expenditures and tenant inducements | 5,400 | 5,393 | 7 | 17,179 | 29,288 | (12,109) |
| Primaris: | | | | | | |
| Capital expenditures | 2,924 | 3,737 | (813) | 10,264 | 11,756 | (1,492) |
| Leasing expenditures and tenant inducements | 2,777 | 1,790 | 987 | 8,822 | 8,153 | 669 |
| H&R Retail: | | | | | | |
| Capital expenditures | - | - | - | 1,065 | 182 | 883 |
| Leasing expenditures and tenant inducements | 705 | 152 | 553 | 1,170 | 1,182 | (12) |
| ECHO: | | | | | | |
| Capital expenditures | 752 | 1,127 | (375) | 2,366 | 2,616 | (250) |
| Leasing expenditures and tenant inducements | 914 | 11 | 903 | 1,206 | 560 | 646 |
| Industrial: | | | | | | |
| Capital expenditures | 2,343 | 2,219 | 124 | 9,694 | 2,941 | 6,753 |
| Leasing expenditures and tenant inducements | 1,385 | 10 | 1,375 | 2,424 | 2,485 | (61) |
| Lantower Residential: | | | | | | |
| Capital expenditures | 1,564 | 1,861 | (297) | 5,901 | 5,219 | 682 |
| Leasing expenditures and tenant inducements | - | - | - | - | - | - |
| Total at the Trusts' proportionate share | 29,071 | 27,895 | 1,176 | 93,766 | 112,899 | (19,133) |
| Less: equity accounted investments | (4,803) | (3,062) | (1,741) | (\$13,199) | (19,293) | 6,094 |
| Total per the Trusts' Financial Statements ⁽¹⁾ | \$24,268 | \$24,833 | (\$565) | \$80,567 | \$93,606 | (\$13,039) |

⁽¹⁾ Equal to the sum of capital expenditures and leasing expenses and tenant inducements per the Trusts' Financial Statements.

H&R's current largest office project is at 160 Elgin St., in Ottawa, ON which is undergoing a complete renovation of the lobby and all of the retail space. Total capital and tenant expenditures spent during the three months and year ended December 31, 2017 were \$6.7 million and \$27.3 million, respectively, compared to the three months and year ended December 31, 2016 of \$8.8 million and \$29.1 million, respectively. H&R expects to spend an additional \$4.8 million to complete these projects and an additional \$2.2 million for elevator upgrades.

Capital and tenant expenditures from the Office segment decreased by \$27.0 million for the year ended December 31, 2017 compared to the respective 2016 period, primarily due to the completion of projects at 310-320-330 Front St., in Toronto, ON and Scotia Plaza.

Capital expenditures from the Industrial segment increased by \$0.1 million and \$6.8 million for the three months and year ended December 31, 2017 compared to the respective 2016 periods, primarily due to re-paving work at two U.S. industrial properties tenanted by Nestle USA. These two properties were subsequently sold in December 2017.

LIQUIDITY AND CAPITAL RESOURCES**Cash Distributions**

In accordance with National Policy 41-201 - *Income Trusts and Other Indirect Offerings*, the Trusts are required to provide the following additional disclosure relating to cash distributions.

| (in thousands of Canadian dollars) | Three months ended December 31, 2017 | Year ended December 31, 2017 | Year ended December 31, 2016 | Year ended December 31, 2015 |
|---|---|---|------------------------------------|------------------------------------|
| Cash provided by operations | \$128,512 | \$479,239 | \$424,196 | \$467,354 |
| Net income | 325,213 | 667,870 | 388,745 | 340,148 |
| Total distributions ⁽¹⁾ | 100,344 | 397,908 | 381,106 | 373,072 |
| Excess cash provided by operations over total distributions | 28,168 | 81,331 | 43,090 | 94,282 |
| Excess (shortfall) of net income over total distributions | 224,869 | 269,962 | 7,639 | (32,924) |

(1) Total distributions include cash distributions to unitholders and unit distributions issued under the DRIP.

Unit distributions issued under the DRIP were \$26.1 million and \$107.4 million, respectively, for the three months and year ended December 31, 2017, which are non-cash distributions. Total distributions include cash distributions to unitholders and unit distributions issued under the DRIP of \$106.8 million and \$105.4 million, respectively, for the years ended December 31, 2016 and 2015, which are non-cash distributions. Unit distributions issued under the DRIP result in an increase in the number of Stapled Units outstanding which may result in increased cash distributions in the future assuming a stable cash component of distributions per unit. Distributions exceeded net income for the year ended December 31, 2015 primarily due to non-cash items. Non-cash items relating to the fair value adjustments on financial instruments and real estate assets, amortization, unrealized gain (loss) on foreign exchange and deferred income tax expense are deducted from or added to net income and have no impact on cash available to pay current distributions.

Major Cash Flow Components

| (in thousands of Canadian dollars) | Three months ended December 31 | | | Year ended December 31 | | |
|--|--------------------------------|-----------|--------------|------------------------|-----------|--------------|
| | 2017 | 2016 | Source/(Use) | 2017 | 2016 | Source/(Use) |
| Cash and cash equivalents, beginning of period | \$51,727 | \$47,808 | \$3,919 | \$48,021 | \$38,287 | \$9,734 |
| Cash flows from operating activities | 128,512 | 98,020 | 30,492 | 479,239 | 424,196 | 55,043 |
| Cash flows from (used) in investing activities | (425,489) | 32,796 | (458,285) | (625,635) | (1,247) | (624,388) |
| Cash flows from (used) in financing activities | 287,534 | (130,603) | 418,137 | 140,659 | (413,215) | 553,874 |
| Cash and cash equivalents, end of period | \$42,284 | \$48,021 | (\$5,737) | \$42,284 | \$48,021 | (\$5,737) |

Cash flows from operating activities increased by \$30.5 million and \$55.0 million for the three months and year ended December 31, 2017, respectively, compared to the respective 2016 periods primarily due to changes in non-cash operating working capital and a one-time mortgage prepayment penalty of \$13.9 million relating to the 50% non-managing interest sale of TransCanada Tower in Q4 2016.

Cash flows from (used) in investing activities decreased by \$458.3 million for the three months ended December 31, 2017 compared to the respective 2016 period, primarily due to an increase in cash spent on acquisitions and a decrease in cash received as a result of lower dispositions in Q4 2017. Cash flows from (used) investing activities decreased by \$624.4 million for the year ended December 31, 2017 compared to the respective 2016 period, primarily due to an increase in cash spent on acquisitions, properties under development and mortgages receivable and a decrease in cash received as a result of lower dispositions in 2017.

Cash flows from (used) in financing activities increased by \$418.1 million for the three months ended December 31, 2017 compared to the respective 2016 period, primarily due to an increase in bank indebtedness. Cash flows from (used) in financing activities increased by \$553.8 million for the year ended December 31, 2017 compared to the respective 2016 period, primarily due to the issuance of mortgages and debentures payable of which proceeds were used to repay bank indebtedness.

Capital Resources

Subject to market conditions, management expects to be able to meet all of the Trusts' ongoing obligations and to finance short-term development commitments through the general operating facilities discussed below and the Trusts' cash flow from operations. As at December 31, 2017, the Trusts are not in default or arrears on any of their obligations including interest or principal payments on debt and any debt covenant.

The Trusts have cash and cash equivalents on hand of \$42.3 million and have the following bank credit facilities as at December 31, 2017:

| Bank Credit Facilities (in thousands of Canadian Dollars) | Maturity Date | Total Facility | Bank Indebtedness | Outstanding Letters of Credit | Available Balance |
|--|--------------------|-------------------|----------------------|----------------------------------|----------------------|
| Unsecured operating facilities: | | | | | |
| H&R unsecured operating facility #1 ^(a) | December 18, 2018 | \$500,000 | (\$208,713) | (\$31,928) | \$259,359 |
| H&R unsecured operating facility #2 ^(b) | March 17, 2021 | 200,000 | (186,629) | - | 13,371 |
| Sub-total unsecured facilities | | 700,000 | (395,342) | (31,928) | 272,730 |
| Secured operating facilities*: | | | | | |
| Primaris secured operating facility ^(a) | July 1, 2019 | 300,000 | (283,340) | (891) | 15,769 |
| H&R and CrestPSP secured operating facility ^(a) | February 19, 2019 | 25,000 | - | (105) | 24,895 |
| H&R Retail co-ownership secured operating facility | September 30, 2019 | 3,514 | (3,514) | - | - |
| Sub-total secured facilities | | 328,514 | (286,854) | (996) | 40,664 |
| | | \$1,028,514 | (\$682,196) | (\$32,924) | \$313,394 |

* Secured by certain investment properties.

The bank credit facilities bear interest at a rate approximating the prime rate of a Canadian chartered bank.

^(a) Can be drawn in either Canadian or U.S. dollars.

^(b) The total facility as at December 31, 2017 is \$200.0 million, plus a 3.00% allowance relating to the fluctuation of the foreign exchange rate, and can be drawn in either Canadian or U.S. dollars. H&R entered into an interest rate swap agreement to economically fix the interest rate at 2.56% per annum on U.S. \$130.0 million of the U.S. dollar denominated borrowing of this facility.

In January 2018, H&R obtained an additional \$200.0 million unsecured revolving operating facility due on January 31, 2023.

As at December 31, 2017, H&R had 108 unencumbered properties, with a fair value of approximately \$3.6 billion. Also, due to H&R's 21-year history and management's conservative strategy of securing long-term financing on individual properties, H&R had numerous other properties with very low loan to value ratios. As at December 31, 2017, H&R had 49 properties valued at approximately \$1.3 billion which are encumbered with mortgages totalling \$235.7 million. In this pool of assets, the average loan to value is 18.3%, the minimum loan to value is 1.2% and the maximum loan to value is 29.3%.

The following is a summary of material contractual obligations at the Trusts' proportionate share (unless otherwise stated) including payments due as at December 31, 2017 for the next five years and thereafter:

| Contractual Obligations ⁽¹⁾ (in thousands of Canadian dollars) | Payments Due by Period | | | | Total |
|--|------------------------|---------------|---------------|------------------------|-------------|
| | 2018 | 2019- 2020 | 2021- 2022 | 2023 and thereafter | |
| Mortgages payable | \$284,884 | \$789,606 | \$1,636,272 | \$1,451,441 | \$4,162,203 |
| Convertible Debentures | - | 99,652 | - | - | 99,652 |
| Senior Debentures | 557,500 | 525,000 | 325,000 | 350,000 | 1,757,500 |
| Bank indebtedness | 208,713 | 701,889 | 186,629 | - | 1,097,231 |
| Total contractual obligations | \$1,051,097 | \$2,116,147 | \$2,147,901 | \$1,801,441 | \$7,116,586 |

⁽¹⁾ The amounts in the above table are the principal amounts due under the contractual agreements.

DBRS Limited (“DBRS”) provides credit ratings of debt securities for commercial entities. A credit rating generally provides an indication of the risk that the borrower will not fulfill its obligations in a timely manner with respect to both interest and principal commitments. Rating categories range from highest credit quality (generally AAA) to default payment (generally D). A credit rating is not a recommendation to buy, sell or hold securities.

DBRS has confirmed that H&R has a credit rating of BBB (high) with a Stable trend as at December 31, 2017. This is a rating achieved by only three REITs and one real estate company to date. A credit rating of BBB (high) by DBRS is generally an indication of adequate credit quality, where the capacity for payment of financial obligations is considered acceptable, however the entity may be vulnerable to future events. A credit rating of BBB or higher is an investment grade rating. There can be no assurance that any rating will remain in effect for any given period of time or that any rating will not be withdrawn or revised by DBRS at any time. The credit rating is reviewed periodically by DBRS.

H&R has no material capital or operating lease obligations.

Funding of Future Commitments

Management believes that as at December 31, 2017, through cash on hand of \$42.3 million and the combined amount available under its general operating facilities of \$313.4 million and its unencumbered property pool of approximately \$3.6 billion, H&R has sufficient funds for future commitments.

The following summarizes the estimated loan to value ratios on properties whose mortgages mature over the next five years:

| Year | Number of Properties | Mortgage Debt due on Maturity (\$000's) ⁽¹⁾ | Weighted Average Interest Rate on Maturity | Fair Value of Investment Properties (\$000's) ⁽¹⁾ | Loan to Value |
|------|----------------------|--|--|--|---------------|
| 2018 | 34 | \$135,308 | 5.0% | \$384,798 | 35% |
| 2019 | 16 | 122,408 | 3.7% | 334,386 | 37% |
| 2020 | 16 | 355,378 | 4.4% | 981,762 | 36% |
| 2021 | 13 | 837,610 | 3.9% | 3,520,012 | 24% |
| 2022 | 48 | 589,839 | 4.0% | 3,255,798 | 18% |
| | 127 | \$2,040,543 | 4.1% | \$8,476,756 | 24% |

⁽¹⁾ Converting U.S. dollars to Canadian dollars at an exchange rate of \$1.26 as at December 31, 2017.

Based on the low percentage of the projected loan to values of the maturing mortgages, H&R is confident it will be able to refinance these mortgages upon maturity should it choose to do so.

OFF-BALANCE SHEET ITEMS

In the normal course of operations, H&R has issued letters of credit in connection with developments, financings, operations and acquisitions. As at December 31, 2017, H&R has outstanding letters of credit totalling \$32.9 million (December 31, 2016 - \$34.3 million), including \$15.1 million (December 31, 2016 - nil) which has been pledged as security for certain mortgages payable. The letters of credit are secured in the same manner as the bank indebtedness.

H&R has co-owners and partners in various projects. As a rule H&R does not provide guarantees or indemnities for these co-owners and partners pursuant to property acquisitions because should such guarantees be provided, recourse would be available against H&R in the event of a default of the co-owners and partners. In such case, H&R would have a claim against the underlying real estate investment. However, in certain circumstances, subject to compliance with H&R's Declaration of Trust and the determination by management that the fair value of the co-owners' or partners' investment is greater than the mortgages payable for which H&R has provided guarantees, such guarantees will be provided. At December 31, 2017, such guarantees amounted to \$369.2 million expiring between 2020 and 2029 (December 31, 2016 - \$171.1 million, expiring between 2020 and 2029), and no amount has been provided for in the Trusts' Financial Statements for these items. These amounts arise where H&R has guaranteed a co-owner's share of the mortgage liability. H&R, however, customarily guarantees or indemnifies the obligations of its nominee companies which hold separate title to each of its properties owned.

In addition, H&R continued to guarantee certain debt assumed by purchasers in connection with past dispositions of properties, and will remain liable until such debts are extinguished or the lenders agree to release H&R's guarantee. At December 31, 2017, the estimated amount of debt subject to such guarantees, and therefore the maximum exposure to credit risk is approximately \$119.3 million, expiring between 2018 and 2020 (December 31, 2016 - \$133.0 million, expiring between 2017 and 2020). There have been no defaults by the primary obligors for debts on which H&R has provided its guarantees, and as a result, no contingent loss on these guarantees has been recognized in the Trusts' Financial Statements.

FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS

Where appropriate, H&R, including ECHO and Jackson Park, uses forward contracts to lock-in lending rates on certain anticipated mortgages, debentures and bank borrowings. This strategy provides certainty to the rate of interest on borrowings when H&R is involved in transactions that may close further into the future than usual for typical transactions. At the end of each reporting period, an interest rate swap is marked-to-market, resulting in an unrealized gain or loss recorded in net income.

Where appropriate, H&R uses forward exchange contracts to lock-in foreign exchange rates. This strategy manages risks related to foreign exchange rates on transactions that will occur in the future. H&R did not enter into any forward exchange contracts during the year ended December 31, 2017.

As at December 31, 2017, H&R had the following interest rate swaps outstanding:

| | | Fair value asset (liability)* | | Net gain (loss) on derivative contracts | |
|--------------------------------------|-----|-------------------------------|------------------|---|------------------|
| | | December 31 | December 31 | Year ended December 31 | |
| | | 2017 | 2016 | 2017 | 2016 |
| Debenture interest rate swap | (a) | \$2,231 | \$776 | \$1,455 | \$776 |
| Debenture interest rate swap | (b) | 177 | (407) | 584 | (407) |
| Bank indebtedness interest rate swap | (c) | 3,966 | (3,384) | 7,350 | (3,384) |
| | | \$6,374 | (\$3,015) | \$9,389 | (\$3,015) |

(a) To fix the interest rate at 2.36% per annum for the Series K senior debentures, which mature on March 1, 2019.

(b) To fix the interest rate at 2.54% per annum for the Series I senior debentures (settled when these debentures matured on January 23, 2017) and, to fix the interest rate at 2.04% per annum for the Series J senior debentures, which mature on February 9, 2018.

(c) To fix the interest rate at 2.56% per annum on U.S. \$130.0 million of bank indebtedness, maturing on March 17, 2021.

* Derivative instruments in asset and liability positions are not presented on a net basis. Derivative instruments in an asset position are recorded in other assets and derivative instruments in a liability position are recorded in accounts payable and accrued liabilities.

SECTION IV

CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

Preparation of the Trusts' Financial Statements requires management to make estimates and judgements that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the Trusts' Financial Statements and reported amounts of revenue and expenses during the reporting period.

For a description of the accounting policies that management believes are subject to greater estimation and judgement, as well as other accounting policies, refer to notes 1 and 2 of the Trusts' Financial Statements.

Use of Estimates

Information about assumption and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year are:

- Fair value of real estate assets; and
- Deferred tax asset (liability).

Use of Judgements

- Business combinations

Accounting for business combinations under IFRS 3, *Business Combinations* ("IFRS 3") is only applicable if it is determined that a business has been acquired. Under IFRS 3, a business is defined as an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to H&R. A business generally consists of inputs, processes applied to those inputs and resulting outputs that are, or will be, used to generate revenues. In the absence of such criteria, a group of assets is deemed to have been acquired. If goodwill is present in a transferred set of activities and assets, the transferred set is presumed to be a business.

Judgement is used by management in determining whether the acquisition of an individual property, or a group of properties, qualifies as a business combination in accordance with IFRS 3 or as an asset acquisition.

- Valuations of real estate assets

Real estate assets, which consist of investment properties and properties under development, are carried on the combined statements of financial position at fair value, as determined by either qualified external valuation professionals or by management. The valuations are based on a number of assumptions, such as appropriate discount rates and capitalization rates and estimates of future rental income, operating expenses and capital expenditures. Valuation of real estate assets is one of the principal estimates and uncertainties in the Trusts' Financial Statements and this MD&A. Refer to note 3 of the Trusts' Financial Statements for further information on estimates and assumptions made in the determination of the fair value of real estate assets. Judgement is applied in determining whether certain costs are additions to the carrying value of the real estate assets, identifying the point at which practical completion of the property occurs and identifying the directly attributable borrowing costs to be included in the carrying value of the development properties.

- Leases

H&R's policy for property rental revenue recognition is described in note 2(f) of the December 31, 2017 Trusts' Financial Statements. H&R makes judgements in determining whether certain leases, in particular those tenant leases with long contractual terms and long-term ground leases where H&R is the lessor, are operating or finance leases. H&R has determined that all of its leases are operating leases.

- Income taxes

H&R currently qualifies as a real estate investment trust and a mutual fund trust for Canadian income tax purposes. A real estate investment trust will not be subject to the tax levied on "specified investment flow-through" ("SIFT") trusts provided it continues to meet prescribed conditions under the Tax Act, including with respect to the nature of its assets and revenue, (the "REIT Conditions") at all times throughout a taxation year. Accordingly, no provision for current or deferred income taxes has been recorded by H&R as at December 31, 2017 in respect of its Canadian entities.

H&R will not be subject to income tax in a year to the extent that it continues to qualify as a real estate investment trust and distributes all of its taxable income to its unitholders. Income allocated to unitholders will be taxed at the unitholder level. H&R currently distributes, and is required to distribute, all of its income to its unitholders. Accordingly, for financial statement reporting purposes, the tax deductibility of H&R's distributions is treated as an exemption from taxation.

- Impairment of equity accounted investments

H&R determines at each reporting date whether there is any objective evidence that the equity accounted investments are impaired. If so, H&R calculates the amount of impairment as the difference between the recoverable amount of the equity accounted investment and its carrying value and recognizes the amount in net income.

NEW STANDARDS AND INTERPRETATIONS NOT YET ADOPTED

Standards issued but currently not yet effective are described below. The Trusts' intend to adopt these standards when they become effective.

(i) *Share-Based Payment* ("IFRS 2")

In 2016, the IASB issued amendments to IFRS 2 *Share-based Payment*, clarifying how to account for certain types of share-based payment transactions. The Trusts intend to adopt the amendments to IFRS 2 in their combined financial statements for the annual period beginning on January 1, 2018.

(ii) *Financial Instruments: Classification and Measurement* ("IFRS 9")

The Trusts will adopt IFRS 9, *Financial Instruments: Classification and Measurement*, which replaces IAS 39 *Financial Instruments: Recognition and Measurement* ("IAS 39"), in the combined financial statements beginning on January 1, 2018, the mandatory effective date. The adoption of IFRS 9 will generally be applied retrospectively, without restatement of comparative information.

IFRS 9 contains a new classification and measurement approach which requires financial assets to be classified and measured based on the business model in which they are held and the characteristics of their contractual cash flows. IFRS 9 contains three principal classification categories for financial assets: measured at amortized cost, fair value through other comprehensive income and fair value through profit or loss, and eliminates the existing IAS 39 categories of held to maturity, loans and receivables and available for sale.

For impairment of financial assets, IFRS 9 replaces the 'incurred loss' model in IAS 39 with a forward-looking 'expected credit loss' model. The new impairment model will apply to financial assets measured at amortized cost or fair value through other comprehensive income, except for investments in equity instruments, and to contract assets.

IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. However, under IAS 39 all fair value changes of liabilities designated as fair value through profit or loss are recognized in profit or loss, whereas under IFRS 9 the amount of change in fair value attributable to changes in the credit risk of the liability is presented in other comprehensive income, and the remaining amount of change in fair value is presented in profit or loss.

IFRS 9 also includes a new general hedge accounting standard which aligns hedge accounting more closely with risk management. The Trusts do not currently apply hedge accounting.

Management does not expect the adoption of IFRS 9 to have a material impact on the combined financial statements.

(iii) *Revenue from Contracts with Customers ("IFRS 15")*

IFRS 15, *Revenue from Contracts with Customers* is effective for annual periods beginning on or after January 1, 2018, and will replace all existing guidance in IFRS related to revenue, including (but not limited to) IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 15 *Agreements for the Construction of Real Estate*.

IFRS 15 contains a single, control-based model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. IFRS 15 also includes additional disclosure requirements for revenue accounted for under the standard.

The Trusts will adopt IFRS 15 in the combined financial statements for the annual period beginning January 1, 2018. The Trust plans to adopt IFRS 15 using the cumulative effect method, with the effect of initially applying this standard recognized at January 1, 2018. As a result, the Trusts will not apply the requirements of IFRS 15 to the comparative period presented. Management does not expect that the adoption of IFRS 15 will have a material impact on the combined financial statements. However, additional disclosure requirements may result in separate disclosure of revenue for service components that are part of a lease (i.e. a non-lease component).

(iv) *Leases ("IFRS 16")*

IFRS 16, *Leases* will replace existing lease guidance in IFRS and related interpretations, and requires lessees to bring most leases on-balance sheet. Lessor accounting remains similar to the current standard. The new standard is effective for years beginning on January 1, 2019.

The Trusts are still evaluating the impact of IFRS 16. In particular, the Trusts are assessing how the new standard may impact the identification of lease and non-lease components, including the allocation of consideration to each lease and non-lease component. The standard requires this allocation to be completed in accordance with the guidance in IFRS 15, that is, on the basis of relative standalone selling prices.

(v) *IFRIC Interpretation 23, Uncertainty over Income Tax Treatments*

On June 7, 2017, the IASB issued IFRIC Interpretation 23 *Uncertainty over Income Tax Treatments*. The Interpretation provides guidance on the accounting for current and deferred tax liabilities and assets in circumstances in which there is uncertainty over income tax treatments. The Interpretation is applicable for annual periods beginning on or after January 1, 2019 with early adoption permitted. The Interpretation requires the Trusts to: a) contemplate whether uncertain tax treatments should be considered separately, or together as a group, based on which approach provides better predictions of the resolution; b) determine if it is probable that the tax authorities will accept the uncertain tax treatment and c) if it is not probable that the uncertain tax treatment will be accepted, measure the tax uncertainty based on the most likely amount or expected value, depending on whichever method better predicts the resolution of the uncertainty. The Trusts intend to adopt the Interpretation in their combined financial statements for the annual period beginning on January 1, 2019. The extent of the impact of adoption of the Interpretation has not yet been determined.

DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Each Trust's CEO and Chief Financial Officer ("CFO") has designed, or caused to be designed under their direct supervision, the applicable Trusts' disclosure controls and procedures (as defined in National Instrument 52-109 - *Certification of Disclosure in Issuers' Annual and Interim Filings* ("NI 52-109"), adopted by the Canadian Securities Administrators to provide reasonable assurance that: (i) material information relating to the applicable Trust, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the annual filings are being prepared; and (ii) information required to be disclosed in the annual filings, interim filings or other reports filed or submitted under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation. The Trusts' CEO and CFO have evaluated,

or caused to be evaluated under their supervision, the effectiveness of the Trusts' disclosure controls and procedures as at December 31, 2017, and based upon that evaluation have each concluded that such disclosure controls and procedures were appropriately designed and were operating effectively as at December 31, 2017. The Trusts' Financial Statements and this MD&A were reviewed and approved by H&R's Audit Committee and the Board of Trustees prior to this publication.

Management of each Trust has reviewed its respective internal control over financial reporting on an annual basis. The Trusts' management, under the supervision of the CEO and the CFO, has evaluated the effectiveness of internal control over financial reporting as at December 31, 2017 using the framework and criteria established in Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission in May 2013 (2013 COSO Framework). Based on this evaluation, the CEO and the CFO have concluded that internal control over financial reporting was effective as of December 31, 2017. No changes were made to either Trust's internal control over financial reporting during the three month period ended December 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Trusts' internal controls over financial reporting.

Each Trust's management, including the CEO and CFO, does not expect that the applicable Trusts' controls and procedures will prevent or detect all misstatements due to error or fraud. Due to the inherent limitations in all control systems, an evaluation of controls can provide only reasonable, not absolute assurance, that all control issues and instances of fraud or error, if any, within the Trusts have been detected. The Trusts are continually evolving and enhancing their systems of controls and procedures.

SECTION V

RISKS AND UNCERTAINTIES

All real estate assets are subject to a degree of risk and uncertainty. They are affected by various factors including general market conditions and local market circumstances. An example of general market conditions would be the availability of long-term mortgage financing whereas local conditions would relate to factors affecting specific properties such as an oversupply of space or a reduction in demand for real estate in a particular area. Management attempts to manage these risks through geographic, type of asset and tenant diversification in H&R's portfolio. The major risk factors including detailed descriptions are outlined below and in H&R's Annual Information Form.

Real Property Ownership

All real property investments are subject to a degree of risk and uncertainty. Such investments are affected by various factors including general economic conditions, local real estate markets, demand for leased premises, competition from other available premises and various other factors.

The value of real property and any improvements thereto may also depend on the credit and financial stability of the tenants. Distributable cash and H&R's income would be adversely affected if one or more major tenants or a significant number of tenants were to become unable to meet their obligations under their leases or if a significant amount of available space in the properties in which H&R has an interest is not able to be leased on economically favourable lease terms. In the event of default by a tenant, delays or limitations in enforcing rights as lessor may be experienced and substantial costs in protecting H&R's investment may be incurred. Furthermore, at any time, a tenant of any of the properties in which H&R has an interest may seek the protection of bankruptcy, insolvency or similar laws that could result in the rejection and termination of such tenant's lease and thereby cause a reduction in the cash flow available to H&R.

Given the prominence of the oil and gas industry in the province of Alberta, the economy of this province can be significantly impacted by commodity prices. For the year ended December 31, 2017, approximately 25.9% of H&R's Same-Asset property operating income (cash basis) was generated from Alberta. Accordingly, any continuing decline or prolonged weakness in commodity prices, could adversely affect those tenants of H&R that are involved in the oil and gas industry, thereby increasing the credit risk of such tenants to H&R which in turn may adversely affect H&R's operating results.

With respect to the Primaris segment, retail shopping centres have traditionally relied on there being a number of anchor tenants (department stores, discount department stores and grocery stores) in the centre, and therefore they are subject to the risk of such anchor tenants either moving out of the property or going out of business. Within the Primaris segment, certain of the major tenants are permitted to cease operating from their leased premises at any time at their option, however, they remain liable to pay all remaining rent in accordance with their leases. Other major tenants are permitted to cease operating from their leased premises or to terminate their leases if certain events occur. Some commercial retail unit tenants have a right to cease operating from their premises if certain major tenants cease operating from their premises. The exercise of such rights by a tenant may have a negative effect on a property. There can be no assurance that such rights will not be exercised in the future.

The ability to rent unleased space in the properties in which H&R has an interest will be affected by many factors and costs may be incurred in making improvements or repairs to property required by a new tenant. A prolonged deterioration in economic conditions could increase and exacerbate the foregoing risks. The failure to rent unleased space on a timely basis or at all would likely have an adverse effect on H&R's financial condition.

Certain significant expenditures, including property taxes, maintenance costs, mortgage payments, insurance costs and related charges must be made throughout the period of ownership of real property regardless of whether the property is producing any income. If H&R is unable to meet mortgage payments on any property, losses could be sustained as a result of the mortgagee's exercise of its rights of foreclosure or sale.

H&R may, in the future, be exposed to a general decline of demand by tenants for space in properties. As well, certain of the leases of the properties held by H&R have early termination provisions and such termination rights are generally exercisable at a cost to the tenant only. The amount of space in H&R's portfolio which could be affected is not significant.

A mortgage on any one property may, from time to time, exceed the estimated current market value of the related property. The cash flow from such a property may not be sufficient to cover debt servicing for that property. The cash flow from H&R's portfolio is, however, expected by management to be sufficient to cover any cash flow shortfalls on such a property.

Credit Risk and Tenant Concentration

H&R is exposed to credit risk in the event that borrowers default on the repayment of the amounts owing to H&R. Management mitigates this risk by ensuring adequate security has been provided in support of mortgages receivable.

H&R is exposed to credit risk as an owner of real estate in that tenants may become unable to pay the contracted rents. Management mitigates this risk by carrying out appropriate credit checks and related due diligence on the significant tenants. Management has diversified H&R's holdings so that it owns several categories of properties (office, retail, industrial and residential) and acquires properties throughout Canada and the United States. In addition, management ensures that no tenant or related group of tenants, other than investment grade tenants, account for a significant portion of the cash flow. The only tenants which individually account for more than 5% of the rentals from investment properties of H&R are Encana Corporation, Bell Canada and Hess Corporation. All of these companies have a public debt rating that is rated with at least a BBB- Stable rating by a recognized rating agency.

Lease Rollover Risk

Lease rollover risk arises from the possibility that H&R may experience difficulty renewing leases as they expire. Management attempts to enter into long-term leases to mitigate this risk. Management attempts to mitigate the risk by having staggered lease maturities and entering into longer term leases with built-in rental escalations. The leases for 39.6% of H&R's total commercial leasable area will expire in the next 5 years.

Interest and Other Debt-Related Risk

H&R has been able to leverage off the low interest rate environment that the Canadian and U.S. economy has experienced in recent years which has enhanced its return to unitholders. A reversal of this trend, however, may lead to the Trusts' debt being refinanced at higher rates, thereby reducing net income and cash flows which could ultimately affect the level of distributions. In order to minimize this risk, H&R negotiates fixed rate term debt with staggered maturities on the portfolio. Derivative financial instruments may be utilized by the H&R in the management of its interest rate exposure. In addition, H&R's Declaration of Trust restricts total indebtedness permitted on the portfolio.

Construction Risks

It is likely that, subject to compliance with H&R's Declaration of Trust, H&R will be involved in various development projects. H&R's obligations in respect of properties under construction, or which are to be constructed, are subject to risks which include (i) the potential insolvency of a third party developer (where H&R is not the developer); (ii) a third party developer's failure to use advanced funds in payment of construction costs; (iii) construction or other unforeseeable delays; (iv) cost overruns; (v) the failure of tenants to occupy and pay rent in accordance with existing lease agreements, some of which are conditional; (vi) the incurring of construction costs before ensuring rental revenues will be earned from the project; and (vii) increases in interest rates during the period of the development. Management strives to mitigate these risks where possible by entering into fixed price construction contracts with general contractors (and to the extent possible, on a bonded basis) and by attempting to obtain long-term financing as early as possible during construction.

Currency Risk

The Trusts are exposed to foreign exchange fluctuations as a result of ownership of assets in the United States and the rental income earned from these properties. In order to mitigate the risk, H&R's debt on these properties is also denominated in U.S. dollars to act as a natural hedge.

H&R is exposed to foreign exchange fluctuations as a result of the U.S. Holdco Notes, Series J senior debentures and the U.S. bank indebtedness each being denominated in U.S. dollars.

Liquidity Risk

Real property investments tend to be relatively illiquid, with the degree of liquidity generally fluctuating in relationship with demand for and the perceived desirability of such investments. Such illiquidity will tend to limit H&R's ability to vary its portfolio promptly in response to changing economic or investment conditions. If for whatever reason, liquidation of assets is required, there is a risk that sale proceeds realized might be less than the previously estimated market value of H&R's investments or that market conditions would prevent prompt disposition of assets.

Cyber Security Risk

Cyber security has become an increasingly problematic issue for issuers and businesses in Canada and around the world, including H&R. Cyber attacks against large organizations are increasing in sophistication and are often focused on financial fraud, compromising sensitive data for inappropriate use or disrupting business operations. A cyber incident is considered to be any adverse event that threatens the confidentiality, integrity or availability of H&R's information resources. More specifically, a cyber-incident is an intentional attack or an unintentional event that can include gaining unauthorized access to information systems to disrupt operations, corrupt data or steal confidential information. As H&R's reliance on technology has increased, so have the risks posed to its systems. H&R's primary risks that could directly result from the occurrence of a cyber-incident include operational interruption, damage to its reputation, damage to H&R's business relationships with its tenants, disclosure of confidential information regarding its tenants, employees and third parties with whom H&R interacts, and may result in negative consequences, including remediation costs, loss of revenue, additional regulatory scrutiny and litigation. H&R has implemented processes, procedures and controls to help mitigate these risks, but these measures, as well as its increased awareness of a risk of a cyber-incident, do not guarantee that its financial results will not be negatively impacted by such an incident.

Financing Credit Risk

H&R is also exposed to credit risk as a lender on the security of real estate in the event that a borrower is unable to make the contracted payments. Such risk is mitigated through credit checks and related due diligence of the borrowers and through careful evaluation of the worth of the underlying assets.

Environmental Risk

As an owner and manager of real estate assets in Canada and the United States, H&R is subject to various laws relating to environmental matters. These laws impose a liability for the cost of removal and remediation of certain hazardous materials released or deposited on properties owned by H&R or on adjacent properties.

In accordance with best management practices, Phase 1 environmental audits are reviewed on all properties prior to acquisition. Further investigation is conducted if Phase 1 tests indicate a potential problem. H&R has operating policies to monitor and manage risk. In addition, the standard lease utilized requires tenants to comply with environmental laws and regulations, and restricts tenants from carrying on environmentally hazardous activities or having environmentally hazardous substances on site.

Co-Ownership Interest in Properties

In certain situations, H&R may be adversely affected by a default by a co-owner of a property under the terms of a mortgage, lease or other agreement. Although all co-owners agreements entered into by H&R provide for remedies to H&R in such circumstances, such remedies may not be exercisable in all circumstances, or may be insufficient or delayed, and may not cure a default in the event that such default by a co-owner is deemed to be a default of H&R.

Joint Arrangement Risks

H&R has several investments in joint ventures and investments in associates. H&R is subject to risks associated with the management and performance of these joint arrangements. Such risks include any disagreements with its partners relating to the development or operations of a property, as well as differences with respect to strategic decision making. Other risks include partners not meeting their financial or operational obligations. H&R attempts to mitigate these risks by maintaining good working relationships with its partners, and conducting due diligence on their partners to ensure there is a similar alignment of strategy prior to creating a joint arrangement.

Unit Prices

Publicly traded trust units will not necessarily trade at values determined solely by reference to the underlying value of trust assets. Accordingly, the Stapled Units may trade at a premium or a discount to the underlying value of the assets of H&R and Finance Trust. Investors in Stapled Units will be subject to all of the risks of an investment in units of Finance Trust and of an investment in units of H&R. See also "Forward-Looking Disclaimer".

One of the factors that may influence the quoted price of the Stapled Units is the annual yield on the Stapled Units. Accordingly, an increase in market interest rates may lead investors in Stapled Units to demand a higher annual yield, which could adversely affect the quoted price of Stapled Units. In

addition, the quoted price for Stapled Units may be affected by changes in general market conditions, fluctuations in the markets for equity securities and numerous other factors beyond the control of H&R and/or Finance Trust.

Availability of Cash for Distributions

As the monthly cash distribution paid by Finance Trust fluctuates, the monthly cash distribution paid by H&R will also fluctuate in order to result in an aggregate monthly cash distribution as previously outlined. Although H&R intends to make distributions of its available cash to unitholders in accordance with its distribution policy, these cash distributions may be reduced or suspended. The actual amount distributed by H&R will depend on numerous factors including monthly cash distributions paid by Finance Trust, capital market conditions, the financial performance of the properties, H&R's debt covenants and obligations, its working capital requirements, its future capital requirements, its development commitments and fluctuations in interest rates. Cash available to H&R for distributions may be reduced from time to time because of items such as principal repayments on debt, tenant allowances, leasing commissions, capital expenditures or any other business needs that the trustees deem reasonable. H&R may be required to use part of its debt capacity in order to accommodate any or all of the above items. The market value of Stapled Units may decline significantly if H&R and/or Finance Trust suspends or reduces distributions. H&R's trustees retain the right to re-evaluate the distribution policy from time to time as they consider appropriate.

Ability to Access Capital Markets

As H&R distributes a substantial portion of its income to unitholders, H&R may need to obtain additional capital through capital markets and H&R's ability to access the capital markets through equity issues and forms of secured or unsecured debt financing may affect the operations of H&R as such financing may be available only on disadvantageous terms, if at all. If financing is not available on acceptable terms, further acquisitions or ongoing development projects may be curtailed and cash available for distributions or to fund future commitments may be adversely affected.

Dilution

The number of units each of the Trusts is authorized to issue is unlimited. The trustees have the discretion to issue additional Stapled Units in certain circumstances, including under H&R's Unit Option Plan and Incentive Unit Plan. In addition, the Trusts issue Stapled Units pursuant to the DRIP and Unit Purchase Plan. Any issuance of Stapled Units may have a dilutive effect on the investors of Stapled Units.

Unitholder Liability

The Declarations of Trust of each of H&R and Finance Trust provide that unitholders will have no personal liability for actions of the Trusts and no recourse will be available to the private property of any unitholder for satisfaction of any obligation or claims arising out of a contract or obligation of a trust. Each Declaration of Trust of H&R and Finance Trust further provides that this lack of unitholder liability, where possible, must be provided for in certain written instruments signed by the applicable Trust. In addition, legislation has been enacted in the Provinces of Ontario and certain other provinces that is intended to provide unitholders in those provinces with limited liability. However, there remains a risk, which the Trusts consider to be remote in the circumstances, that a unitholder could be held personally liable for a Trust's obligations to the extent that claims are not satisfied out of the Trusts' assets. It is intended that the Trusts' affairs will be conducted to seek to minimize such risk wherever possible.

Redemption Right

Unitholders are entitled to have their units redeemed at any time on demand. It is anticipated that this redemption right will not be the primary mechanism for unitholders to liquidate their investments. The entitlement of holders of units of H&R to receive cash upon the redemption of their units is subject to the limitations that: (i) the total amount payable by H&R in respect of those units and all other units of H&R tendered for redemption in the same calendar month does not exceed \$50,000 (subject to certain adjustments and provided that the trustees of H&R may waive this limitation at their sole discretion), (ii) at the time such units are tendered for redemption, the outstanding Stapled Units shall be listed for trading or quoted on a stock exchange or traded or quoted on another market which the trustees consider, in their sole discretion, provides representative fair market value prices for the Stapled Units; and (iii) the normal trading of the units of H&R is not suspended or halted on any stock exchange on which the Stapled Units are listed (or, if not so listed, on any market on which the Stapled Units are quoted for trading) on the redemption date or for more than five trading days during the ten-day trading period commencing immediately prior to such date. In certain circumstances, H&R's Declaration of Trust provides for the in specie distributions of notes of H&R Portfolio LP Trust in the event of redemption of units of H&R that are part of the Stapled Units. The notes which may be distributed in specie to unitholders in connection with a redemption will not be listed on any stock exchange, no established market is expected to develop for such notes and they may be subject to resale restrictions under applicable securities laws.

Debentures

The likelihood that purchasers of the 2020 convertible debentures and the Series C, E, F, G, J, K, L, M, N, O and P Senior Debentures will receive payments owing to them under the terms of such debentures will depend on the financial health of H&R and its creditworthiness. In addition, such debentures are unsecured obligations of H&R and are subordinate in right of payment to all H&R's existing and future senior indebtedness as defined in each such respective trust indenture. Therefore, if H&R becomes bankrupt, liquidates its assets, reorganizes or enters into certain other transactions, H&R's assets

will be available to pay its obligations with respect to such debentures only after it has paid all of its senior indebtedness in full. There may be insufficient assets remaining following such payments to pay amounts due on any or all of the debentures then outstanding.

The debentures are also effectively subordinate to claims of creditors (including trade creditors) of H&R's subsidiaries except to the extent H&R is a creditor of such subsidiaries ranking at least *pari passu* with such other creditors. Finance Trust is a creditor of U.S. Holdco, a subsidiary of H&R. A parent entity is entitled only to the residual equity of its subsidiaries after all debt obligations of its subsidiaries are discharged. In the event of bankruptcy, liquidation or reorganization of H&R, holders of indebtedness of H&R (including holders of the convertible debentures), may become subordinate to lenders to the subsidiaries of H&R. The indentures governing such debentures do not prohibit or limit the ability of H&R or its subsidiaries to incur additional debt or liabilities (including senior indebtedness), to amend and modify the ranking of any indebtedness or to make distributions, except, in respect of distributions where an event of default has occurred and such default has not been cured or waived. The indentures do not contain any provision specifically intended to protect holders of debentures in the event of a future leveraged transaction involving H&R.

Tax Risk

The Tax Act includes rules (referred to herein as the "SIFT Rules") which effectively tax certain income of a publicly traded trust or partnership that is distributed to its investors on the same basis as would have applied had the income been earned through a taxable corporation and distributed by way of dividend to its shareholders. The SIFT Rules apply only to "SIFT trusts", "SIFT partnerships" (each as defined in the Tax Act, and collectively, "SIFTs") and their investors. A trust that qualifies as a "real estate investment trust" (as defined in the Tax Act) for a taxation year will not be considered to be a SIFT trust in that year (the "REIT Exemption").

Based on a review of H&R's assets and revenues, management believes that H&R satisfied the tests to qualify for the REIT Exemption for 2017. Management of H&R intends to conduct the affairs of H&R so that it qualifies for the REIT Exemption at all times. However, as the REIT Exemption includes complex revenue and asset tests, no assurances can be provided that H&R will continue to qualify for any subsequent year.

The Tax Act includes rules affecting certain publicly traded stapled securities of SIFTs, REITs and corporations which can result in the denial of a deduction for certain payments made by another entity to a REIT, or to a subsidiary of a REIT (the "Stapled Security Rules"). Management of each of H&R and Finance Trust has reviewed the Stapled Security Rules and has concluded that the Stapled Security Rules should not materially adversely affect H&R, Finance Trust or holders of Stapled Units. However, no assurances can be given in this regard.

There can be no assurance that income tax laws and the treatment of mutual fund trusts will not be changed in a manner which adversely affects holders of Stapled Units. If H&R or Finance Trust ceases to qualify as a "mutual fund trust" under the Tax Act and the units thereof cease to be listed on a designated stock exchange (which currently includes the TSX), H&R Units or Finance Trust Units, as the case may be, will cease to be qualified investments for registered retirement savings plans, deferred profit sharing plans, registered retirement income funds, registered education savings plans, registered disability savings plans and tax-free savings accounts.

Pursuant to rules in the Tax Act, if H&R or Finance Trust experiences a "loss restriction event" (i) it will be deemed to have a year-end for tax purposes (which would result in an unscheduled distribution of undistributed net income and net realized capital gains, if any, at such time to Unitholders to the extent necessary so that such trust is not liable for income tax on such amounts under Part I of the Tax Act), and (ii) it will become subject to the loss restriction rules generally applicable to a corporation that experiences an acquisition of control, including a deemed realization of any unrealized capital losses and restrictions on its ability to carry forward losses. Generally, H&R or Finance Trust will be subject to a loss restriction event if a person becomes a "majority-interest beneficiary", or a group of persons becomes a "majority-interest group of beneficiaries", of such trust, each as defined in the affiliated persons rules contained in the Tax Act, with certain modifications. Generally, a majority-interest beneficiary of a trust is a beneficiary of the trust whose beneficial interests in the income or capital of the trust, as the case may be, together with the beneficial interests in the income or capital of the trust, as the case may be, of persons and partnerships with whom such beneficiary is affiliated for the purposes of the Tax Act, represent greater than 50% of the fair market value of all the interests in the income or capital of the trust, as the case may be.

H&R operates in the United States through U.S. Holdco which is capitalized with debt and equity provided by H&R and debt in the form of U.S. Holdco Notes owed to Finance Trust and H&R Portfolio Limited Partnership. As at December 31, 2017, Finance Trust holds U.S. \$223.9 million of U.S. Holdco Notes. During 2017, H&R made loans to U.S. Holdco ("U.S. Holdco Loans") to indirectly fund additional U.S. Holdco acquisitions of income generating real property and Management anticipates that U.S. Holdco will continue to borrow funds from H&R in the future for similar purposes, to fund its operations or to refinance existing loans. U.S. Holdco treats the U.S. Holdco Notes and U.S. Holdco Loans as indebtedness for U.S. federal income tax purposes. If the IRS or a court were to determine that the U.S. Holdco Notes and/or the U.S. Holdco Loans should be treated for U.S. federal income tax purposes as equity rather than debt, the interest on the U.S. Holdco Notes and/or the U.S. Holdco Loans could be treated as a dividend, and interest on the U.S. Holdco Notes and/or the U.S. Holdco Loans would not be deductible for U.S. federal income tax purposes. In addition, if the IRS were to determine that the interest rate on the U.S. Holdco Notes and/or the U.S. Holdco Loans did not represent an arm's length rate, any excess amount over the arm's length rate would not be deductible and could be re-characterized as a dividend payment instead of an interest payment. This would significantly increase the U.S. federal income tax liability of U.S. Holdco, potentially including the tax liability for prior years in which U.S. Holdco has claimed a deduction for interest paid on the U.S. Holdco Notes. In addition, U.S. Holdco could be subject to penalties. Such an increase in tax liability could materially adversely affect U.S. Holdco's ability to make interest payments on the U.S. Holdco Notes and/or the U.S. Holdco Loans or H&R's ability to make distributions on its units.

Additionally, payments of interest on the U.S. Holdco Notes considered to be paid to non-U.S. holders of Stapled Units as discussed below could be subject to withholding taxes.

On October 13, 2016, the U.S. Treasury and the Internal Revenue Service (“IRS”) issued final and temporary regulations under section 385 of the Code (“Section 385 Regulations”) that could potentially apply to recharacterize as equity certain related party indebtedness issued after April 4, 2016. Generally, the Section 385 Regulations (i) establish threshold documentation requirements that must be satisfied for related party indebtedness issued after January 1, 2018 (however, the effective date of this provision has been delayed one year and is only applicable for debt issues after January 1, 2019 per IRS Notice 2017-36) in order for such related party indebtedness to be treated as debt for U.S. federal income tax purposes, (ii) treat related party indebtedness as equity for U.S. federal income tax purposes if such related party indebtedness was issued in certain transactions, including in exchange for stock of a related party or in a distribution and (iii) recharacterize related party indebtedness as equity for U.S. federal income tax purposes in certain circumstances including where the debtor corporation pays a distribution after April 4, 2016 in excess of the accumulated earnings and profits for tax years ending after April 4, 2016, during which the debtor corporation is related to the holder of the debt. In general, the Section 385 Regulations only apply to related party indebtedness debt issued by U.S. corporations after April 4, 2016 and so most of the U.S. Holdco Notes should not be impacted by the Section 385 Regulations. However, the Section 385 Regulations could apply to U.S. Holdco Notes that are refinanced in the future and/or to any issuances of related party indebtedness issued after April 4, 2016, including the U.S. Holdco Loans issued after this date. Management believes that the Section 385 Regulations should not apply to treat the existing U.S. Holdco Loans as equity as the U.S. Holdco Loans were not issued in exchange for stock of a related party or otherwise in a transaction described in the Section 385 Regulations and U.S. Holdco has not paid any distributions to H&R since April 4, 2016 or engaged in any other transaction that would cause such loans to be recharacterized under the Section 385 Regulations. Management does not currently anticipate causing U.S. Holdco to pay distributions in excess of U.S. Holdco’s earnings and profits accumulated in tax years ending after April 4, 2016 or engaging in any other transactions that will cause indebtedness of U.S. Holdco to be treated or recharacterized as equity. However, there can be no assurance that such a distribution or transaction will not occur in the future. In the event that any indebtedness of U.S. Holdco were recharacterized as equity, any interest paid or accrued on such indebtedness would not be deductible by U.S. Holdco and any payments made by U.S. Holdco thereon could be treated as dividends subject to U.S. withholding tax.

For taxable years beginning before January 1, 2018, Section 163(j) of the Code (prior to its amendment by U.S. Tax Reform, “Prior Section 163(j)”) applied to limit the deduction of interest paid to a related party, including debt financing provided by H&R to U.S. Holdco (e.g., the U.S. Holdco Loans or by acquiring U.S. Holdco Notes). With respect to the U.S. Holdco Notes, H&R took the position that, due to the treatment of Finance Trust as a grantor trust that is disregarded for U.S. federal tax purposes, the interest paid to Finance Trust was treated as having been paid to the holders of the Finance Trust Units and was therefore not subject to Prior Section 163(j). If Prior Section 163(j) applied to interest paid to H&R and/or Finance Trust, depending on the facts and circumstances and the availability of net operating losses to U.S. Holdco (which are subject to normal assessment by the IRS), the U.S. federal income tax liability of U.S. Holdco could increase for years subject to Prior Section 163(j).

As discussed below in “U.S. Tax Reform”, Prior Section 163(j) has been repealed and replaced with a new section 163(j) that is applicable to taxable years beginning after December 31, 2017. New section 163(j) applies to both related and third party debt and there is no debt to equity ratio safe harbor. New section 163(j) limits all interest deductions (related and third party) to 30% of “adjusted taxable income” (defined similarly to earnings before interest, taxes, depreciation and amortization for taxable years beginning before January 1, 2022, and earnings before interest and taxes thereafter). However, there is an exception to the limitation of new section 163(j) for certain “real property trades or businesses” that make an irrevocable election. If such an election is made, the real property trade or business is required to use the alternative depreciation system (ADS) that applies to tax-exempt use property to depreciate certain assets for U.S. federal income tax purposes. As discussed below, it is expected that H&R’s U.S. subsidiaries are eligible for the real property trade or business exception and may elect out of section 163(j) if the interest deduction limitation would cause adverse tax results.

U.S. Tax Reform

Overview

U.S. Tax Reform was signed into law by the president on December 22, 2017. Therefore, U.S. Tax Reform is enacted as of the date of the Trusts’ Financial Statements and it directly affects the valuation and assessment of H&R’s deferred income tax assets or liabilities. Therefore, Management has considered the material effects of tax reform on the Trusts’ Financial Statements (if any).

U.S. corporate rate reduction

The U.S. federal corporate income tax rate has been reduced to 21% effective January 1, 2018. Therefore, the U.S. federal corporate income tax rate applied to the gross deferred income tax assets or liabilities is 21% (24% including the effect of state taxes) instead of 35% (37.5% including the effect of state taxes). The change in rate, after all other changes to the deferred tax assets or liabilities for the year ended December 31, 2017, has resulted in a one-time recovery of income tax of \$136.1 million.

Section 163(j) carryover

Under the tax reform bill, Prior Section 163(j) has been repealed and replaced with a new section 163(j) effective January 1, 2018. H&R has U.S. \$154.4 million of Prior Section 163(j) interest carryover that was recorded as a deferred tax asset under the old regime. The IRS has not yet provided specific guidance on how to treat a deferred interest carryover under the old regime. Accordingly, H&R has taken a reserve against its Prior Section 163(j)

carryover, which has resulted in a one-time expense of \$ \$48.1 million (after taking into account the reduction in value due to the rate change described above). Management continues to monitor guidance from the IRS to determine the future deductibility, if any, of the deferred interest carryover.

New Section 163(j)

As mentioned above, a new section 163(j) has been enacted. However, a real property trade or business may elect out of this new regime. A real property trade or business is defined as an “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business”. With input from its tax advisors, H&R has taken the view that the U.S. subsidiaries of H&R are engaged in real property trades or businesses and therefore are eligible to elect out of section 163(j) with respect to such businesses. Once an election is made, the election is irrevocable. If such an election is made, the real property trade or business is required to use the alternative depreciation system (“ADS”) that applies to tax-exempt use property to depreciate certain assets for U.S. federal income tax purposes. It is expected that treasury regulations will be released to provide guidance on the timing and manner of making the election.

Risks relating to tax reforms

As the new U.S. tax law moves through the implementation process, there is risk that regulatory, administrative or legislative actions could have a materially adverse effect on H&R's deferred income tax assets or liabilities. Management continues to monitor ongoing developments and IRS guidance.

Additional Tax Risks Applicable to Unitholders

H&R is classified as a foreign corporation for United States federal income tax purposes. A foreign corporation will be classified as a PFIC for United States federal income tax purposes if either (i) 75% or more of its gross income is passive income or (ii) on average for the taxable year, 50% or more of its assets (by value) produce or are held for the production of passive income. The properties of H&R are managed by subsidiaries of H&R rather than directly by its own employees. Although H&R's officers and employees oversee the activities of the managers, it is unclear whether H&R will be characterized as a PFIC for U.S. federal income tax purposes. If H&R were treated as a PFIC, then in the absence of certain elections being made by a U.S. Unitholder with respect to such U.S. Unitholder's H&R Units, any distributions in respect of H&R Units which are treated as “excess distribution” under the applicable rules and any gain on a sale or other disposition of H&R Units would be treated as ordinary income and would be subject to special tax rules, including an interest charge. In addition, if H&R were treated as a PFIC, then dividends paid on H&R Units will not qualify for the reduced 20% U.S. federal income tax rate applicable to certain qualifying dividends received by noncorporate taxpayers.

The foregoing adverse consequences of PFIC characterization can be mitigated by making certain elections. U.S. Unitholders should consult with their own tax advisors regarding the implications of these rules and the advisability of making one of the applicable PFIC elections, taking into account their particular circumstances. If H&R were a PFIC, U.S. Unitholders would be required to file an annual return on IRS Form 8621.

U.S. individuals are required to report an interest in any “specified foreign financial asset” if the aggregate value of such assets owned by the U.S. individual exceeds \$50,000 (or such higher threshold as may apply to a particular taxpayer pursuant to the instructions to IRS Form 8938). H&R Units are treated as a specified foreign financial asset for this purpose.

Finance Trust qualifies as an investment trust that is classified as a grantor trust for U.S. federal income tax purposes under Treasury Regulation section 301.7701-4(c) (a “Fixed Investment Trust”) and section 671 of the Code. In general, an investment trust will qualify as a Fixed Investment Trust if: (i) the trust has a single class of ownership interests, representing undivided beneficial interests in the assets of the trust; and (ii) there is no power under the trust agreement to vary the investment of the holders. If Finance Trust is a Fixed Investment Trust, then it will generally be disregarded for U.S. federal income tax purposes, with the result that the holders of Finance Trust Units will be treated as owning directly their pro rata shares of all of the Finance Trust assets (i.e. primarily the U.S. Holdco Notes). Moreover, all payments made on the U.S. Holdco Notes will be treated as payments made directly to the holders of the Finance Trust units in proportion to their interest in Finance Trust.

Provided that Finance Trust qualifies as a Fixed Investment Trust and the U.S. Holdco Notes are respected as debt for U.S. federal income tax purposes, payments of principal and interest on the U.S. Holdco Notes will be treated as payments directly to Unitholders. Interest on the U.S. Holdco Notes will generally be taxable to U.S. holders as ordinary income at the time it is paid or accrued and will be subject to U.S. federal income taxation at a maximum marginal rate of 39.6% (37% for taxable years beginning after December 31, 2017 and beginning January 1, 2026) plus an additional 3.8% tax that applies to investment income earned by certain high income non-corporate taxpayer. Interest on the U.S. Holdco Notes paid to Canadian resident Unitholders may be eligible for an exemption from U.S. withholding tax under the *Canada-U.S. Tax Convention* (the “U.S. Treaty”) if the applicable limitation on benefit provisions contained in the U.S. Treaty are satisfied. If the U.S. Holdco Notes were treated as equity rather than debt for U.S. federal income tax purposes, then the stated interest on the U.S. Holdco Notes would be treated as a distribution with respect to units.

U.S. Unitholders are required to file an information return on IRS Form 3520 to report their interest in the Finance Trust and to include a copy of their Form 3520-A Foreign Grantor Trust Owner Statement, which is being provided by Finance Trust to its registered U.S. Unitholders. If you have not received a Foreign Grantor Trust Owner Statement, pro forma information to prepare a Form 3520-A Foreign Grantor Trust Owner Statement will be available on our website. You should consult with your own tax advisor regarding the requirements of filing information returns.

A holder of Stapled Units that is a resident of the U.S. for purposes of the Tax Act will generally be subject to Canadian withholding tax under Part XIII of the Tax Act at the rate of 25% on the portion of the income of H&R and Finance Trust paid or credited (whether in cash or *in specie*) in respect of such Stapled Units, subject to reduction under the U.S. Treaty if applicable. In the case of income paid or credited on H&R units, the withholding rate applicable to a U.S. Unitholder entitled to the benefits of the U.S. Treaty in respect of such income would generally be reduced to 15%. In the case of income paid or credited to a U.S. resident holder of Finance Trust Units, there is uncertainty as to the appropriate rate of withholding under the U.S. Treaty and in light of this uncertainty, management of Finance Trust currently applies the 25% withholding rate under the Tax Act to income paid or credited to U.S. residents. U.S. Unitholders may be entitled to a refund of a portion of such withholding tax if the rate applied by Finance Trust were determined to be excessive. You should consult with your own tax advisor regarding the advisability of applying for such a refund.

OUTSTANDING UNIT DATA

The beneficial interests in each of the Trusts are represented by a single class of units of each Trust respectively, which are unlimited in number. Each such unit carries a single vote at any meeting of unitholders of the respective Trust. As at February 7, 2018, there were 289,859,263 Stapled Units issued and outstanding (each comprised of an H&R unit and a Finance Trust unit).

As at December 31, 2017, the maximum number of units authorized to be issued under H&R's Unit Option Plan was 28,000,000. Of this amount, 21,402,296 options had been granted, 452,170 have expired and 7,049,874 remain to be granted. Of the amount originally granted, 10,091,913 had been exercised and expired and therefore, 11,310,383 options to purchase Stapled Units were outstanding. As at February 7, 2018, there were 11,310,383 options to purchase Stapled Units outstanding of which 6,497,292 are fully vested.

As at December 31, 2017, the maximum number of units authorized to be granted under H&R's Incentive Unit Plan was 5,000,000. Of this amount, 651,026 had been granted, of which 39,731 had been expired, 179,762 have been settled. 4,388,705 remain to be granted and therefore, 431,533 incentive units remain outstanding. As at February 7, 2018, there were 285,342 incentive units outstanding.

As at December 31, 2017, there were 15,979,430 exchangeable units outstanding of which 9,500,000 exchangeable units are accompanied by special voting units. As at February 7, 2018, there were 15,979,430 exchangeable units outstanding of which 9,500,000 exchangeable units are accompanied by special voting units.

The following table lists the principal outstanding balance of H&R's convertible debentures as at February 7, 2018, and the number of Stapled Units required to convert the convertible debentures to equity:

| Convertible Debentures | Principal outstanding as at February 7, 2018 | Maximum number of Stapled Units issuable |
|---------------------------------------|--|--|
| 2020 Convertible Debentures (HR.DB.D) | \$99.7 million | 4,240,510 |

ADDITIONAL INFORMATION

Additional information relating to H&R and Finance Trust, including H&R's Annual Information Form, is available on SEDAR at www.sedar.com

SUBSEQUENT EVENTS

- (a) In January 2018, H&R secured a U.S. \$51.4 million mortgage for a term of 10 years.
- (b) In January 2018, H&R issued \$250.0 million principal amount of Series O senior debentures maturing on January 23, 2023.
- (c) In January 2018, H&R obtained an additional \$200.0 million unsecured revolving operating facility due on January 31, 2023.
- (d) In February 2018, H&R repaid all of its Series E and Series J senior debentures upon maturity for a cash payment of \$100.0 million and U.S. \$125.0 million, respectively.
- (e) In February 2018, H&R issued U.S. \$125.0 million principal amount of Series P senior debentures maturing on February 13, 2020.

Combined Financial Statements of

H&R REAL ESTATE INVESTMENT TRUST
and
H&R FINANCE TRUST

Years ended December 31, 2017 and 2016



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INDEPENDENT AUDITORS' REPORT

To the Unitholders of H&R Real Estate Investment Trust

We have audited the accompanying combined financial statements of H&R Real Estate Investment Trust and H&R Finance Trust (collectively, the "Trusts"), which comprise the combined statements of financial position as at December 31, 2017 and 2016, the combined statements of comprehensive income, changes in unitholders' equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Combined Financial Statements

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

Auditors' Responsibility

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

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

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



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Opinion

In our opinion, the combined financial statements present fairly, in all material respects, the combined financial position of the Trusts as at December 31, 2017 and 2016, and their combined financial performance and their combined cash flows for the years then ended in accordance with International Financial Reporting Standards.

KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

February 14, 2018
Toronto, Canada

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Financial Position
(In thousands of Canadian dollars)

| | <i>Note</i> | December 31 2017 | December 31 2016 |
|--|-------------|----------------------|----------------------|
| Assets | | | |
| Real estate assets: | | | |
| Investment properties | 3 | \$ 13,074,123 | \$ 12,564,144 |
| Properties under development | 3 | 83,132 | 118,268 |
| | | 13,157,255 | 12,682,412 |
| Equity accounted investments | 4 | 1,125,135 | 1,051,187 |
| Assets classified as held for sale | 5 | - | 211,550 |
| Other assets | 6 | 234,189 | 161,842 |
| Cash and cash equivalents | 7 | 42,284 | 48,021 |
| | | \$ 14,558,863 | \$ 14,155,012 |
| Liabilities and Unitholders' Equity | | | |
| Liabilities: | | | |
| Mortgages payable | 8 | \$ 3,958,631 | \$ 4,001,451 |
| Debentures payable | 9 | 1,852,790 | 1,491,591 |
| Exchangeable units | 10 | 341,321 | 370,533 |
| Deferred tax liability | 23 | 325,131 | 386,775 |
| Liabilities classified as held for sale | 5 | - | 126,815 |
| Bank indebtedness | 7 | 682,196 | 647,772 |
| Accounts payable and accrued liabilities | 11 | 219,031 | 217,425 |
| | | 7,379,100 | 7,242,362 |
| Unitholders' equity | | 7,179,763 | 6,912,650 |
| Commitments and contingencies | 24 | | |
| Subsequent events | 13(f), 26 | | |
| | | \$ 14,558,863 | \$ 14,155,012 |

See accompanying notes to the combined financial statements.

Approved on behalf of the Board of Trustees:

"Edward Gilbert" Trustee

"Thomas J. Hofstedter" Trustee

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Comprehensive Income

(In thousands of Canadian dollars)

Years ended December 31, 2017 and 2016

| | <i>Note</i> | 2017 | 2016 |
|---|-------------|---------------------|--------------|
| Property operating income: | | | |
| Rentals from investment properties | 15 | \$ 1,168,454 | \$ 1,196,011 |
| Property operating costs | | (427,013) | (431,271) |
| | | 741,441 | 764,740 |
| Net income from equity accounted investments | 4 | 167,407 | 48,341 |
| Other income | 16 | 1,040 | 20,353 |
| Finance cost - operations | 17 | (270,358) | (287,325) |
| Finance income | 17 | 4,999 | 4,715 |
| Trust expenses | | (18,111) | (29,852) |
| Fair value adjustments on financial instruments | 17 | 27,049 | (33,830) |
| Fair value adjustment on real estate assets | 3 | 1,796 | 133,738 |
| Loss on sale of real estate assets, net of related costs | 3 | (7,729) | (8,167) |
| Loss on foreign exchange | | (17,903) | (8,944) |
| Transaction costs | | - | (13,483) |
| Net income before income taxes | | 629,631 | 590,286 |
| Income tax recovery (expense) | 23 | 38,239 | (201,541) |
| Net income | | 667,870 | 388,745 |
| Other comprehensive loss: | 14 | | |
| Items that are or may be reclassified subsequently to net income | | | |
| Unrealized loss on translation of U.S. denominated foreign operations | | (131,302) | (38,397) |
| Transfer of realized loss on cash flow hedges to net income | | 30 | 30 |
| | | (131,272) | (38,367) |
| Total comprehensive income attributable to unitholders | | \$ 536,598 | \$ 350,378 |

See accompanying notes to the combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Changes in Unitholders' Equity

(In thousands of Canadian dollars)

Years ended December 31, 2017 and 2016

| UNITHOLDERS' EQUITY | <i>Note</i> | Value of Units | Accumulated net income | Accumulated distributions | Accumulated other comprehensive income (loss) (note 14) | Total |
|---|--------------|---------------------|---------------------------|------------------------------|--|---------------------|
| Unitholders' equity, January 1, 2016 | | \$ 5,236,472 | \$ 4,163,529 | \$ (2,921,668) | \$ 346,587 | \$ 6,824,920 |
| Proceeds from issuance of units | | 121,175 | - | - | - | 121,175 |
| Net income | | - | 388,745 | - | - | 388,745 |
| Distributions to unitholders | <i>13(d)</i> | - | - | (381,106) | - | (381,106) |
| Conversion of convertible debentures | <i>9(c)</i> | 17 | - | - | - | 17 |
| Units repurchased and cancelled | <i>13(f)</i> | (2,734) | - | - | - | (2,734) |
| Other comprehensive loss | | - | - | - | (38,367) | (38,367) |
| Unitholders' equity, December 31, 2016 | | 5,354,930 | 4,552,274 | (3,302,774) | 308,220 | 6,912,650 |
| Proceeds from issuance of units | | 144,360 | - | - | - | 144,360 |
| Net income | | - | 667,870 | - | - | 667,870 |
| Distributions to unitholders | <i>13(d)</i> | - | - | (397,908) | - | (397,908) |
| Conversion of convertible debentures | <i>9(c)</i> | 2 | - | - | - | 2 |
| Units repurchased and cancelled | <i>13(f)</i> | (15,939) | - | - | - | (15,939) |
| Other comprehensive loss | | - | - | - | (131,272) | (131,272) |
| Unitholders' equity, December 31, 2017 | | \$ 5,483,353 | \$ 5,220,144 | \$ (3,700,682) | \$ 176,948 | \$ 7,179,763 |

See accompanying notes to the combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Combined Statements of Cash Flows

(In thousands of Canadian dollars)

Years ended December 31, 2017 and 2016

| | Note | 2017 | 2016 |
|--|-------|------------------|------------------|
| Cash provided by (used in): | | | |
| Operations: | | | |
| Net income | | \$ 667,870 | \$ 388,745 |
| Finance cost - operations | 17 | 270,358 | 287,325 |
| Interest paid | | (258,328) | (299,533) |
| Items not affecting cash: | | | |
| Net income from equity accounted investments | 4 | (167,407) | (48,341) |
| Rent amortization of tenant inducements | 15 | 2,354 | 2,241 |
| Loss on foreign exchange | | 17,903 | 8,944 |
| Fair value adjustment on real estate assets | 3 | (1,796) | (133,738) |
| Fair value adjustments on financial instruments | 17 | (27,049) | 33,830 |
| Loss on sale of real estate assets, net of related costs | 3 | 7,729 | 8,167 |
| Unit-based compensation | 13(c) | 4,869 | 17,916 |
| Deferred income taxes | 23 | (39,777) | 199,591 |
| Change in other non-cash operating items | 18 | 2,513 | (40,951) |
| | | 479,239 | 424,196 |
| Investing: | | | |
| Properties under development: | | | |
| Acquisitions | 3 | (71,260) | - |
| Additions | 3, 18 | (14,479) | (20,104) |
| Investment properties: | | | |
| Net proceeds on disposition of real estate assets | | 115,432 | 347,454 |
| Acquisitions | 3, 18 | (417,428) | (325,169) |
| Redevelopment | 3, 18 | (111,986) | (65,814) |
| Capital expenditures | 3 | (51,845) | (58,924) |
| Leasing expenses and tenant inducements | 3 | (28,722) | (34,682) |
| Equity accounted investments, net | | 6,169 | 92,447 |
| Mortgages receivable | | (107,233) | 58,363 |
| Proceeds from sale of investment | | 56,597 | - |
| Restricted cash | 6, 18 | (880) | 5,182 |
| | | (625,635) | (1,247) |
| Financing: | | | |
| Bank indebtedness | 7 | 69,704 | 331,359 |
| Mortgages payable: | | | |
| New mortgages payable | 8 | 588,094 | 131,949 |
| Principal repayments | 8 | (585,659) | (489,891) |
| Repayment of loan payable | | - | (54,102) |
| Redemption of debentures payable | 9(c) | (249,394) | (254,983) |
| Proceeds from issuance of debentures payable | 9(c) | 619,299 | 198,185 |
| Proceeds from issuance of units, net of issue costs | | 5,051 | 1,266 |
| Units repurchased and cancelled | 13(f) | (15,939) | (2,734) |
| Distributions to unitholders | 13(d) | (290,497) | (274,264) |
| | | 140,659 | (413,215) |
| Increase (decrease) in cash and cash equivalents | | (5,737) | 9,734 |
| Cash and cash equivalents, beginning of year | 7 | 48,021 | 38,287 |
| Cash and cash equivalents, end of year | 7 | \$ 42,284 | \$ 48,021 |

See note on supplemental cash flow information (note 18).

See accompanying notes to the combined financial statements.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Notes to Combined Financial Statements

(In thousands of Canadian dollars, except unit and per unit amounts)

Years ended December 31, 2017 and 2016

These combined financial statements include the accounts of H&R Real Estate Investment Trust (the "REIT") and H&R Finance Trust ("Finance Trust", together with the REIT, the "Trusts"). The REIT is an unincorporated open-ended trust and Finance Trust is an unincorporated investment trust both domiciled in Canada. The REIT owns, operates and develops commercial and residential properties across Canada and in the United States. The principal office and centre of administration of the Trusts is located at 3625 Dufferin Street, Suite 500, Toronto, Ontario M3K 1N4. Unitholders of each Trust participate pro rata in distributions of income and, in the event of termination of a Trust, participate pro rata in the net assets remaining after satisfaction of all liabilities of such Trust.

On October 1, 2008, the REIT completed an internal reorganization pursuant to a Plan of Arrangement (the "Plan of Arrangement") as described in the REIT's information circular dated August 20, 2008, resulting in the stapling of the Trusts' units. The Plan of Arrangement further resulted in, among other things, the creation of Finance Trust on October 1, 2008. Each unitholder received, for each REIT unit held, a unit of Finance Trust. Each issued and outstanding Finance Trust unit is stapled to a unit of the REIT on a one-for-one basis so as to form stapled units ("Stapled Units"), and such Stapled Units are listed and posted for trading on the Toronto Stock Exchange ("TSX") under the symbol HR.UN. The units of each of the Trusts may only be transferred together as Stapled Units unless an event of "uncoupling" has occurred.

On October 24, 2013, the Ontario Securities Commission (on its behalf and on behalf of the other provincial securities regulators) issued a decision which permits the REIT and Finance Trust to file one set of combined financial statements rather than separate financial statements. These combined financial statements are being presented on a basis whereby the assets and liabilities of the REIT and Finance Trust have been combined in accordance with the accounting principles applicable to both the REIT and Finance Trust in accordance with International Financial Reporting Standards ("IFRS") to reflect the financial position and results of the REIT and Finance Trust on a combined basis. The combined presentation is useful to the unitholders of the Trusts, for the following reasons:

- The units of the Trusts are stapled (as noted above), resulting in the Trusts being under common ownership;
- A support agreement between the Trusts ensures that until such time as an event of "uncoupling" occurs, when units are issued by the REIT, units must also be issued by Finance Trust simultaneously so as to maintain the stapled unit structure;
- The sole activity of Finance Trust is to provide capital funding to H&R REIT (U.S.) Holdings Inc. ("U.S. Holdco"), a wholly owned U.S. subsidiary of the REIT; and
- The investment activities of Finance Trust are restricted in its Declaration of Trust to providing such funding to U.S. Holdco and to make temporary investments of excess funds.

1. Basis of preparation:

(a) Statement of compliance

These combined financial statements have been prepared in accordance with IFRS as published by the International Accounting Standards Board ("IASB") and using accounting policies described herein.

The combined financial statements were approved by the Board of Trustees of the REIT on February 14, 2018.

(b) Functional currency and presentation

These combined financial statements are presented in Canadian dollars, except where otherwise stated, which is the Trusts' functional currency. All financial information has been rounded to the nearest thousand.

The Trusts present their combined statements of financial position based on the liquidity method, where all assets and liabilities are presented in ascending order of liquidity.

H&R REAL ESTATE INVESTMENT TRUST

H&R FINANCE TRUST

Notes to Combined Financial Statements

(In thousands of Canadian dollars, except unit and per unit amounts)

Years ended December 31, 2017 and 2016

1. Basis of preparation (continued):

(c) Basis of measurement

The combined financial statements have been prepared on the historical cost basis except for the following items in the combined statements of financial position which have been measured at fair value:

- (i) Real estate assets;
- (ii) Derivative financial instruments;
- (iii) Liabilities for cash-settled unit-based compensation;
- (iv) Convertible debentures; and
- (v) Exchangeable units.

(d) Use of estimates and judgements

The preparation of these combined financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies, the reported amounts of assets, liabilities, income and expenses and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates.

(i) Use of estimates

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year are included in the following notes:

- Fair value of real estate assets (note 3); and
- Deferred tax asset (liability) (note 23).

(ii) Use of judgements

The critical judgements made in applying accounting policies that have the most significant effect on the amounts recognized in these combined financial statements are as follows:

- Business combinations

Accounting for business combinations under IFRS 3, *Business Combinations* ("IFRS 3") is only applicable if it is determined that a business has been acquired. Under IFRS 3, a business is defined as an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to the REIT. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. In the absence of such criteria, a group of assets is deemed to have been acquired. If goodwill is present in a transferred set of activities and assets, the transferred set is presumed to be a business. Judgement is used by management in determining whether the acquisition of an individual property, or group of properties, qualifies as a business combination in accordance with IFRS 3 or as an asset acquisition.

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1. Basis of preparation (continued):

- Valuations of real estate assets

Real estate assets, which consist of investment properties and properties under development, are carried on the combined statements of financial position at fair value, as determined by either qualified external valuation professionals or by management. The valuations are based on a number of assumptions, such as appropriate discount rates and capitalization rates and estimates of future rental income, operating expenses and capital expenditures. Valuation of real estate assets is one of the principal estimates and uncertainties of these combined financial statements. Refer to note 3 for further information on estimates and assumptions made in the determination of the fair value of real estate assets. Judgement is applied in determining whether certain costs are additions to the carrying value of the real estate assets, identifying the point at which practical completion of the property occurs and identifying the directly attributable borrowing costs to be included in the carrying value of the development properties.

- Leases

The REIT makes judgements in determining whether certain leases, in particular those tenant leases with long contractual terms and long-term ground leases where the REIT is the lessor, are operating or finance leases. The REIT has determined that all of its leases are operating leases.

- Income taxes

The REIT is a mutual fund trust and a real estate investment trust pursuant to the *Income Tax Act* (Canada) ("Tax Act"). Under current tax legislation, the REIT is not liable to pay Canadian income tax provided that its taxable income is fully distributed to unitholders each year. The REIT is a real estate investment trust if it meets prescribed conditions under the Tax Act relating to the nature of its assets and revenue (the "REIT Conditions"). The REIT has reviewed the REIT Conditions and has assessed its interpretation and application to the REIT's assets and revenue, and it has determined that it qualifies as a real estate investment trust pursuant to the Tax Act. The REIT expects to continue to qualify as a real estate investment trust; however, should it no longer qualify, the REIT would be subject to tax on its taxable income distributed to unitholders.

- Impairment of equity accounted investments

The REIT determines at each reporting date whether there is any objective evidence that the equity accounted investments are impaired. If so, the REIT calculates the amount of impairment as the difference between the recoverable amount of the equity accounted investment and its carrying value and recognizes the amount in net income.

2. Significant accounting policies:

The accounting policies set out below have been applied consistently for all periods presented in these combined financial statements.

(a) *Basis of combination:*

The principles used to prepare these combined financial statements are similar to those used to prepare consolidated financial statements. The combined financial statements include the assets, liabilities, unitholders' equity, comprehensive income (loss) and cash flows of the Trusts, after elimination of the following:

- (i) the REIT's notes payable to Finance Trust; and
- (ii) the REIT's interest expense and Finance Trust's interest income from the notes payable to Finance Trust.

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2. Significant accounting policies (continued):

The foreign exchange gain (loss) recorded in net income as a result of translating Finance Trust's U.S. dollar note receivable from U.S. Holdco is not eliminated on combination as it flows through net income on Finance Trust's books and other comprehensive income on the REIT's books. This is because U.S. Holdco is a subsidiary of the REIT and forms part of its net investment in the United States, but is not a subsidiary of Finance Trust.

The combination of the Trusts does not result in the elimination of the equity of Finance Trust as neither of the Trusts hold any interest in the other. The equity of the Trusts is presented by way of combining the two together.

(b) *Basis of consolidation:*

These combined financial statements include the accounts of all entities in which the REIT holds a controlling interest. The REIT carries out a portion of its activities through joint operations and records its proportionate share of assets, liabilities, revenues, expenses and cash flows of all joint operations in which it participates. All material intercompany transactions and balances have been eliminated upon consolidation.

(c) *Investment properties:*

Investment properties are held to earn rental income or for capital appreciation, or both, but not for sale in the ordinary course of business. All of the REIT's commercial properties are investment properties which are measured at fair value, under IAS 40, *Investment Property* ("IAS 40").

The REIT performs an assessment of each investment property acquired to determine whether the acquisition is to be accounted for as an asset acquisition or a business combination. A transaction is considered to be a business combination if the acquired property meets the definition of a business under IFRS 3, as set out in note 1(d)(ii). The REIT expenses transaction costs on business combinations and capitalizes transaction costs on asset acquisitions.

Upon acquisition, investment properties are initially recorded at cost. Subsequent to initial recognition, the REIT uses the fair value model to account for investment properties. Under the fair value model, investment properties are recorded at fair value, determined based on available market evidence at each reporting date. The related gain or loss in fair value is recognized in net income in the year in which it arises.

Subsequent capital expenditures are capitalized to investment properties only when it is probable that future economic benefits of the expenditure will flow to the REIT and the cost can be measured reliably. All other repairs and maintenance costs are expensed when incurred. Leasing costs, such as commissions incurred in negotiating tenant leases, are included in investment properties.

Gains or losses from the disposal of investment properties are determined as the difference between the net disposal proceeds and the carrying amount of the investment property and are recognized in net income in the year of disposal.

(d) *Properties under development:*

Properties under development for future use as investment property are accounted for as investment property under IAS 40. Costs eligible for capitalization to properties under development are initially recorded at cost, and subsequent to initial recognition are accounted for using the fair value method. At each reporting date, the properties under development are recorded at fair value based on available market evidence. The related gain or loss in fair value is recognized in net income in the year in which it arises.

The cost of properties under development includes direct development costs, realty taxes and borrowing costs that are directly attributable to the development. Borrowing costs associated with direct expenditures on properties under development are capitalized. Borrowing costs relating to the purchase of a site or property acquired for redevelopment are also capitalized. The amount of borrowing costs capitalized is determined first by reference to borrowing specific to the project, where relevant, and otherwise by applying a weighted average cost of borrowings to eligible expenditures after adjusting for borrowings associated with other specific developments. Borrowing costs are capitalized from the commencement of the development until the date of practical completion. The capitalization of borrowing costs is suspended if there are prolonged periods when development activity is interrupted.

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2. Significant accounting policies (continued):

Upon practical completion of a development, the development property is transferred to investment properties at the fair value on the date of practical completion. The REIT considers practical completion to have occurred when the property is capable of operating in the manner intended by management. Generally this occurs upon completion of construction and receipt of all necessary occupancy and other material permits. Where the REIT has pre-leased space as of or prior to the start of the development and the lease requires the REIT to construct tenant improvements which enhance the value of the property, practical completion is considered to occur on completion of such improvements.

(e) *Assets and liabilities held for sale:*

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. For this purpose, a sale is considered to be highly probable if management is committed to a plan to achieve the sale; there is an active program to find a buyer; the non-current asset is being actively marketed at a reasonable price; the sale is anticipated to be completed within one year from the date of classification; and it is unlikely there will be changes to the plan.

Non-current liabilities that are to be assumed by the buyer on disposition of the non-current asset, are also classified as held for sale. Non-current assets and non-current liabilities held for sale are classified separately from other assets and other liabilities in the statement of financial position. These amounts are not offset or presented as a single amount.

(f) *Revenue recognition:*

The REIT retains substantially all of the benefits and risks of ownership of its investment properties and therefore, accounts for its leases with tenants as operating leases. Rentals from investment properties include all amounts earned from tenants, including recovery of operating costs.

Rental revenue from investment property is recognized in net income on a straight-line basis over the term of the related lease. The difference between the rental revenue recognized and the amounts contractually due under the lease agreements is recorded as accrued rent receivable, which is included in the investment property balance. Lease incentives granted are recognized as an integral part of total rental income over the term of the lease.

(g) *Income taxes:*

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in net income except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is not recognized for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable net income, and differences relating to investments in subsidiaries and jointly controlled entities to the extent that it is probable that they will not reverse in the foreseeable future. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, if such entities intend to settle current tax liabilities and assets on a net basis or the entities' tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

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2. Significant accounting policies (continued):

The REIT is a mutual fund trust and a real estate investment trust pursuant to the Tax Act. Under current tax legislation, a real estate investment trust is entitled to deduct distributions from taxable income such that it is not liable to pay income tax provided that its taxable income is fully distributed to unitholders. The REIT intends to continue to qualify as a real estate investment trust and to make distributions not less than the amount necessary to ensure that the REIT will not be liable to pay income taxes. The REIT qualified as a real estate investment trust throughout 2017 and the 2016 comparative year.

Finance Trust qualifies as a mutual fund trust that is not a specified investment flow-through trust under the Tax Act. In accordance with the terms of Finance Trust's Declaration of Trust, all of the net income for tax purposes will be paid or be payable to unitholders in the taxation year so that no income tax is payable by Finance Trust.

For financial statement reporting purposes, the tax deductibility of the REIT's and Finance Trust's distributions are treated as an exemption from taxation as the REIT and Finance Trust have distributed and are committed to continue distributing all of their taxable income to their unitholders.

(h) *Unit-based compensation:*

The REIT has a unit option plan and incentive unit plan available for REIT trustees, officers, employees and consultants as disclosed in note 13(c). These plans are considered to be a cash-settled liability under IFRS 2, *Share-based Payment* and as a result is measured at each reporting period and at settlement date at its fair value as defined by IFRS. The fair value of the amount payable to participants in respect of the unit option plan and incentive unit plan is recognized as an expense with a corresponding increase or decrease in liabilities, over the period that the employees unconditionally become entitled to payment. Any change in the fair value of the liability is recognized as a component of trust expenses.

(i) *Cash and cash equivalents:*

Cash and cash equivalents include deposits in banks, certificates of deposit and short-term investments with original maturities of less than 90 days.

(j) *Restricted cash:*

Restricted cash includes amounts held in reserve by lenders to fund mortgage payments, repairs and capital expenditures or property tax payments.

(k) *Foreign currency translation:*

The REIT accounts for its investment in U.S. Holdco, a wholly owned subsidiary of the REIT in the United States ("foreign operations"), as a U.S. dollar functional currency foreign operation. Assets and liabilities of foreign operations are translated into Canadian dollars at the exchange rates in effect at the combined statements of financial position dates and revenue and expenses are translated at the average exchange rates for the reporting periods.

The foreign currency translation adjustment is recorded as a separate component of accumulated other comprehensive income (loss) until there is a reduction in the REIT's net investment in the foreign operations. The U.S. dollar denominated senior debenture and bank indebtedness are designated as a hedge of the REIT's investment in self-sustaining operations. Accordingly, the accumulated unrealized gains or losses arising from the translation of these obligations are recorded as a foreign currency translation adjustment in accumulated other comprehensive income (loss).

Assets and liabilities denominated in a currency other than the functional currency are translated into the functional currency at the exchange rates in effect at the combined statements of financial position dates and revenue and expenses are translated at the actual exchange rate on the date incurred, with any gain (loss) recorded in net income, unless the asset or liability is designated as a hedge.

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2. Significant accounting policies (continued):

(l) *Financial instruments:*

(i) Non-derivative financial assets

Cash and cash equivalents, restricted cash, accounts receivable and mortgages receivable, with fixed or determinable payments that are not quoted in an active market, are non-derivative financial assets classified as loans and receivables. Such assets are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method, less any impairment losses.

The Trusts derecognize a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Financial assets and liabilities are offset and the net amount presented in the combined statements of financial position when, and only when, the Trusts have a current legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

(ii) Non-derivative financial liabilities

Non-derivative financial liabilities consist of mortgages payable, senior debentures, bank indebtedness and accounts payable and accrued liabilities. Such financial liabilities are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition these financial liabilities are measured at amortized cost using the effective interest method.

The Trusts derecognize a financial liability when their contractual obligations are discharged or cancelled or expire.

(iii) Derivative financial instruments

The REIT holds derivative financial instruments to hedge its interest rate risk exposures. Derivatives are recognized initially at fair value; attributable transaction costs are recognized in net income as incurred. Subsequent to initial recognition, derivatives are measured at fair value at the end of each reporting period. Any resulting gain or loss is recognized in net income immediately unless the derivative is designated and effective as a hedging instrument. None of the REIT's derivative instruments, as described in note 12, are accounted for as hedges.

(iv) Financial liabilities measured at fair value through profit or loss

A financial liability is classified at fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition.

The convertible debentures and exchangeable units were designated at fair value through profit or loss upon initial recognition. Any gains or losses arising on remeasurement are recognized in net income.

(m) *Stapled Units:*

Under IAS 32, *Financial Instruments: Presentation* ("IAS 32"), puttable instruments, such as the Stapled Units are generally classified as financial liabilities unless the exemption criteria are met for equity classification. As a result of the REIT receiving consent of its unitholders to modify the REIT's Declaration of Trust to eliminate the mandatory distribution and leave distributions to the discretion of the trustees and the ability of the trustees to fund distributions by way of issuing additional units, the REIT met the exemption criteria under IAS 32 for equity classification. Finance Trust also met the exemption criteria under IAS 32 for equity classification. Nevertheless, the Stapled Units are not considered ordinary units under IAS 33, *Earnings Per Share*, and therefore an income per unit calculation is not presented.

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2. Significant accounting policies (continued):

(n) *Finance costs:*

Finance costs are comprised of interest expense on borrowings, distributions on exchangeable units classified as liabilities, gain (loss) on change in fair value of convertible debentures, gain (loss) on change in fair value of exchangeable units and net gain (loss) on derivative instruments.

Finance costs associated with financial liabilities presented at amortized cost are recognized in net income using the effective interest method.

(o) *Investment in associates and joint ventures:*

An associate is an entity over which the Trust has significant influence. Significant influence is the power to participate in an entity's financial and operating policy decisions, which is presumed to exist when an investor holds 20 percent or more of the voting power of another entity. An investment is considered an associate when significant influence exists but there is no joint control over the investment. The Trusts account for investments in associates using the equity method.

The Trusts consider investments in joint arrangements to be joint ventures when they jointly control one or more investment properties with another party and have rights to the net assets of the arrangements. This occurs when the joint arrangement is structured through a separate vehicle, such as a partnership, with separation maintained.

The Trusts' interests in their associates and joint ventures are accounted for using the equity method and are carried on the combined statements of financial position at cost, adjusted for the Trusts' proportionate share of post-acquisition changes in the net assets, less any identified impairment loss. The Trusts' share of profits and losses is recognized in the share of net income from the associate or joint venture investments in the combined statements of comprehensive income and the Trusts' other comprehensive income includes their share of the associate or joint ventures' other comprehensive income.

An associate or a joint venture is considered to be impaired if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the joint venture and that event has a negative impact on the future cash flows of the joint venture that can be reliably estimated.

(p) *Joint Operations:*

The Trusts consider investments in joint arrangements to be joint operations when they make operating, financial and strategic decisions over one or more investment properties jointly with another party and have direct rights to the assets and obligations for the liabilities relating to the arrangement. When the arrangement is considered to be a joint operation, the Trusts will include their share of the underlying assets, liabilities, revenue and expenses in their financial results.

(q) *Business Combinations:*

The purchase method of accounting is used for acquisitions meeting the definition of a business. The consideration transferred in a business combination is measured at fair value.

Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their acquisition date fair values. The excess of the cost of acquisition over the fair value of the REIT's share of the identifiable net assets acquired, if any, is recorded as goodwill. If the cost of acquisition is less than the fair value of the REIT's share of the net assets acquired, the difference is recognized directly in the combined statements of comprehensive income for the year as an acquisition gain. Any transaction costs incurred with respect to the business combination are expensed in the period incurred.

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2. Significant accounting policies (continued):

(r) *Levies:*

Under IFRS Interpretations Committee Interpretation, 21, *Levies* (“IFRIC 21”) realty taxes payable by the REIT are considered levies. Based on the guidance of IFRIC 21, the REIT recognizes the full amount of annual U.S. realty tax liabilities at the point in time when the realty tax obligation is imposed.

(s) *Subsidiaries*

Subsidiaries are entities controlled by the Trusts. The Trusts control an entity when it is exposed to, or has rights to, variable returns from their involvement with the entity and has the ability to affect those returns through its power over the entity. The financial statements of subsidiaries are included in the combined financial statements from the date on which control commences until the date on which control ceases.

(t) *New standards and interpretations not yet adopted:*

Standards issued but not yet effective up to the date of issuance of these combined financial statements are described below. The Trusts intend to adopt these standards when they become effective.

(i) *Share-Based Payment (“IFRS 2”)*

In 2016, the IASB issued amendments to IFRS 2 *Share-based Payment*, clarifying how to account for certain types of share-based payment transactions. The Trusts intend to adopt the amendments to IFRS 2 in its combined financial statements for the annual period beginning on January 1, 2018. The Trusts do not expect the standard to have a material impact on the financial statements.

(ii) *Financial Instruments: Classification and Measurement (“IFRS 9”)*

The Trusts will adopt IFRS 9, *Financial Instruments: Classification and Measurement*, which replaces IAS 39 *Financial Instruments: Recognition and Measurement* (“IAS 39”), in the combined financial statements beginning on January 1, 2018, the mandatory effective date. The adoption of IFRS 9 will generally be applied retrospectively, without restatement of comparative information.

IFRS 9 contains a new classification and measurement approach which requires financial assets to be classified and measured based on the business model in which they are held and the characteristics of their contractual cash flows. IFRS 9 contains three principal classification categories for financial assets: measured at amortized cost, fair value through other comprehensive income and fair value through profit or loss, and eliminates the existing IAS 39 categories of held to maturity, loans and receivables and available for sale.

For impairment of financial assets, IFRS 9 replaces the ‘incurred loss’ model in IAS 39 with a forward-looking ‘expected credit loss’ model. The new impairment model will apply to financial assets measured at amortized cost or fair value through other comprehensive income, except for investments in equity instruments, and to contract assets.

IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. However, under IAS 39 all fair value changes of liabilities designated as fair value through profit or loss are recognized in profit or loss, whereas under IFRS 9 the amount of change in fair value attributable to changes in the credit risk of the liability is presented in other comprehensive income, and the remaining amount of change in fair value is presented in profit or loss.

IFRS 9 also includes a new general hedge accounting standard which aligns hedge accounting more closely with risk management. The Trusts do not currently apply hedge accounting.

Management does not expect the adoption of IFRS 9 to have a material impact on the combined financial statements.

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2. Significant accounting policies (continued):

(iii) *Revenue from Contracts with Customers ("IFRS 15")*

IFRS 15, *Revenue from Contracts with Customers* is effective for annual periods beginning on or after January 1, 2018, and will replace all existing guidance in IFRS related to revenue, including (but not limited to) IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 15 *Agreements for the Construction of Real Estate*.

IFRS 15 contains a single, control-based model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. IFRS 15 also includes additional disclosure requirements for revenue accounted for under the standard.

The Trusts will adopt IFRS 15 in the combined financial statements for the annual period beginning January 1, 2018. The Trust plans to adopt IFRS 15 using the cumulative effect method, with the effect of initially applying this standard recognized at January 1, 2018. As a result, the Trusts will not apply the requirements of IFRS 15 to the comparative period presented. Management does not expect that the adoption of IFRS 15 will have a material impact on the combined financial statements. However, additional disclosure requirements may result in separate disclosure of revenue for service components that are part of a lease (i.e. a non-lease component).

(iv) *Leases ("IFRS 16")*

IFRS 16, *Leases* will replace existing lease guidance in IFRS and related interpretations, and requires lessees to bring most leases on-balance sheet. Lessor accounting remains similar to the current standard. The new standard is effective for years beginning on January 1, 2019.

The Trusts are still evaluating the impact of IFRS 16. In particular, the Trusts are assessing how the new standard may impact the identification of lease and non-lease components, including the allocation of consideration to each lease and non-lease component. The standard requires this allocation to be completed in accordance with the guidance in IFRS 15, that is, on the basis of relative standalone selling prices.

(v) *IFRIC Interpretation 23, Uncertainty over Income Tax Treatments*

On June 7, 2017, the IASB issued IFRIC Interpretation 23 *Uncertainty over Income Tax Treatments*. The Interpretation provides guidance on the accounting for current and deferred tax liabilities and assets in circumstances in which there is uncertainty over income tax treatments. The Interpretation is applicable for annual periods beginning on or after January 1, 2019 with early adoption permitted. The Interpretation requires: a) the Trusts to contemplate whether uncertain tax treatments should be considered separately, or together as a group, based on which approach provides better predictions of the resolution; b) determine if it is probable that the tax authorities will accept the uncertain tax treatment and c) if it is not probable that the uncertain tax treatment will be accepted, measure the tax uncertainty based on the most likely amount or expected value, depending on whichever method better predicts the resolution of the uncertainty. The Trusts intend to adopt the Interpretation in their combined financial statements for the annual period beginning on January 1, 2019. The extent of the impact of adoption of the Interpretation has not yet been determined.

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3. Real estate assets:

| | December 31, 2017 | | December 31, 2016 | |
|--|-----------------------|------------------------------|-----------------------|------------------------------|
| | Investment Properties | Properties Under Development | Investment Properties | Properties Under Development |
| Opening balance, beginning of year | \$ 12,564,144 | \$ 118,268 | \$ 12,576,075 | \$ 97,504 |
| Acquisitions, including transaction costs | 430,537 | 71,260 | 325,169 | - |
| Dispositions | (70,062) | - | (337,428) | - |
| Transfer from equity accounted investment | 62,500 | - | - | - |
| Transfer of investment properties to assets classified as held for sale | - | - | (211,550) | - |
| Operating capital | | | | |
| Capital expenditures | 51,845 | - | 58,924 | - |
| Leasing expenses and tenant inducements | 28,722 | - | 34,682 | - |
| Development capital | | | | |
| Redevelopment (including capitalized interest) | 113,212 | - | 62,729 | - |
| Additions to properties under development (including capitalized interest) | - | 15,555 | - | 20,764 |
| Amortization of tenant inducements, straight-line rents and blend and extend rents included in revenue | (1,478) | - | 5,585 | - |
| Transfer of properties under development that have reached substantial completion to investment properties | 116,525 | (116,525) | - | - |
| Fair value adjustment on real estate assets | 3,038 | (1,242) | 133,738 | - |
| Change in foreign exchange | (224,860) | (4,184) | (83,780) | - |
| Closing balance, end of year | \$ 13,074,123 | \$ 83,132 | \$ 12,564,144 | \$ 118,268 |

Legal title to each of the properties in the United States is held by a separate legal entity which is 100% owned, directly or indirectly, by U.S. Holdco, a wholly owned subsidiary of the REIT. In certain cases, the assets of each such separate legal entity are not available to satisfy the debts or obligations of any other person or entity. Each such separate legal entity maintains separate books and records. This structure does not prevent distributions to the entity owners provided there are no conditions of default.

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3. Real estate assets (continued):

Asset acquisitions:

During the year ended December 31, 2017, the REIT acquired five residential properties and one residential property under development which was transferred to investment properties upon substantial completion (year ended December 31, 2016 – four residential properties and a 50% ownership interest in one industrial property). The results of operations for these acquisitions are included in these combined financial statements from the date of acquisition.

The following table summarizes the purchase price plus transaction costs of the assets and liabilities as at the respective dates of acquisition:

| | December 31 2017 | December 31 2016 |
|----------------------------------|---------------------|---------------------|
| Assets | | |
| Investment properties | \$ 430,516 | \$ 323,877 |
| Property under development | 71,260 | - |
| | 501,776 | 323,877 |
| Liabilities | | |
| Mortgage payable | - | - |
| Total net assets settled in cash | \$ 501,776 | \$ 323,877 |

During the year ended December 31, 2017, the REIT incurred additional costs of \$21 (December 31, 2016 - \$1,292) in respect of prior year acquisitions which are not included in the above table.

Asset dispositions:

During the year ended December 31, 2017, the REIT sold three retail properties, a 50% ownership interest in two Primaris properties, a 50% interest in one industrial property, one residential property and one office property and recognized a loss on sale of real estate assets of \$7,729. The loss on sale of real estate assets includes mark-to-market adjustments on the purchaser's assumption of a mortgage of \$3,544.

During the year ended December 31, 2016, the REIT sold five retail properties, a 50% ownership interest in two industrial properties, a 50% non-managing interest in one office property and a portion of an office property (sold as separate condominium units) and recognized a loss on sale of real estate assets of \$8,167.

Fair value disclosure:

The estimated fair values of the REIT's real estate assets are based on the following methods and key assumptions:

- (i) Consideration of recent sales of similar properties within similar market areas;
- (ii) Discounted cash flow analyses which are based upon, among other things, rental income from current leases and assumptions about rental income from future leases reflecting market conditions at each reporting period, less future cash outflows in respect of such leases and capital expenditures for the property utilizing appropriate discount rates and terminal capitalization rates, generally over a projection period of ten years;
- (iii) The direct capitalization method which calculates fair value by applying a capitalization rate to the normalized net operating income.

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3. Real estate assets (continued):

- (iv) External independent appraisals. During the year ended December 31, 2017, certain properties were valued by professional external independent appraisers. These properties represent 32.3% of the fair value of investment properties as at December 31, 2017 (year ended December 31, 2016 - 30.2%). The remainder of the portfolio was valued by the REIT's internal valuation team. The properties that were externally appraised are selected by management to form a representative cross section of the REIT's portfolio based on size, geography and the availability of market data. In addition, an external independent appraisal is often obtained for properties acquired or for mortgage financing purposes.

The REIT utilizes external industry sources to determine a range of capitalization and discount rates. To the extent that externally provided capitalization and discount rates ranges change from one reporting period to the next, the fair value of the investment properties is increased or decreased accordingly.

The following table highlights the significant assumptions used in determining the fair value of the REIT's investment properties:

| | Overall Capitalization Rates | | | Discount Rates | | | Terminal Capitalization Rates | | |
|--------------------------|------------------------------|---------------|--------------|----------------|---------------|--------------|-------------------------------|---------------|--------------|
| | Canada | United States | Total | Canada | United States | Total | Canada | United States | Total |
| December 31, 2017 | 5.63% | 5.78% | 5.67% | 6.46% | 6.60% | 6.50% | 5.88% | 6.08% | 5.94% |
| December 31, 2016 | 5.73% | 5.92% | 5.79% | 6.66% | 6.78% | 6.69% | 6.09% | 6.24% | 6.13% |

Fair value sensitivity:

The REIT's investment properties are classified as level 3 under the fair value hierarchy, as the inputs in the valuations of these investment properties are not based on observable market data. The following table provides a sensitivity analysis for the weighted average capitalization rate applied as at December 31, 2017:

| Capitalization Rate Sensitivity Increase (Decrease) | Overall Capitalization Rate | Fair Value of Investment Properties | Fair Value Variance | % Change |
|---|-----------------------------|-------------------------------------|---------------------|--------------|
| (0.75%) | 4.92% | \$ 15,067,130 | \$ 1,993,007 | 15.24% |
| (0.50%) | 5.17% | \$ 14,338,545 | \$ 1,264,422 | 9.67% |
| (0.25%) | 5.42% | \$ 13,677,173 | \$ 603,050 | 4.61% |
| December 31, 2017 | 5.67% | \$ 13,074,123 | \$ - | 0.00% |
| 0.25% | 5.92% | \$ 12,522,006 | \$ (552,117) | (4.22%) |
| 0.50% | 6.17% | \$ 12,014,632 | \$ (1,059,491) | (8.10%) |
| 0.75% | 6.42% | \$ 11,546,772 | \$ (1,527,351) | (11.68%) |

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4. Equity accounted investments:

The REIT has entered into a number of arrangements with other parties for the purpose of jointly owning and operating investment properties. In order to determine how these arrangements should be accounted for, the REIT has assessed the structure of the arrangement, and whether the REIT has control over the operations of such properties. The REIT's arrangements fall into two categories: a) joint ventures, where the REIT has joint control over the operations, where each investment is structured as a separate vehicle and the REIT has rights to the net assets of the entities; and b) investments in associates, where the REIT has significant influence over the investment but does not have joint control over the operations. Both of these types of arrangements are accounted for using the equity method.

During the year ended December 31, 2017, the REIT: (i) acquired a 33.3% net interest in the Koenig Lane Development LP ("Koenig"), a joint venture, for \$6,413; (ii) disposed of nine industrial properties; and (iii) commenced accounting for F1RST Tower as a proportionately consolidated investment property in the combined financial statements, as the legal structure of F1RST Tower, formerly Telus Tower, changed effective January 1, 2017 from a partnership that was an equity accounted investment to a co-ownership which is proportionately consolidated.

During the year ended December 31, 2016, the REIT: (i) acquired a 31.7% net interest in the Hercules Development Partners LP ("Hercules"), a joint venture, for \$13,694; (ii) disposed of its 33.3% ownership interests in 100 Yonge and Scotia Plaza for a gain on sale of investment in joint venture at the REIT's share of \$14,965; and (iii) disposed of one industrial property.

| | Location | Principal activity | Ownership interest | |
|---|------------------|--|---------------------|---------------------|
| | | | December 31 2017 | December 31 2016 |
| Investments in joint ventures: ^(a) | | | | |
| 100 Yonge | Toronto, Ontario | Own and operate investment property | N/A | (c) |
| Scotia Plaza | Toronto, Ontario | Own and operate investment property | N/A | (c) |
| F1RST Tower | Calgary, Alberta | Own and operate investment property | (d) | 50.0% |
| 6 industrial properties | United States | Own and operate investment property | 50.5% | 50.5% |
| Hercules | United States | Develop, own and operate investment property | 31.7% | 31.7% |
| Koenig | United States | Develop, own and operate investment property | 33.3% | - |
| Investments in associates: ^(b) | | | | |
| ECHO Realty LP ("ECHO") | United States | Own and operate investment properties | 33.6% | 33.6% |
| LIC Operator Co., L.P. ("LIC") | United States | Develop, own and operate investment property | 50.0% | 50.0% |

(a) Where the REIT has joint control over the operations, each investment is structured as a separate vehicle and the REIT has rights to the net assets of the entities.

(b) Where the REIT has significant influence over the investment but does not have joint control over the operations.

(c) The REIT disposed of its 33.3% ownership interests in 100 Yonge and Scotia Plaza in June 2016.

(d) Commencing January 1, 2017, the REIT proportionately consolidates F1RST Tower due to a change in the legal structure of the investment.

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4. Equity accounted investments (continued):

The following tables summarize the total amounts of the financial information of the equity accounted investments and reconciles the summarized financial information to the carrying amount of the REIT's interest in these arrangements. The REIT has determined that it is appropriate to aggregate each of the investments in joint ventures and investments in associates as the individual investments are not individually material:

| | December 31, 2017 | | | December 31, 2016 | | |
|---|-------------------------------|---------------------------|--------------|-------------------------------|---------------------------|--------------|
| | Investments in joint ventures | Investments in associates | Total | Investments in joint ventures | Investments in associates | Total |
| Equity accounted investments: | | | | | | |
| Investment properties | \$ 112,896 | \$ 2,328,749 | \$ 2,441,645 | \$ 553,633 | \$ 2,262,258 | \$ 2,815,891 |
| Properties under development | 68,222 | 1,596,490 | 1,664,712 | 43,336 | 1,002,968 | 1,046,304 |
| Other assets | 103,056 | 76,940 | 179,996 | 2,636 | 93,304 | 95,940 |
| Loan receivable | - | - | - | 17,200 | - | 17,200 |
| Cash and cash equivalents | 107,205 | 30,383 | 137,588 | 7,115 | 90,978 | 98,093 |
| Mortgages payable | (36,232) | (536,907) | (573,139) | (208,636) | (666,763) | (875,399) |
| Deferred tax liability | (310) | - | (310) | (330) | - | (330) |
| Bank indebtedness | - | (993,432) | (993,432) | - | (479,807) | (479,807) |
| Accounts payable and accrued liabilities | (4,393) | (99,794) | (104,187) | (7,888) | (111,302) | (119,190) |
| Non-controlling interest | - | (74,428) | (74,428) | - | (57,671) | (57,671) |
| Net assets | 350,444 | 2,328,001 | 2,678,445 | 407,066 | 2,133,965 | 2,541,031 |
| REIT's share of net assets | 163,907 | 961,228 | 1,125,135 | 196,721 | 863,066 | 1,059,787 |
| Elimination of intercompany loans | - | - | - | (8,600) | - | (8,600) |
| Amount in the combined statements of financial position | \$ 163,907 | \$ 961,228 | \$ 1,125,135 | \$ 188,121 | \$ 863,066 | \$ 1,051,187 |

ECHO reports its financial position to the REIT one month in arrears due to time constraints on its reporting. Therefore, the above amounts include ECHO's financial information as at November 30, 2017 and November 30, 2016, respectively. In December 2016, ECHO acquired three properties for approximately \$23,500, at the REIT's share.

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4. Equity accounted investments (continued):

| | Year ended December 31, 2017 | | | Year ended December 31, 2016 | | |
|--|-------------------------------|---------------------------|------------|-------------------------------|--------------------------|------------|
| | Investments in joint ventures | Investments in associates | Total | Investments in joint ventures | Investment in associates | Total |
| Net income (loss) from equity accounted investments: | | | | | | |
| Rentals from investment properties | \$ 31,506 | \$ 216,095 | \$ 247,601 | \$ 131,627 | \$ 178,715 | \$ 310,342 |
| Property operating costs | (4,855) | (46,852) | (51,707) | (51,122) | (39,055) | (90,177) |
| Net income from equity accounted investments | - | 1,750 | 1,750 | - | 1,573 | 1,573 |
| Finance income | 87 | 1,071 | 1,158 | 1,758 | 1,487 | 3,245 |
| Finance cost - operations | (5,431) | (47,874) | (53,305) | (20,943) | (40,481) | (61,424) |
| Trust expenses | (293) | (6,387) | (6,680) | (381) | (4,212) | (4,593) |
| Fair value adjustments on financial instruments | - | 9,213 | 9,213 | - | (1,857) | (1,857) |
| Fair value adjustment on real estate assets | (30,517) | 262,840 | 232,323 | (220,908) | 129,436 | (91,472) |
| Gain (loss) on sale of real estate assets | (1,993) | 802 | (1,191) | (105) | (1,273) | (1,378) |
| Income taxes | (236) | (197) | (433) | (501) | (111) | (612) |
| Net income (loss) | (11,732) | 390,461 | 378,729 | (160,575) | 224,222 | 63,647 |
| Net income attributable to non-controlling interest | - | (2,640) | (2,640) | - | (1,365) | (1,365) |
| Net income (loss) attributable to owners | (11,732) | 387,821 | 376,089 | (160,575) | 222,857 | 62,282 |
| REIT's share of net income (loss) attributable to shareholders | (5,854) | 173,261 | 167,407 | (63,903) | 98,194 | 34,291 |
| REIT's share of gain on sale of investment in joint venture* | - | - | - | 14,965 | - | 14,965 |
| Elimination of intercompany loan interest | - | - | - | (826) | (89) | (915) |
| Amount in the combined statements of comprehensive income (loss) | \$ (5,854) | \$ 173,261 | \$ 167,407 | \$ (49,764) | \$ 98,105 | \$ 48,341 |

* During the year ended December 31, 2016, the REIT disposed of its 33.3% ownership interests in 100 Yonge and Scotia Plaza for a gain on sale of investment in joint venture at the REIT's share of \$14,965.

ECHO reports its financial results to the REIT one month in arrears due to time constraints on its reporting. Therefore, the above amounts include ECHO's financial information for December 1, 2016 to November 30, 2017 and December 1, 2015 to November 30, 2016, respectively.

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5. Assets and liabilities classified as held for sale:

As at December 31, 2017, the REIT has no properties (December 31, 2016 – 50% ownership interest in two Primaris properties) classified as held for sale.

The following table sets forth the combined statement of financial position items associated with investment properties classified as held for sale:

| | December 31 2017 | December 31 2016 |
|--|---------------------|---------------------|
| Assets | | |
| Investment properties | \$ - | \$ 211,550 |
| Liabilities | | |
| Mortgages payable | \$ - | \$ 126,567 |
| Accounts payable and accrued liabilities | - | 248 |
| | \$ - | \$ 126,815 |

6. Other assets:

| | December 31 2017 | December 31 2016 |
|------------------------------------|---------------------|---------------------|
| Mortgages receivable* | \$ 153,211 | \$ 43,817 |
| Prepaid expenses and sundry assets | 33,554 | 92,975 |
| Restricted cash | 25,311 | 11,275 |
| Accounts receivable | 15,739 | 12,999 |
| Derivative instruments | 6,374 | 776 |
| | \$ 234,189 | \$ 161,842 |

* As at December 31, 2017, mortgages receivable bear interest at effective rates between 3.25% and 9.00% per annum (December 31, 2016 - between 4.40% and 9.00% per annum) with a weighted average effective rate of 7.42% per annum (December 31, 2016 - 7.99%), and mature between 2018 and 2026 (December 31, 2016 - mature between 2020 and 2026).

Future repayments are as follows:

| | December 31 2017 |
|---------------------------|---------------------|
| Years ending December 31: | |
| 2018 | \$ 84,566 |
| 2019 | 4,304 |
| 2020 | 16,072 |
| 2021 | 37,848 |
| 2022 | - |
| Thereafter | 10,421 |
| | \$ 153,211 |

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7. Cash and cash equivalents and bank indebtedness:

Cash and cash equivalents at December 31, 2017 includes cash on hand of \$42,022 (December 31, 2016 - \$47,760) and bank term deposits of \$262 (December 31, 2016 - \$261) at a rate of interest of 0.85% (December 31, 2016 - 0.43%).

The Trusts have the following bank credit facilities as at December 31, 2017:

| | | Maturity Date | Total Facility | Bank Indebtedness | Outstanding Letters of Credit | Available Balance |
|--|-----|--------------------|----------------|-------------------|-------------------------------|-------------------|
| Unsecured operating facilities: | | | | | | |
| H&R REIT unsecured operating facility #1 | (a) | December 18, 2018 | \$ 500,000 | \$ (208,713) | \$ (31,928) | \$ 259,359 |
| H&R REIT unsecured operating facility #2 | (b) | March 17, 2021 | 200,000 | (186,629) | - | 13,371 |
| Sub-total unsecured facilities | | | 700,000 | (395,342) | (31,928) | 272,730 |
| Secured operating facilities*: | | | | | | |
| Primaris secured operating facility | (a) | July 1, 2019 | 300,000 | (283,340) | (891) | 15,769 |
| H&R REIT and CrestPSP secured operating facility | (a) | February 19, 2019 | 25,000 | - | (105) | 24,895 |
| H&R REIT co-ownership secured operating facility | | September 30, 2019 | 3,514 | (3,514) | - | - |
| Sub-total secured facilities | | | 328,514 | (286,854) | (996) | 40,664 |
| | | | \$ 1,028,514 | \$ (682,196) | \$ (32,924) | \$ 313,394 |

* Secured by certain investment properties.

The bank credit facilities bear interest at a rate approximating the prime rate of a Canadian chartered bank.

(a) Can be drawn in either Canadian or U.S. dollars.

(b) The total facility as at December 31, 2017 is \$200,000, plus a 3% allowance relating to the fluctuation of the foreign exchange rate, and can be drawn in either Canadian or U.S. dollars. The REIT entered into an interest swap agreement to fix the interest rate at 2.56% per annum on U.S. \$130,000 of the U.S. dollar denominated borrowing of this facility (note 12).

Included in bank indebtedness at December 31, 2017 are U.S. dollar denominated amounts of \$467,000 (December 31, 2016 - U.S. \$441,000). The Canadian equivalent of these amounts is \$588,420 (December 31, 2016 - \$590,940).

The following table shows the change in bank indebtedness from January 1, 2017 to December 31, 2017:

| | December 31 2017 |
|--|---------------------|
| Opening balance, beginning of year | \$ 647,772 |
| Net proceeds from bank credit facilities | 69,704 |
| Change in foreign exchange | (35,280) |
| Closing balance, end of year | \$ 682,196 |

In January 2018, the REIT obtained an additional \$200,000 unsecured revolving operating facility due on January 31, 2023.

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8. Mortgages payable:

The mortgages payable are secured by real estate assets and letters of credit in certain cases, that generally bear fixed interest rates with a contractual weighted average rate of 4.26% (December 31, 2016 - 4.41%) per annum and mature between 2018 and 2033 (December 31, 2016 - maturing between 2017 and 2033). Included in mortgages payable at December 31, 2017 are U.S. dollar denominated mortgages of U.S. \$1,189,793 (December 31, 2016 - U.S. \$1,024,869). The Canadian equivalent of these amounts is \$1,499,139 (December 31, 2016 - \$1,373,324).

Debt related to certain Canadian properties is held by separate legal entities, where the rent received from each property is first used to satisfy the related debt obligations with any balance then available to satisfy the cash flow requirements of the REIT.

Future principal mortgage payments are as follows:

| | December 31 |
|---|---------------------|
| | 2017 |
| Years ending December 31: | |
| 2018 | \$ 264,796 |
| 2019 | 259,885 |
| 2020 | 486,327 |
| 2021 | 950,854 |
| 2022 | 660,115 |
| Thereafter | 1,343,463 |
| | 3,965,440 |
| Financing costs and mark-to-market adjustment arising on acquisitions | (6,809) |
| | \$ 3,958,631 |

The following table shows the change in mortgages payable from January 1, 2017 to December 31, 2017:

| | December 31 |
|--|---------------------|
| | 2017 |
| Opening balance, beginning of year | \$ 4,001,451 |
| Principal repayments: | |
| Scheduled amortization on mortgages | (133,330) |
| Mortgage repayments | (452,329) |
| New mortgages | 588,094 |
| Transfer from equity accounted investment | 39,854 |
| Effective interest rate accretion on mortgages | (3,119) |
| Change in foreign exchange rates | (81,990) |
| Closing balance, end of year | \$ 3,958,631 |

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9. Debentures payable:

The full terms of the debentures are contained in the trust indenture and supplemental trust indentures; the following table summarizes the key terms:

| | | | | | December 31 2017 | December 31 2016 | |
|---|------------------|---------------------------------|-------------------------------|---------------------|---------------------|---------------------|-------------------|
| | Maturity | Contractual interest rate | Effective interest rate | Conversion price | Principal amount | Carrying value | Carrying value |
| Convertible Debentures (a) | | | | | | | |
| 2018 Convertible Debentures (HR.DB.H) | | 5.40% | 5.40% | 24.73 | \$ - | \$ - | \$ 76,254 |
| 2020 Convertible Debentures (HR.DB.D) | June 30, 2020 | 5.90% | 5.90% | 23.50 | 99,652 | 103,140 | 102,644 |
| | | 5.90% | 5.90% | | 99,652 | 103,140 | 178,898 |
| Senior Debentures (b) | | | | | | | |
| Series I Senior Debentures | (1) | 2.54% | (1) | - | - | - | 59,992 |
| Series B Senior Debentures | | 5.90% | 6.06% | - | - | - | 114,992 |
| Series E Senior Debentures ⁽⁵⁾ | February 2, 2018 | 4.90% | 5.22% | - | 100,000 | 99,971 | 99,705 |
| Series J Senior Debentures ⁽⁵⁾ | February 9, 2018 | 2.04% | (2) | - | 157,500 | 157,480 | 167,278 |
| Series G Senior Debentures | June 20, 2018 | 3.34% | 3.54% | - | 175,000 | 174,847 | 174,511 |
| Series C Senior Debentures | December 1, 2018 | 5.00% | 5.30% | - | 125,000 | 124,690 | 124,350 |
| Series K Senior Debentures | March 1, 2019 | 2.36% | (3) | - | 200,000 | 199,633 | 199,331 |
| Series M Senior Debentures | July 23, 2019 | 2.66% | (4) | - | 150,000 | 149,683 | - |
| Series F Senior Debentures | March 2, 2020 | 4.45% | 4.58% | - | 175,000 | 174,519 | 174,316 |
| Series L Senior Debentures | May 6, 2022 | 2.92% | 3.11% | - | 325,000 | 321,158 | 198,218 |
| Series N Senior Debentures | January 30, 2024 | 3.37% | 3.45% | - | 350,000 | 347,669 | - |
| | | 3.30% | 3.49% | | 1,757,500 | 1,749,650 | 1,312,693 |
| | | 3.44% | 3.62% | | \$1,857,152 | \$ 1,852,790 | \$ 1,491,591 |

The Convertible Debentures are measured at fair value, with fair value determined using the quoted price on the TSX on December 31, 2017 and December 31, 2016.

- (1) Bore interest at a rate equal to 3-month Canadian Dealer Offered Rate plus 165 basis points. The REIT entered into an interest rate swap on the Series I senior debentures to fix the interest rate at 2.54% per annum (note 12). In January 2017, the REIT repaid all of its Series I senior debentures upon maturity for a cash payment of \$60,000.
- (2) Denominated as \$125,000 U.S. dollars and bears interest at a rate equal to 3-month London Interbank Offered Rate plus 108 basis points. The REIT entered into an interest rate swap on the Series J senior debentures to fix the interest rate at 2.04% (note 12).
- (3) Bears interest at a rate equal to 3-month Canadian Dealer Offered Rate plus 143 basis points. The REIT entered into an interest rate swap on the Series K senior debentures to fix the interest rate at 2.36% per annum (note 12).
- (4) Bears interest at a rate equal to 3-month Canadian Dealer Offered Rate plus 123 basis points. The interest rate for the period from October 23, 2017 to December 31, 2017 is 2.66%.
- (5) In February 2018, the REIT repaid all of its Series E and Series J senior debentures upon maturity for a cash payment of \$100,000 and U.S. \$125,000, respectively.

In January 2018, the REIT issued \$250,000 principal amount of Series O senior debentures maturing on January 23, 2023.

In February 2018, the REIT issued U.S. \$125,000 principal amount of Series P senior debentures maturing on February 13, 2020.

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9. Debentures payable (continued):

(a) *2018 Convertible Debentures and 2020 Convertible Debentures:*

In July 2010, the REIT completed a public offering of \$100,000 Series D convertible unsecured subordinated debentures (the "2020 Convertible Debentures"). On or after June 30, 2016 and prior to the maturity date, the 2020 Convertible Debentures may be redeemed by the REIT, in whole or in part, at a price equal to the principal amount plus accrued interest. Interest on the 2020 Convertible Debentures is payable semi-annually on June 30 and December 31.

Each 2020 Convertible Debenture is convertible into freely tradeable Stapled Units at the holder's option at (i) any time prior to the maturity date and (ii) the business day immediately preceding the date specified by the REIT for redemption of the 2020 Convertible Debentures, at a specified conversion price, subject to adjustment upon the occurrence of certain events in accordance with the indenture governing the 2020 Convertible Debentures.

On redemption or maturity of the 2020 Convertible Debentures, the REIT may, at its option and subject to certain conditions, elect to satisfy its obligation to repay all or any portion of the principal amount of the 2020 Convertible Debentures that are to be redeemed or that are to mature through the issuance of Stapled Units by way of issuing (or causing it to be issued) a variable number of Stapled Units equal to the principal amount of the 2020 Convertible Debentures that are to be redeemed or that are to mature divided by 95% of the then fair market value of the Stapled Units.

On April 4, 2013, the REIT assumed all of Primaris's outstanding convertible debentures (the "2018 Convertible Debentures"). In September 2017, the REIT redeemed all of the outstanding 2018 Convertible Debentures for a cash payment of \$74,394.

(b) *Senior Debentures:*

In January 2017, the REIT issued \$150,000 Series M unsecured senior debentures (the "Series M Senior Debentures"). On issuance, the REIT recorded a liability of \$149,461 net of issue costs of \$539.

In January 2017 and April 2017, the REIT issued \$200,000 and \$150,000 Series N unsecured senior debentures (the "Series N Senior Debentures"), respectively. On issuance, the REIT recorded an aggregate liability of \$347,393 net of aggregate issuance costs of \$2,607.

In August 2017, the REIT issued an additional \$125,000 Series L unsecured senior debentures (the "Series L Senior Debentures") bringing the total principal amount outstanding to \$325,000. On issuance of the additional \$125,000, the REIT recorded a liability of \$122,445 net of issue costs of \$2,555.

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9. Debentures payable (continued):

At its option, the REIT may redeem any of the fixed rate Senior Debentures, in whole at any time, or in part from time to time (i) in the case of the Series N and Series O senior debentures, prior to the specified par call date; and (ii) in the case of any other fixed rate senior debentures, prior to maturity on payment of a redemption price equal to the greater of (i) the Canada Yield Price as defined in the relevant supplemental trust indenture and (ii) par, together in each case with accrued and unpaid interest to the date fixed for redemption. Between the specified par call date and maturity, the applicable Senior Debentures may be redeemed on payment of a redemption price equal to par. The REIT will give notice of any redemption at least 30 days but not more than 60 days before the date fixed for redemption. Where less than all of any Senior Debentures are to be redeemed pursuant to their terms, the Senior Debentures to be so redeemed will be redeemed on a pro rata basis according to the principal amount of Senior Debentures registered in the respective name of each holder of Senior Debentures or in such other manner as the indenture trustee may consider equitable.

(c) A summary of the changes in the carrying value of debentures payable is as follows:

| | December 31 2017 | December 31 2016 |
|--|---------------------|---------------------|
| Convertible Debentures | | |
| Carrying value, beginning of year | \$ 178,898 | \$ 253,349 |
| Conversion - 2016 Convertible Debentures | - | (17) |
| Conversion - 2020 Convertible Debentures | (2) | - |
| Redemption - 2016 Convertible Debentures (HR.DB.E) | (1) - | (74,983) |
| Redemption - 2018 Convertible Debentures (HR.DB.H) | (1) (74,394) | - |
| (Gain) loss on change in fair value | (1,362) | 549 |
| Carrying value, end of year | 103,140 | 178,898 |
| Senior Debentures | | |
| Carrying value, beginning of year | 1,312,693 | 1,297,420 |
| Redemption - Series I Senior Debentures | (1) (60,000) | - |
| Redemption - Series D Senior Debentures | (1) - | (180,000) |
| Redemption - Series B Senior Debentures | (1) (115,000) | - |
| Issuance - Series M Senior Debentures | (2) 149,461 | - |
| Issuance - Series N Senior Debentures | (2) 347,393 | - |
| Issuance - Series L Senior Debentures | (2) 122,445 | 198,185 |
| Change due to foreign exchange rates | (10,000) | (4,987) |
| Accretion adjustment | 2,658 | 2,075 |
| Carrying value, end of year | 1,749,650 | 1,312,693 |
| | \$ 1,852,790 | \$ 1,491,591 |

(1) During the year ended December 31, 2017, the REIT redeemed debentures payable of \$249,394 (2016 - \$254,983).

(2) During the year ended December 31, 2017, the REIT issued debentures payable of \$619,299 (2016 - \$198,185).

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10. Exchangeable units:

Certain of the REIT's subsidiaries have in aggregate 15,979,430 (December 31, 2016 - 16,563,816) exchangeable units outstanding which are puttable instruments where, upon redemption, the REIT has a contractual obligation to issue Stapled Units. A subsidiary of the REIT also holds 433,174 (December 31, 2016 - 433,174) Stapled Units to mirror these exchangeable units. Therefore, when such exchangeable units are exchanged for Stapled Units, the number of outstanding Stapled Units will not increase. Holders of all exchangeable units are entitled to receive the economic equivalence of distributions on a per unit amount equal to a per Stapled Unit amount provided to holders of Stapled Units. These puttable instruments are classified as a liability under IFRS and are measured at fair value through net income. Fair value is determined by using the quoted prices for the Stapled Units as the exchangeable units are exchangeable into Stapled Units at the option of the holder. The quoted price as at December 31, 2017 was \$21.36 per Stapled Unit (December 31, 2016 - \$22.37).

A summary of the carrying value of exchangeable units is as follows:

| | December 31 2017 | December 31 2016 |
|---|---------------------|---------------------|
| Carrying value, beginning of year | \$ 370,533 | \$ 334,110 |
| Exchanged for Stapled Units | (13,324) | (2,295) |
| (Gain) loss on fair value of exchangeable units | (15,888) | 38,718 |
| Carrying value, end of year | \$ 341,321 | \$ 370,533 |

The REIT and Finance Trust have entered into various exchange and support agreements that provide, among other things, the mechanics whereby exchangeable units may be exchanged for Stapled Units.

11. Accounts payable and accrued liabilities:

| | <i>Note</i> | December 31 2017 | December 31 2016 |
|--|-------------|---------------------|---------------------|
| Current: | | | |
| Other accounts payable and accrued liabilities | | \$ 149,282 | \$ 141,984 |
| Mortgage interest payable | | 9,376 | 10,595 |
| Prepaid rent | | 23,059 | 20,757 |
| Debenture interest payable | | 13,295 | 10,495 |
| Derivative instruments | 12 | - | 3,791 |
| Unit-based compensation payable: | | | |
| Options | 13(c) | 2,249 | 6,451 |
| Incentive units | 13(c) | 3,156 | 3,981 |
| Non-current: | | | |
| Security deposits | | 5,752 | 4,932 |
| Unit-based compensation payable: | | | |
| Options | 13(c) | 10,297 | 11,461 |
| Incentive units | 13(c) | 2,565 | 2,978 |
| | | \$ 219,031 | \$ 217,425 |

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12. Derivative instruments:

| | | Fair value asset (liability)* | | Net gain (loss) on derivative contracts | |
|--------------------------------------|-----|-------------------------------|-------------------|---|-------------------|
| | | December 31 | December 31 | December 31 | December 31 |
| | | 2017 | 2016 | 2017 | 2016 |
| Debenture interest rate swap | (a) | \$ 2,231 | \$ 776 | \$ 1,455 | \$ 776 |
| Debenture interest rate swap | (b) | 177 | (407) | 584 | (407) |
| Bank indebtedness interest rate swap | (c) | 3,966 | (3,384) | 7,350 | (3,384) |
| | | \$ 6,374 | \$ (3,015) | \$ 9,389 | \$ (3,015) |

The REIT entered into interest rate swaps as follows:

- (a) To fix the interest rate at 2.36% per annum for the Series K senior debentures, which mature on March 1, 2019.
- (b) To fix the interest rate at 2.54% per annum for the Series I senior debentures (settled when these debentures matured on January 23, 2017) and, to fix the interest rate at 2.04% per annum for the Series J senior debentures, which mature on February 9, 2018.
- (c) To fix the interest rate at 2.56% per annum on U.S. \$130 million of bank indebtedness, maturing on March 17, 2021.

* Derivative instruments in asset and liability positions are not presented on a net basis. Derivative instruments in an asset position are recorded in other assets and derivative instruments in a liability position are recorded in accounts payable and accrued liabilities.

13. Unitholders' equity:

The REIT is an unincorporated open-ended trust. The beneficial interests in the REIT are divided into two classes of trust units: units of the REIT and special voting units.

(a) Description of units:

Each unit of the REIT and special voting unit carries a single vote at any meeting of unitholders. Holders of special voting units do not have any additional rights than those of holders of units of the REIT. The aggregate number of units of the REIT which the REIT may issue is unlimited and the aggregate number of special voting units which the REIT may issue is 9,500,000. The units of the REIT carry the right to participate pro rata in any distributions. As at December 31, 2017, 9,500,000 special voting units are issued and outstanding (December 31, 2016 - 9,500,000 special voting units).

Finance Trust is an unincorporated investment trust. The beneficial interests in Finance Trust are represented by a single class of units which are unlimited in number. Each unit carries a single vote at any meeting of unitholders and carries the right to participate pro rata in any distributions.

The units of the REIT are stapled with the units of Finance Trust effective October 1, 2008. These Stapled Units are listed and posted for trading on the TSX. The REIT has entered into a support agreement ("Support Agreement") with Finance Trust to coordinate the issuance of Stapled Units under various arrangements (note 13(e)).

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13. Unitholders' equity (continued):

The units of the Trusts are freely transferable and, other than as disclosed herein, the trustees shall not impose any restriction on the transfer of units. Provided that an event of uncoupling ("Event of Uncoupling") has not occurred: (a) each unit of the REIT may only be transferred together with a unit of Finance Trust; (b) no unit may be issued by the REIT to any person unless: (i) a unit of Finance Trust is simultaneously issued to such person, or (ii) the REIT has arranged that units will be consolidated (subject to any applicable regulatory approval) immediately after such issuance, such that each holder of a REIT unit will hold an equal number of Finance Trust units and units of the REIT immediately following such consolidation; and (c) a unitholder may require the REIT to redeem any particular number of units only if it also requires, at the same time, and in accordance with the provisions of the Finance Trust Declaration of Trust, Finance Trust to redeem that same number of units of Finance Trust.

An Event of Uncoupling shall occur only: (a) in the event that unitholders of the REIT vote in favour of the uncoupling of units of Finance Trust and units of the REIT such that the two securities will trade separately; or (b) at the sole discretion of the trustees of Finance Trust, but only in the event of the bankruptcy, insolvency, winding-up or reorganization (under an applicable law relating to insolvency) of the REIT or U.S. Holdco or the taking of corporate action by the REIT or U.S. Holdco in furtherance of any such action or the admitting in writing by the REIT or U.S. Holdco of its inability to pay its debts generally as they become due. The trustees of the Trusts shall use all reasonable efforts to obtain and maintain a listing for the units of the REIT and, unless an Event of Uncoupling has occurred, the Stapled Units, on one or more stock exchanges in Canada.

The unitholders have the right to require the Trusts to redeem their units on demand. Provided that no Event of Uncoupling has occurred, unitholders who tender their units of one of the Trusts for redemption will also be required to tender for redemption corresponding units of the other Trust in accordance with the provisions of the respective Declarations of Trust. Upon the tender of their units for redemption, all of the unitholder's rights to and under such units are surrendered and the unitholder is entitled to receive a price per unit as determined by the applicable Declaration of Trust.

Upon valid tender for redemption of each unit of the REIT, the unitholder is entitled to receive a price per unit of the REIT as determined by a formula based on the market price of Stapled Units less an amount based on the principal amount of U.S. Holdco Notes owing per outstanding unit of Finance Trust. The redemption price payable by the REIT will be satisfied by way of a cash payment to the unitholder or, in certain circumstances, including where such payment would cause the REIT's monthly cash redemption obligations to exceed \$50 (subject to adjustment in certain circumstances or waiver by the trustees) an *in specie* distribution of notes of H&R Portfolio LP Trust (a subsidiary of the REIT).

Upon valid tender for redemption of each unit of Finance Trust, the unitholder is entitled to receive, except as provided below, a price per unit payable in cash equal to the Canadian dollar equivalent of the outstanding principal amount of the U.S. Holdco Notes as of the redemption date, divided by the total number of Finance Trust units issued and outstanding immediately prior to the redemption date. In certain circumstances, including where such payment would cause Finance Trust's monthly cash redemption obligations to exceed \$50 (subject to adjustment in certain circumstances or waiver by the trustees) the redemption price per Finance Trust unit being redeemed, to which a redeeming unitholder is entitled shall be the fair market value of the Finance Trust units being redeemed, as determined by the trustees, which shall be payable by way of delivery of U.S. Holdco Notes.

(b) Unit Purchase Plan and Dividend Reinvestment Plan (the "DRIP"):

The Trusts offer holders of Stapled Units and holders of exchangeable units resident in Canada the opportunity to participate in its DRIP. The DRIP allows participants to have their monthly cash distributions reinvested in additional Stapled Units at a 3% discount to the weighted average price of the Stapled Units on the TSX for the five trading days (the "Average Market Price") immediately preceding the cash distribution date. The Direct Unit Purchase Plan allows participants to purchase additional Stapled Units on a monthly basis at the Average Market Price subject to a minimum purchase of \$250 per month (up to a maximum of \$13,500 per year) for each participant.

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13. Unitholders' equity (continued):

Changes in the issued and outstanding number of Stapled Units during the years ended December 31, 2017 and 2016 are as follows:

| | Note | |
|---|-------|--------------------|
| As at January 1, 2016 | | 279,610,123 |
| Issuance of units: | | |
| Issued under the Dividend Reinvestment Plan and Unit Purchase Plan (the "DRIP") | | 5,610,389 |
| Options exercised | | 100,334 |
| Exchangeable units exchanged into Stapled Units | | 100,000 |
| Conversion of convertible debentures | | 661 |
| Units repurchased and cancelled | 13(f) | (141,800) |
| As at December 31, 2016 | | 285,279,707 |
| Issuance of units: | | |
| Issued under the DRIP | | 5,557,815 |
| Issued upon exercise of options | | 652,291 |
| Incentive units settled in Stapled Units | | 1,354 |
| Exchangeable units exchanged into Stapled Units | | 584,386 |
| Conversion of convertible debentures | | 85 |
| Units repurchased and cancelled | 13(f) | (755,420) |
| As at December 31, 2017 | | 291,320,218 |

The weighted average number of basic Stapled Units for the year ended December 31, 2017 is 288,787,282 (December 31, 2016 - 282,215,659).

(c) Unit-based compensation:

In order to provide long-term compensation to the REIT's trustees, officers, employees and consultants, there may be grants of options and incentive units, which are each subject to certain restrictions.

(i) Unit option plan:

As at December 31, 2017, a maximum of 28,000,000 (December 31, 2016 - 28,000,000) options to purchase Stapled Units were authorized to be issued, of which 21,402,296 options (December 31, 2016 - 21,402,296 options) have been granted, 452,170 options (December 31, 2016 - 343,422 options) have expired and 7,049,874 options (December 31, 2016 - 6,941,126 options) remain to be granted. The exercise price of each option approximated the quoted price of the Stapled Units on the date of grant and shall be increased by the amount, if any, by which the fair quoted value of one Finance Trust unit at the time of exercise of such option exceeds the fair quoted value of one Finance Trust unit at the time of grant of such option. The options vest at 33.3% per year from the grant date, will be fully vested after three years, and expire ten years after the date of the grant.

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13. Unitholders' equity (continued):

A summary of the status of the unit option plan and the changes during the respective years are as follows:

| | December 31, 2017 | | December 31, 2016 | |
|----------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|
| | Units | Weighted average exercise price | Units | Weighted average exercise price |
| Outstanding, beginning of year | 13,820,539 | \$ 20.26 | 6,575,006 | \$ 21.57 |
| Granted | - | - | 7,345,867 | 18.98 |
| Exercised | (2,401,408) | (19.15) | (100,334) | 11.74 |
| Expired | (108,748) | (19.65) | - | - |
| Outstanding, end of year | 11,310,383 | \$ 20.51 | 13,820,539 | \$ 20.26 |
| Options exercisable, end of year | 6,008,045 | \$ 21.62 | 5,186,652 | \$ 21.66 |

The options outstanding at December 31, 2017 are exercisable at varying prices ranging from \$15.42 to \$23.18 (December 31, 2016 - \$9.30 to \$23.18) with a weighted average remaining life of 6.8 years (December 31, 2016 - 7.7 years). The vested options are exercisable at varying prices ranging from \$15.42 to \$23.18 (December 31, 2016 - \$9.30 to \$23.18) with a weighted average remaining life of 5.7 years (December 31, 2016 - 5.6 years).

(ii) Incentive unit plan:

As at December 31, 2017, a maximum of 5,000,000 (December 31, 2016 - 5,000,000) incentive units exchangeable into Stapled Units were authorized to be issued under the incentive unit plan. Of this amount, 651,026 incentive units (December 31, 2016 - 419,025 incentive units) have been granted, of which 39,731 incentive units (December 31, 2016 - 11,665 incentive units) have expired and 179,762 incentive units (December 31, 2016 - nil incentive units) have been settled. 4,388,705 incentive units (December 31, 2016 - 4,592,640 incentive units) remain to be granted and 431,533 incentive units remain outstanding (December 31, 2016 - 407,360 incentive units).

Incentive units are recognized based on the grant date fair value. The grant agreements provide that the awards will be satisfied in cash, unless the holder elects to have them satisfied in Stapled Units issued from treasury, with the result that the awards are classified as cash-settled unit-based payments and presented as liabilities. 100% of the incentive units vest on the third anniversary of the grant date and are subject to forfeiture until the recipients of the awards have held office with or provided services to the REIT for a specified period of time. The incentive units may, if specified at the time of grant, accrue cash distributions during the vesting period and accrued distributions will be paid when the incentive units vest.

The Trusts grant performance units under the incentive unit plan with a three-year performance period for certain senior executives. The performance units will be subject to both internal and external measures consisting of both absolute and relative performance over a three-year period, which upon vesting are cash settled.

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13. Unitholders' equity (continued):

A summary of the status of the incentive unit plan and the changes during the respective years are as follows:

| | December 31 2017 | December 31 2016 |
|--------------------------------|---------------------|---------------------|
| | Units | Units |
| Outstanding, beginning of year | 407,360 | 302,990 |
| Granted | 232,001 | 104,370 |
| Settled | (179,762) | - |
| Expired | (28,066) | - |
| Outstanding, end of year | 431,533 | 407,360 |

The fair values of the unit options and incentive units, included in accounts payable and accrued liabilities, are as follows:

| | December 31 2017 | December 31 2016 |
|-----------------|---------------------|---------------------|
| Options | \$ 12,546 | \$ 17,912 |
| Incentive units | 5,721 | 6,959 |
| | \$ 18,267 | \$ 24,871 |

Unit-based compensation expense included in trust expenses is as follows:

| | 2017 | 2016 |
|-----------------|----------|-----------|
| Options | \$ 2,127 | \$ 14,323 |
| Incentive units | 2,742 | 3,593 |
| | \$ 4,869 | \$ 17,916 |

(d) Distributions:

Under the REIT's Declaration of Trust, the total amount of income of the REIT to be distributed to unitholders for each calendar month shall be subject to the discretion of the trustees, however, the total income distributed shall not be less than the amount necessary to ensure that the REIT will not be liable to pay income tax under Part I of the Tax Act for any year. The method of payment is at the discretion of the trustees.

Pursuant to Finance Trust's Declaration of Trust, unitholders of Finance Trust are entitled to receive all of the Distributable Cash of Finance Trust, as defined in the Declaration of Trust. Distributable Cash means, subject to certain exceptions, all amounts received by Finance Trust less certain costs, expenses or other amounts payable by Finance Trust, and less any amounts which, in the opinion of the trustees, may reasonably be considered to be necessary to provide for the payment of any costs or expenditures that have been or will be incurred in the activities and operations of Finance Trust and to provide for payment of any tax liability of Finance Trust.

For the year ended December 31, 2017, the Trusts declared distributions per Stapled Unit of \$1.38 (December 31, 2016 - \$1.35).

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13. Unitholders' equity (continued):

The details of the distributions are as follows:

| | 2017 | 2016 |
|--|------------|------------|
| Cash distributions to unitholders | \$ 290,497 | \$ 274,264 |
| Unit distributions (issued under the DRIP) | 107,411 | 106,842 |
| | \$ 397,908 | \$ 381,106 |

(e) Support agreement:

Pursuant to provisions of the Declarations of Trust for Finance Trust and the REIT, at all times, each REIT unit must be stapled to a Finance Trust unit (and each Finance Trust unit must be stapled to a REIT unit) unless there is an Event of Uncoupling. As part of the Plan of Arrangement, the REIT and Finance Trust entered into the Support Agreement which provided, among other things, for the co-ordination of the declaration and payment of all distributions so as to provide for simultaneous record dates and payment dates; for co-ordination so as to permit the REIT to perform its obligations pursuant to the REIT's Declaration of Trust, Unit Option Plan, Incentive Unit Plan, DRIP and Unitholder Rights Plan; for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable and permit the REIT to perform its obligations arising under any security issued by the REIT (including securities convertible, exercisable or exchangeable into Stapled Units); for Finance Trust to take all such actions and do all such things as are necessary or desirable to enable the REIT to perform its obligations or exercise its rights under its convertible debentures; and for Finance Trust to take all such actions and do all such things as are necessary or desirable to issue Finance Trust units simultaneously (or as close to simultaneously as possible) with the issue of REIT units and to otherwise ensure at all times that each holder of a particular number of REIT units holds an equal number of Finance Trust units, including participating in and cooperating with any public or private distribution of Stapled Units by, among other things, signing prospectuses or other offering documents.

In the event that the REIT issues additional REIT units, pursuant to the Support Agreement, the REIT and Finance Trust will co-ordinate so as to ensure that each subscriber receives both REIT units and Finance Trust units, which shall trade together as Stapled Units. Prior to such event, the REIT shall provide notice to Finance Trust to cause Finance Trust to issue and deliver the requisite number of Finance Trust units to be received by and issued to, or to the order of, each subscriber as the REIT directs. In consideration of the issuance and delivery of each such Finance Trust unit, the REIT (on behalf of the purchaser) or the purchaser, as the case may be, shall pay (or arrange for the payment of) a purchase price equal to the fair market value (as determined by Finance Trust in consultation with the REIT) of each such Finance Trust unit at the time of such issuance. The remainder of the subscription price for Stapled Units shall be allocated to the issuance of REIT units by the REIT.

(f) Normal course issuer bid:

On August 8, 2017, the Trusts received approval from the TSX for the renewal of their normal course issuer bid ("NCIB"), allowing the Trusts to purchase for cancellation up to a maximum of 5,000,000 Stapled Units on the open market until the earlier of August 14, 2018 or the date on which the Trusts have purchased the maximum number of Stapled Units permitted under the NCIB. During the year ended December 31, 2017, the Trusts purchased and cancelled 755,420 Stapled Units at a weighted average price of \$21.10 per Stapled Unit, for a total cost of \$15,939. During the year ended December 31, 2016, under a previous NCIB, the Trusts purchased and cancelled 141,800 Stapled Units at a weighted average price of \$19.28 per Stapled Unit, for a total cost of \$2,734.

Subsequent to December 31, 2017, the Trusts purchased and cancelled 2,945,120 Stapled Units at a weighted average price of \$21.00 per unit, for a total cost of \$61,846.

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14. Accumulated other comprehensive income:

Items that are or may be reclassified subsequently to net income:

| | Cash flow hedges | Foreign operations | Total |
|---|------------------|--------------------|-------------------|
| Balance as at January 1, 2016 | \$ (342) | \$ 346,929 | \$ 346,587 |
| Transfer of realized loss on cash flow hedges to net income | 30 | - | 30 |
| Unrealized gain on translation of U.S. denominated foreign operation | - | (38,397) | (38,397) |
| Balance as at December 31, 2016 | (312) | 308,532 | 308,220 |
| Transfer of realized loss on cash flow hedges to net income | 30 | - | 30 |
| Unrealized loss on translation of U.S. denominated foreign operation | - | (131,302) | (131,302) |
| Balance as at December 31, 2017 | \$ (282) | \$ 177,230 | \$ 176,948 |

15. Rentals from investment properties:

| | 2017 | 2016 |
|---|---------------------|---------------------|
| Rental income | \$ 1,177,626 | \$ 1,193,471 |
| Straight-lining of contractual rent | (6,818) | 4,781 |
| Rent amortization of tenant inducements | (2,354) | (2,241) |
| | \$ 1,168,454 | \$ 1,196,011 |

Operating Leases:

The REIT leases its investment properties under operating leases (note 2(f)). The future minimum lease payments under non-cancellable leases are as follows:

| | 2017 | 2016 |
|-----------------------|---------------------|---------------------|
| Less than 1 year | \$ 712,256 | \$ 665,873 |
| Between 1 and 5 years | 2,270,517 | 2,324,926 |
| More than 5 years | 3,451,321 | 3,827,411 |
| | \$ 6,434,094 | \$ 6,818,210 |

16. Other income:

On January 15, 2015, Target Corporation announced plans to discontinue operating stores in Canada through its subsidiary Target Canada Co. ("Target"). As at December 31, 2016, Primaris had an interest in nine malls where Target was a tenant: a 50% interest in four of these malls and a 100% interest in the other five malls. Three of the leases were guaranteed by Target Corporation, the U.S. parent of Target.

In March 2016, Primaris entered into binding agreements with Target and Target Corporation concluding the terms of settlement relating to the leases that were disclaimed pursuant to the *Companies' Creditors Arrangement Act*. The binding agreements were approved by the courts in June 2016.

Distributions in respect of the settlement proceeds, in the amount of \$1,040, were received in 2017 (2016 - \$20,353).

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17. Finance costs:

| | 2017 | 2016 |
|---|-------------------|------------|
| Finance cost - operations | | |
| Contractual interest on mortgages payable | \$ 174,492 | \$ 196,228 |
| Contractual interest on debentures payable | 62,565 | 60,019 |
| Effective interest rate accretion | 1,808 | (2,595) |
| Bank interest and charges | 11,877 | 13,302 |
| Exchangeable unit distributions | 22,254 | 22,480 |
| | 272,996 | 289,434 |
| Capitalized interest* | (2,638) | (2,109) |
| | 270,358 | 287,325 |
| Finance income | (4,999) | (4,715) |
| Fair value adjustments on financial instruments** | (27,049) | 33,830 |
| | \$ 238,310 | \$ 316,440 |

* The weighted average rate of borrowings for the capitalized interest is 4.0% (December 31, 2016 - 4.75%).

** During the year ended December 31, 2017, the Trusts realized a gain of U.S. \$6,718 (2016 – nil) on the sale of an investment previously classified as held for trading.

18. Supplemental cash flow information:

| | 2017 | 2016 |
|--|-----------------|-------------|
| Straight-lining of contractual rent | \$ (876) | \$ (7,828) |
| Prepaid expenses and sundry assets | 8 | (69,808) |
| Accounts receivable | (2,728) | 1,687 |
| Accounts payable and accrued liabilities | 6,109 | 34,998 |
| | \$ 2,513 | \$ (40,951) |

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18. Supplemental cash flow information (continued):

The following amounts have been excluded from operating, investing and financing activities in the combined statements of cash flows:

| | Note | 2017 | 2016 |
|---|-------|------------|------------|
| Non-cash items: | | | |
| Non-cash distributions to unitholders in the form of DRIP units | 13(d) | \$ 107,411 | \$ 106,842 |
| Non-cash conversion of convertible debentures | 9(c) | 2 | 17 |
| Non-cash distributions to exchangeable unitholders in the form of DRIP units | | 11,051 | 9,767 |
| Non-cash adjustment to proceeds | | 7,523 | 1,005 |
| Non-cash assumption of mortgage payable on disposition of investment properties | | (126,567) | - |
| Mortgages receivable from the sale of investment properties | | 4,200 | - |
| Restricted cash from the disposition of investment properties | | 26,265 | - |
| Restricted cash used for the acquisition of investment properties | | (13,109) | - |
| Exchangeable units exchanged for Stapled Units | 10 | 13,324 | 2,295 |
| Other items: | | | |
| Decrease in accounts payable on redevelopment | | 336 | 4,534 |
| (Increase) Decrease in accounts payable included in finance cost - operations | | (1,809) | 3,341 |
| Capitalized interest on redevelopment | 17 | (1,562) | (1,449) |
| Capitalized interest on properties under development | 17 | (1,076) | (660) |

19. Capital risk management:

The REIT's primary objectives when managing capital are:

- to provide unitholders with stable and growing distributions generated by revenue it derives from investments in real estate assets; and
- to maximize unit value through the ongoing active management of the REIT's assets, the acquisition of additional properties and the development and construction of projects which are pre-leased to creditworthy tenants.

The REIT considers its capital to be:

| | December 31 2017 | December 31 2016 |
|---------------------|----------------------|----------------------|
| Mortgages payable | \$ 3,958,631 | \$ 4,001,451 |
| Debentures payable | 1,852,790 | 1,491,591 |
| Exchangeable units | 341,321 | 370,533 |
| Bank indebtedness | 682,196 | 647,772 |
| Unitholders' equity | 7,179,763 | 6,912,650 |
| | \$ 14,014,701 | \$ 13,423,997 |

As long as the REIT complies with its investment and debt restrictions set out in its Declaration of Trust, it is free to determine the appropriate level of capital in context with its cash flow requirements, overall business risks and potential business opportunities. As a result of this, the REIT will make adjustments to its capital based on its investment strategies and changes in economic conditions.

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19. Capital risk management (continued):

The REIT's level of indebtedness is subject to the limitations set out in its Declaration of Trust. The REIT is limited to a total indebtedness to total assets ratio of 65% (for this purpose "indebtedness" excludes, Convertible Debentures and U.S. Holdco notes payable to Finance Trust). As at December 31, 2017, this ratio was 43.9% (December 31, 2016 - 43.1%). Management uses this ratio as a key indicator in managing the REIT's capital.

In addition to the above key ratio, the REIT's bank credit facilities (note 7), debentures payable (note 9) and certain mortgages have various covenants calculated as defined within these agreements. The REIT monitors these covenants and was in compliance as at December 31, 2017 and December 31, 2016.

20. Risk management:

(a) Credit risk:

The REIT is exposed to credit risk in the event that borrowers default on the repayment of the amounts owing to the REIT. Management mitigates this risk by ensuring adequate security has been provided in support of mortgages receivable.

The REIT is exposed to credit risk as an owner of investment properties in that tenants may become unable to pay the contracted rent. Management mitigates this risk by carrying out appropriate credit checks and related due diligence on significant tenants. Management has diversified the REIT's holdings so that it owns several categories of properties and acquires investment properties throughout Canada and the United States.

In addition, management ensures that no tenant or related group of tenants, other than investment grade tenants, account for a significant portion of the REIT's cash flow. The REIT has two tenants which individually account for more than 5% of the rentals from investment properties of the REIT: Encana Corporation and Bell Canada. Both of these companies have a public debt rating that is rated with at least a BBB Negative rating by a recognized rating agency.

The REIT's exposure to credit risk on receivables is as follows:

| | <i>Note</i> | December 31 2017 | December 31 2016 |
|----------------------|-------------|-----------------------------|---------------------|
| Mortgages receivable | 6 | \$ 153,211 | \$ 43,817 |
| Accounts receivable | 6 | 15,739 | 12,999 |
| | | \$ 168,950 | \$ 56,816 |

(b) Liquidity risk:

The Trusts are subject to liquidity risk whereby they may not be able to refinance or pay their debt obligations when they become due.

The Trusts manage liquidity risk by:

- Ensuring appropriate lines of credit available are available. As at December 31, 2017 the combined amounts available under their bank credit facilities was \$313,394 (note 7);
- Maintaining a large unencumbered asset pool. As at December 31, 2017, there were 108 unencumbered properties with a fair value of approximately \$3,614,735; and

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20. Risk management (continued):

- Structuring their financing so as to stagger the maturities of its debt, thereby minimizing exposure to liquidity risk in any one year (notes 7, 8 and 9).

Management monitors the Trusts' liquidity risk through review of financial covenants contained in bank credit facility agreements, debt agreements and compliance with the REIT's Declaration of Trust.

The Trusts' obligations are as follows:

| | Note | 2018 | Thereafter | Total |
|--|------|---------------------|---------------------|---------------------|
| Mortgages payable* | 8 | \$ 264,796 | \$ 3,700,644 | \$ 3,965,440 |
| Debentures payable* | 9 | 557,500 | 1,299,652 | 1,857,152 |
| Bank indebtedness* | 7 | 208,713 | 473,483 | 682,196 |
| Accounts payable and accrued liabilities** | 11 | 198,168 | 8,317 | 206,485 |
| | | \$ 1,229,177 | \$ 5,482,096 | \$ 6,711,273 |

* Amounts in the above table only include the principal amount for each debt obligation.

** Excludes options payable.

(c) Market risk:

The Trusts are subject to currency risk and interest rate risk. The Trusts' objective is to manage and control market risk exposure within acceptable parameters, while optimizing the return on risk.

(i) Currency risk:

Foreign exchange risk is the risk that the fair value or future cash flows of an exposure will fluctuate because of changes in foreign exchange rates. A portion of the REIT's properties are located in the United States, resulting in the REIT being subject to foreign currency fluctuations which may impact its financial position and results. In order to mitigate the risk, the REIT's debt on these properties is also denominated in U.S. dollars to act as a natural hedge. Additionally, the REIT has designated the Series J senior debentures and the U.S. bank indebtedness as part of the net investment hedge of its U.S. operations.

A \$0.10 weakening of the U.S. dollar against the average Canadian dollar exchange rate of \$1.30 for the year ended December 31, 2017 (December 31, 2016 - \$1.32) as well as the Canadian dollar exchange rate as at December 31, 2017 of \$1.26 (December 31, 2016 - \$1.34) would have decreased other comprehensive loss by approximately \$146,900 (December 31, 2016 - \$116,600) and decreased net income by approximately \$21,600 (December 31, 2016 - \$26,700). This analysis assumes that all other variables, in particular interest rates, remain constant (a \$0.10 weakening of the Canadian dollar against the U.S. dollar at December 31, 2016 would have had the equal but opposite effect).

(ii) Interest rate risk:

The Trusts are exposed to interest rate risk on its borrowings. It minimizes this risk by obtaining long-term fixed interest rate debt. At December 31, 2017, the percentage of fixed rate debt to total debt was 88.2% (December 31, 2016 - 91.1%). Therefore, a change in interest rates at the reporting date would not have a material impact on net income as the majority of the Trust's borrowings are through fixed rate instruments.

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20. Risk management (continued):

As at December 31, 2017, bank indebtedness of \$518,396 is subject to variable interest rates. An increase in interest rates of 100 basis points for the year ended December 31, 2017 would have decreased net income by approximately \$2,200 (December 31, 2016 - \$3,800). This analysis assumes that all other variables, in particular foreign exchange rates, remain constant.

The floating rate Series J and K senior debentures are subject to variable rates, however the REIT entered into interest rate swaps to reduce exposure to fluctuations in interest rates. In 2017, the floating rate Series M senior debentures were subject to variable interest rates. An increase in interest rates of 100 basis points for the year ended December 31, 2017 would have decreased net income by approximately \$1,300. This analysis assumes that all other variables, in particular foreign exchange rates, remain constant.

As at December 31, 2017, the floating rate mortgages payable of \$96,966 are subject to variable interest rates. An increase in interest rates of 100 basis points for the year ended December 31, 2017 would have decreased net income by approximately \$1,300 (December 31, 2016 - \$1,000). This analysis assumes that all other variables, in particular foreign exchange rates, remain constant.

(d) *Fair values:*

(i) *Financial assets and liabilities carried at amortized cost:*

The fair values of the Trusts' accounts receivable, cash and cash equivalents and accounts payable and accrued liabilities approximate their carrying amounts due to the relatively short periods to maturity of these financial instruments.

The fair value of the mortgages receivable has been determined by discounting the cash flows of these financial obligations using year-end market rates for debt of similar terms and credit risks.

The fair value of the mortgages payable has been determined by discounting the cash flows of these financial obligations using year-end market rates for debt of similar terms and credit risks.

The fair value of the Senior Debentures has been determined by discounting the cash flows of these financial obligations using year-end market rates for debt of similar terms and credit risks.

(ii) *Assets and Liabilities carried at fair value:*

Assets and liabilities measured at fair value in the combined statements of financial position, or disclosed in the notes to the financial statements, are categorized using a fair value hierarchy that reflects the significance of the inputs used in determining the fair values:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

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20. Risk management (continued):

| December 31, 2017 | Note | Level 1 | Level 2 | Level 3 | Total fair value | Carrying value |
|--|------|--------------|------------|---------------|------------------|----------------|
| Assets measured at fair value | | | | | | |
| Investment properties | 3 | \$ - | \$ - | \$ 13,074,123 | \$ 13,074,123 | \$ 13,074,123 |
| Properties under development | 3 | - | - | 83,132 | 83,132 | 83,132 |
| Derivative instruments | 12 | - | 6,374 | - | 6,374 | 6,374 |
| | | | | | - | - |
| Assets for which fair values are disclosed | | | | | | |
| Mortgages receivable | 6 | - | - | 155,621 | 155,621 | 153,211 |
| | | - | 6,374 | 13,312,876 | 13,319,250 | 13,316,840 |
| Liabilities measured at fair value | | | | | | |
| Convertible debentures | 9 | (103,140) | - | - | (103,140) | (103,140) |
| Exchangeable units | 10 | (341,321) | - | - | (341,321) | (341,321) |
| | | | | | - | - |
| Liabilities for which fair values are disclosed | | | | | | |
| Mortgages payable | 8 | - | - | (4,067,657) | (4,067,657) | (3,958,631) |
| Senior debentures | 9 | - | - | (1,779,043) | (1,779,043) | (1,749,650) |
| Bank indebtedness | 7 | - | - | (680,095) | (680,095) | (682,196) |
| | | (444,461) | - | (6,526,795) | (6,971,256) | (6,834,938) |
| | | \$ (444,461) | \$ 6,374 | \$ 6,786,081 | \$ 6,347,994 | \$ 6,481,902 |
| December 31, 2016 | | | | | | |
| | Note | Level 1 | Level 2 | Level 3 | Total fair value | Carrying value |
| Assets measured at fair value | | | | | | |
| Investment properties | 3 | \$ - | \$ - | \$ 12,564,144 | \$ 12,564,144 | \$ 12,564,144 |
| Properties under development | 3 | - | - | 118,268 | 118,268 | 118,268 |
| Derivative instruments | 12 | - | 776 | - | 776 | 776 |
| | | | | | - | - |
| Assets for which fair values are disclosed | | | | | | |
| Mortgages receivable | 6 | - | - | 47,402 | 47,402 | 43,817 |
| | | - | 776 | 12,729,814 | 12,730,590 | 12,727,005 |
| Liabilities measured at fair value | | | | | | |
| Convertible debentures | 9 | (178,898) | - | - | (178,898) | (178,898) |
| Exchangeable units | 10 | (370,533) | - | - | (370,533) | (370,533) |
| Derivative instruments | 12 | - | (3,791) | - | (3,791) | (3,791) |
| | | | | | - | - |
| Liabilities for which fair values are disclosed | | | | | | |
| Mortgages payable | 8 | - | - | (4,181,006) | (4,181,006) | (4,001,451) |
| Senior debentures | 9 | - | - | (1,352,637) | (1,352,637) | (1,312,693) |
| Bank indebtedness | 7 | - | - | (645,746) | (645,746) | (647,772) |
| | | (549,431) | (3,791) | (6,179,389) | (6,732,611) | (6,515,138) |
| | | \$ (549,431) | \$ (3,015) | \$ 6,550,425 | \$ 5,997,979 | \$ 6,211,867 |

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21. Compensation of key management personnel:

Key management personnel are those individuals that have the authority and responsibility for planning, directing and controlling the REIT's activities, directly or indirectly.

| | 2017 | 2016 |
|---|-----------------|------------------|
| Salaries and short-term employee benefits | \$ 3,794 | \$ 4,435 |
| Unit-based compensation | 3,353 | 13,375 |
| | \$ 7,147 | \$ 17,810 |

22. Segmented disclosures:

(i) Operating segments:

The Trusts have six reportable operating segments (Office, which also includes the Trusts' head office and Finance Trust, Primaris, H&R Retail, ECHO, Industrial and Residential (operating as Lantower Residential)), in two geographical locations (Canada and the United States). The operating segments derive their revenue primarily from rental income from leases. The segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker, determined to be the Chief Executive Officer ("CEO") of the Trusts. The CEO measures and evaluates the performance of the Trusts based on property operating income on a proportionately consolidated basis for the Trusts' equity accounted investments. The accounting policies of the segments presented here are consistent with the Trusts' accounting policies as described in note 2.

Real estate assets by reportable segment as at December 31, 2017 and December 31, 2016 are as follows:

| December 31, 2017 | Office* | Primaris | H&R Retail | ECHO | Industrial | Lantower Residential | Total |
|--|---------------------|---------------------|---------------------|-------------|---------------------|-------------------------|----------------------|
| Number of investment properties | 36 | 31 | 123 | 227 | 93 | 17 | 527 |
| Real estate assets: | | | | | | | |
| Investment properties | \$ 6,562,552 | \$ 2,945,800 | \$ 1,399,672 | \$ 789,419 | \$ 1,035,920 | \$ 1,187,191 | \$ 13,920,554 |
| Properties under development | - | - | - | 10,345 | 83,132 | 805,127 | 898,604 |
| | 6,562,552 | 2,945,800 | 1,399,672 | 799,764 | 1,119,052 | 1,992,318 | 14,819,158 |
| Less: Trusts' proportionate share of real estate assets relating to equity accounted investments | - | - | - | (799,764) | (57,012) | (805,127) | (1,661,903) |
| | \$ 6,562,552 | \$ 2,945,800 | \$ 1,399,672 | \$ - | \$ 1,062,040 | \$ 1,187,191 | \$ 13,157,255 |

* Includes the Trusts' head office.

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22. Segmented disclosures (continued):

| December 31, 2016 | Office* | Primaris | H&R Retail | ECHO | Industrial | Lantower Residential | Total |
|--|--------------|--------------|---------------|------------|--------------|-------------------------|---------------|
| Number of investment properties | 37 | 31 | 126 | 215 | 101 | 12 | 522 |
| Real estate assets: | | | | | | | |
| Investment properties | \$ 6,495,994 | \$ 3,154,000 | \$ 1,547,286 | \$ 767,579 | \$ 1,102,016 | \$ 755,358 | \$ 13,822,233 |
| Properties under development | - | - | - | 10,240 | 118,268 | 500,287 | 628,795 |
| | 6,495,994 | 3,154,000 | 1,547,286 | 777,819 | 1,220,284 | 1,255,645 | 14,451,028 |
| Less: assets classified as held for sale | - | (211,550) | - | - | - | - | (211,550) |
| Less: Trusts' proportionate share of real estate assets relating to equity accounted investments | (62,500) | - | - | (777,819) | (216,460) | (500,287) | (1,557,066) |
| | \$ 6,433,494 | \$ 2,942,450 | \$ 1,547,286 | \$ - | \$ 1,003,824 | \$ 755,358 | \$ 12,682,412 |

* Includes the Trusts' head office.

Property operating income by reportable segment for the years ended December 31, 2017 and December 31, 2016 is as follows:

| | Office* | Primaris | H&R Retail | ECHO | Industrial | Lantower Residential | Sub-total | Less: Equity Accounted Investments | December 31 2017 |
|------------------------------------|------------|------------|---------------|-----------|------------|-------------------------|--------------|--|---------------------|
| Property operating income: | | | | | | | | | |
| Rentals from investment properties | \$ 600,792 | \$ 281,086 | \$ 125,194 | \$ 72,548 | \$ 96,838 | \$ 80,454 | \$ 1,256,912 | \$ (88,458) | \$ 1,168,454 |
| Property operating costs | (210,426) | (123,822) | (29,410) | (15,254) | (26,003) | (40,511) | (445,426) | 18,413 | (427,013) |
| | \$ 390,366 | \$ 157,264 | \$ 95,784 | \$ 57,294 | \$ 70,835 | \$ 39,943 | \$ 811,486 | \$ (70,045) | \$ 741,441 |

| | Office* | Primaris | H&R Retail | ECHO | Industrial | Lantower Residential | Sub-total | Less: Equity Accounted Investments | December 31 2016 |
|------------------------------------|------------|------------|---------------|-----------|------------|-------------------------|--------------|--|---------------------|
| Property operating income: | | | | | | | | | |
| Rentals from investment properties | \$ 655,856 | \$ 300,883 | \$ 142,432 | \$ 59,999 | \$ 98,197 | \$ 52,801 | \$ 1,310,168 | \$ (114,157) | \$ 1,196,011 |
| Property operating costs | (239,655) | (129,975) | (29,969) | (13,112) | (27,327) | (24,294) | (464,332) | 33,061 | (431,271) |
| | \$ 416,201 | \$ 170,908 | \$ 112,463 | \$ 46,887 | \$ 70,870 | \$ 28,507 | \$ 845,836 | \$ (81,096) | \$ 764,740 |

* Includes the Trusts' head office.

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22. Segmented disclosures (continued):

(ii) Geographical locations:

The Trusts operate in Canada and the United States.

Investment properties and properties under development are attributed to countries based on the location of the properties.

| | December 31 2017 | December 31 2016 |
|--|----------------------|---------------------|
| Real estate assets: | | |
| Canada | \$ 9,344,350 | \$ 9,335,849 |
| United States | 5,475,050 | 5,115,179 |
| | 14,819,400 | 14,451,028 |
| Less: assets classified as held for sale | - | (211,550) |
| Less: Trusts' proportionate share of investment properties and properties under development relating to equity accounted investments | (1,662,145) | (1,557,066) |
| | \$ 13,157,255 | \$ 12,682,412 |
| | 2017 | 2016 |
| Rentals from investment properties: | | |
| Canada | \$ 871,955 | \$ 943,965 |
| United States | 384,957 | 366,203 |
| | 1,256,912 | 1,310,168 |
| Less: Trusts' proportionate share of rentals relating to equity accounted investments | (88,458) | (114,157) |
| | \$ 1,168,454 | \$ 1,196,011 |

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23. Income tax expense (recovery):

| | 2017 | 2016 |
|--|--------------------|-------------------|
| Income tax computed at the Canadian statutory rate of nil applicable to the REIT for 2017 and 2016 | \$ - | \$ - |
| Current U.S. income taxes | 1,538 | 1,950 |
| Deferred income taxes applicable to U.S. Holdco: | | |
| Impact of U.S. Tax Reform | (87,970) | - |
| Other | 48,193 | 199,591 |
| | (39,777) | 199,591 |
| Income tax expense (recovery) in the determination of net income | \$ (38,239) | \$ 201,541 |

The Tax Act contains legislation (the "SIFT Rules") affecting the tax treatment of "specified investment flow-through" ("SIFT") trusts. A SIFT includes a publicly-traded trust. Under the SIFT Rules, distributions of certain income by a SIFT are not deductible in computing the SIFT's taxable income, and a SIFT is subject to tax on such income at a rate that is substantially equivalent to the general tax rate applicable to a Canadian corporation. The SIFT Rules do not apply to a publicly-traded trust that qualifies as a real estate investment trust under the Tax Act, such as the REIT.

The REIT has certain subsidiaries in the United States that are subject to tax on their taxable income at a combined federal and state tax rate of approximately 37.5% in 2017 (2016 - 37.5%). As a result of U.S. legislation enacted on December 22, 2017, commonly referred to as the Tax Cuts and Jobs Act of 2017 ("U.S. Tax Reform"), deferred income taxes at December 31, 2017 have been measured based upon the newly enacted federal income tax rate. The income tax recovery for the year ended December 31, 2017 reflects the impact of U.S. Tax Reform resulting from the reduction in the federal tax rate from 35% to 21% effective in 2018 (24% including state tax) and a reduction in certain deferred tax assets related to deferred interest deductions.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

| | December 31 2017 | December 31 2016 |
|--|---------------------|---------------------|
| Deferred tax assets: | | |
| Net operating losses | \$ 6,924 | \$ 17,219 |
| Deferred interest deductions | - | 61,940 |
| Accounts payable and accrued liabilities | 1,387 | 2,320 |
| Other assets | 2,257 | 1,787 |
| | 10,568 | 83,266 |
| Deferred tax liabilities: | | |
| Investment properties | 256,507 | 404,881 |
| Equity accounted investments | 79,192 | 65,160 |
| | 335,699 | 470,041 |
| Deferred tax liability | \$ (325,131) | \$ (386,775) |

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23. Income tax expense (recovery) continued:

As at December 31, 2017, U.S. Holdco had accumulated net operating losses available for carryforward for U.S. income tax purposes of \$28,879 (December 31, 2016 - \$45,903), the benefit of which has been recognized and deferred interest deductions of \$194,489 (December 31, 2016 - \$165,125), the benefit of which has not been recognized as a result of U.S. Tax Reform. Certain aspects of U.S. Tax Reform may be subject to clarifications or varying interpretations including the treatment of deferred interest deductions. The net operating losses will expire between 2031 and 2032. The deductible temporary differences do not generally expire under current tax legislation.

24. Commitments and contingencies:

- (a) In the normal course of operations, the REIT has issued letters of credit in connection with developments, financings, operations and acquisitions. As at December 31, 2017, the REIT has outstanding letters of credit totalling \$32,924 (December 31, 2016 - \$34,305), including \$15,120 (December 31, 2016 - nil) which has been pledged as security for certain mortgages payable. The letters of credit are secured in the same manner as the bank indebtedness (note 7).
- (b) The REIT provides guarantees on behalf of third parties, including co-owners. As at December 31, 2017, the REIT issued guarantees amounting to \$369,173 (December 31, 2016 - \$171,064), which expire between 2020 and 2029 (December 31, 2016 - expire between 2022 and 2029), relating to the co-owner's share of mortgage liability. In addition, the REIT continues to guarantee certain debt assumed by purchasers in connection with past dispositions of properties, and will remain liable until such debts are extinguished or the lenders agree to release the REIT's guarantees. At December 31, 2017, the estimated amount of debt subject to such guarantees, and therefore the maximum exposure to credit risk, is \$119,279 (December 31, 2016 - \$133,040) which expires between 2018 and 2020 (December 31, 2016 - expires between 2017 and 2020). There have been no defaults by the primary obligor for debts on which the REIT has provided its guarantees, and as a result, no contingent loss on these guarantees has been recognized in these combined financial statements.

Credit risks arise in the event that these parties default on repayment of their debt since they are guaranteed by the REIT. These credit risks are mitigated as the REIT has recourse under these guarantees in the event of a default by the borrowers, in which case the REIT's claim would be against the underlying real estate investments.

- (c) The REIT is obligated, under certain contract terms, to construct and develop investment properties.
- (d) The REIT is involved in litigation and claims in relation to the investment properties that arise from time to time in the normal course of business. In the opinion of management, any liability that may arise from such contingencies would not have a material adverse effect on the combined financial statements.

25. Subsidiaries:

Significant subsidiaries of the REIT are as follows:

| Name of Entity | Place of Business | Ownership interest | |
|--|-------------------|---------------------|---------------------|
| | | December 31 2017 | December 31 2016 |
| Bow Centre Street Limited Partnership | Canada | 100% | 100% |
| H&R Portfolio Limited Partnership | Canada | 100% | 100% |
| H&R REIT Management Services Limited Partnership | Canada | 100% | 100% |
| H&R REIT (U.S.) Holdings Inc. | United States | 100% | 100% |
| Primaris Management Inc. | Canada | 100% | 100% |
| PRR Trust | Canada | 100% | 100% |

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26. Subsequent events:

- (a) In January 2018, the REIT secured a U.S. \$51,400 mortgage for a term of 10 years.
- (b) In January 2018, the REIT issued \$250,000 principal amount of Series O senior debentures maturing on January 23, 2023.
- (c) In January 2018, the REIT obtained an additional \$200,000 unsecured revolving operating facility due on January 31, 2023.
- (d) In February 2018, the REIT repaid all of its Series E and Series J senior debentures upon maturity for a cash payment of \$100,000 and U.S. \$125,000, respectively.
- (e) In February 2018, the REIT issued U.S. \$125,000 principal amount of Series P senior debentures maturing on February 13, 2020.

Unitholder Distribution Reinvestment Plan and Unit Purchase Plan

H&R offers holders of Stapled Units and holders of Exchangeable Units resident in Canada the opportunity to participate in its Unitholder Distribution Reinvestment Plan (the "DRIP") and Unit Purchase Plan.

The DRIP allows participants to have their monthly cash distributions reinvested in additional Stapled Units at the weighted average price of the Stapled Units on the TSX for the five trading days (the "Average Market Price") immediately preceding the cash distribution date. In addition, participants will be entitled to receive an additional distribution equal to 3% of each cash distribution reinvested pursuant to the DRIP which will be reinvested in additional Stapled Units.

The Unit Purchase Plan allows participants to purchase additional Stapled Units on a monthly basis at the Average Market Price, subject to a minimum purchase of \$250 per month (up to a maximum of \$13,500 per year) for each participant.

For more information on the DRIP and/or the Unit Purchase Plan, please contact us by email through the "Contact Us" webpage of our website or contact the plan agent: AST Trust Company (Canada), P.O. Box 4229, Station A, Toronto, Ontario M5W 0G1, Tel: 1-800-387-0825 (or for callers outside North America 416-682-3860), Fax: 1-888-488-1416, Email: inquiries@canstockta.com, Website: www.canstockta.com.

Corporate Information

H&R REIT Board of Trustees

Thomas J. Hofstedter ⁽¹⁾, President and Chief Executive Officer, H&R Real Estate Investment Trust
Robert Dickson ^(2,3), Strategic financial consultant, marketing communications industry
Edward Gilbert ⁽²⁾, Chief Operating Officer, Firm Capital Mortgage Investment Trust
Laurence A. Lebovic ⁽¹⁾, Chief Executive Officer, Runnymede Development Corporation Ltd.
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H&R Finance Trust Board of Trustees

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Neil Sigler ⁽²⁾, Vice President, Gold Seal Management Inc.

(1) Investment Committee

(2) Audit Committee

(3) Compensation, Governance and Nominating Committee

Officers

Thomas J. Hofstedter, President and Chief Executive Officer
Larry Froom, Chief Financial Officer
Robyn Kestenber, Executive Vice-President, Corporate Development
Nathan Uhr, Chief Operating Officer (H&R REIT)
Pat Sullivan, Chief Operating Officer (Primaris)
Philippe Lapointe, Chief Operating Officer (Lantower Residential)
Cheryl Fried, Executive Vice-President, Finance (H&R REIT)
Blair Kundell, Vice-President, Operations (H&R REIT)
Jason Birken, Vice-President, Finance (H&R REIT)

Auditors: KPMG LLP

Legal Counsel: Blake, Cassels & Graydon LLP

Taxability of Distributions: The 2017 distributions by H&R REIT were comprised of capital gains (22.8%), other taxable income (33.8%), foreign non-business income (12.4%) and tax deferred return of capital (31.0%). The 2017 distributions by H&R Finance Trust were comprised of foreign non-business income (92.2%) and tax deferred return of capital (7.8%). For a Canadian resident unitholder, only 60.3% of the 2017 distributions on a Stapled Unit are subject to tax when considering these allocations and the non-taxable portion of the capital gains.

Plan Eligibility: RRSP, RRIF, DPSP, RESP, RDSP, TFSA

Stock Exchange Listing: Stapled Units and debentures of H&R are listed on the Toronto Stock Exchange under the trading symbols HR.UN and HR.DB.D.

Unitholder Distribution Reinvestment Plan and Direct Unit Purchase Plan: H&R REIT offers holders of Stapled Units and holders of exchangeable units resident in Canada the opportunity to participate in its Unitholder Distribution Reinvestment Plan (the "DRIP") and Direct Unit Purchase Plan. The DRIP allows participants to have their monthly cash distributions of H&R REIT reinvested in additional Stapled Units of H&R at a 3% discount to the weighted average price of the Stapled Units on the TSX for the five trading days (the "Average Market Price") immediately preceding the cash distribution date. The Direct Unit Purchase Plan allows participants to purchase additional Stapled Units on a monthly basis at the Average Market Price subject to a minimum purchase of \$250 per month (up to a maximum of \$13,500 per year) for each participant. For more information on the DRIP and/or the Direct Unit Purchase Plan, please contact us by email through the "Contact Us" webpage of our website, or contact our Registrar and Transfer Agent.

Registrar and Transfer Agent: AST Trust Company (Canada), P.O. Box 4229, Station A, Toronto, Ontario, Canada M5W 0G1, Telephone: 1-800-387-0825 (or for callers outside North America 416-682-3860), Fax: 1-888-488-1416, E-mail: inquiries@canstockta.com, Website: www.canstockta.com.

Contact Information: Investors, investment analysts and others seeking financial information should go to our website at www.hr-reit.com, or e-mail info@hr-reit.com, or call 416-635-7520 and ask for Larry Froom, Chief Financial Officer, or fax 416-398-0040, or write to H&R Real Estate Investment Trust, 3625 Dufferin Street, Suite 500, Toronto, Ontario, Canada, M3K 1N4



H&R Real Estate Investment Trust and H&R Finance Trust



Modera Westshore, Tampa



Dufferin Mall, Toronto



Corus Quay, Toronto