# INNVEST

INNVEST REAL ESTATE INVESTMENT TRUST | QUARTERLY REPORT 2014


## Q1 2014

**An in-depth look at InnVest's financial results for the three months ended March 31, 2014.**

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# Letter to Unitholders

We have announced a number of exciting changes for InnVest in the last few months including expanding our capital partners, initiating a process to build a dedicated management team and amending existing agreements to enhance flexibility and alignment. These efforts demonstrate our commitment to growing unitholder value and positioning InnVest as the leading growth platform in Canada's hospitality industry.

The accretive nature of our divestiture program continues to positively contribute to our operating performance. Our active capital investment program is expected to further improve long-term cash flow and profitability metrics across the portfolio.

**First Quarter Highlights**

- Revenue per available room ("RevPAR") on a same-hotel basis improved 0.5% driven by rate gains and stable occupancies. Excluding hotels under renovation during the quarter or recovering from renovations recently undertaken, RevPAR growth would have exceeded 3.5%;
- Same-hotel revenues improved 1.2% over the prior year. Overall revenues declined $9.4 million reflecting asset sales. Notwithstanding the revenue decline, gross operating profit improved 1.7% to $13.5 million and margins increased 110 basis points;
- Realized an improved net loss of $34.9 million compared to a loss of $41.7 million in the prior period, benefitting from lower non-cash charges in 2014, InnVest typically incurs a loss in the first quarter given the seasonality of the portfolio;
- Funds from operations and adjusted funds from operations improved 12.5% and 11.8%, respectively;
- Sold four non-core assets for aggregate gross proceeds of $14.3 million and have commitments to sell six additional hotels for aggregate gross proceeds of $23.9 million. In aggregate, management has completed or committed transactions representing over 80% of its divestiture objectives through 2014;
- Refinanced one mortgage for $68.0 million with incremental proceeds available to repay mortgage maturities in April;
- Subsequent to the end of the quarter, InnVest entered into subordinated loan agreements with KingSett Capital for $50.0 million including InnVest's option to draw an additional $50.0 million. Subsequently, InnVest called its $70.0 million Series C convertible debentures for early redemption in June 2014; and
- Following the end of the quarter, management also announced its intention to internalize InnVest's asset management function and completed amendments to its hotel management agreement with Westmont.

The first quarter is historically InnVest's lowest earnings period. Given the seasonality of the portfolio, the first quarter is not reflective of anticipated results for the annual period. Revenues (on a same-hotel basis) are typically higher in the second and third quarters due to business and leisure travel trends as compared to the first and fourth quarters.

**Anthony Messina**
President and Chief Executive Officer

March 7, 2014

# Management's Discussion and Analysis

## INTRODUCTION

InnVest Real Estate Investment Trust ("InnVest" or the "REIT") is an unincorporated open-ended real estate investment trust which owns a portfolio of hotels across Canada. The unaudited interim condensed consolidated financial statements ("Interim Financial Statements") and financial data included in this management's discussion and analysis ("MD&A") reflect the consolidated financial results of InnVest. This MD&A is dated May 7, 2014.

The following MD&A is intended to assist readers in understanding InnVest, its history, business environment, strategies, performance and risk factors and includes a discussion of the results of operations and financial condition of InnVest for the three months ended March 31, 2014, with a comparison to the results of operations and financial condition for the three months ended March 31, 2013. The MD&A should be read in conjunction with the Interim Financial Statements of InnVest and the notes thereto as at March 31, 2014 and December 31, 2013 and for the three months ended March 31, 2014 and 2013.

Monetary data in tabular form and in the text, unless otherwise indicated, are in thousands of Canadian dollars, except for per unit, average daily rate ("ADR"), and revenue per available room ("RevPAR") amounts.

Certain measures in this MD&A do not have any standardized meaning as prescribed by International Financial Reporting Standards ("IFRS") and therefore are considered non-IFRS measures. Please refer to *Non-IFRS Financial Measures and Additional IFRS Financial Measures* on page 16 for a discussion of those measures used by InnVest, including a reconciliation to IFRS financial measures.

Additional information relating to InnVest, including its Annual Information Form, can be accessed on the Canadian Securities Administrators' System for Electronic Document Analysis and Retrieval ("SEDAR") located at www.sedar.com and on its website at www.innvestreit.com.

## FORWARD-LOOKING STATEMENTS

In the interest of providing InnVest unitholders and potential investors with information regarding InnVest, certain statements contained in this MD&A constitute forward-looking statements within the meaning of applicable securities laws. These statements include, but are not limited to, statements made concerning InnVest's objectives, its strategies to achieve those objectives, as well as other statements with respect to management's beliefs, plans, estimates and intentions, and similar statements concerning anticipated future events, results, circumstances and performance or expectations that are not historical facts. Forward-looking information typically contains statements with words such as "outlook", "objective", "may", "could" "continue", "anticipate", "believe", "expect", "estimate", "plan", "intend", "forecast", "project" or similar expressions suggesting future outcomes or events. Such forward-looking statements reflect management's current beliefs and are based on information currently available to management.

These forward-looking statements are not guarantees of future events or performance and, by their nature, are based on InnVest's estimates and assumptions, which are subject to risks and uncertainties, including those described under "Risks and Uncertainties" in this MD&A. Readers are cautioned not to place undue reliance on forward-looking statements, as there can be no assurance that the plans, intentions or expectations upon which they are based will occur. By its nature, InnVest's forward-looking information involves numerous assumptions, inherent risks and uncertainties, which may cause InnVest's actual performance and financial results in future periods to differ materially from any estimates or projections of future performance or results expressed or implied by such forward-looking statements. Factors that could cause actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements include, but are not limited to, the status of InnVest as a real estate investment trust for Canadian federal income tax purposes in any year; changes in business strategies (including InnVest's ability to divest of assets, its intent to internalize asset management and return expectations on capital investments completed); ability to refinance debt maturities; general global economic and business conditions; medical concerns relating to travel and/or specific destinations; general global credit market conditions; the effects of competition and pricing pressures; industry overcapacity; shifts in market demands; changes in laws and regulations, including environmental and regulatory laws; potential increases in maintenance and operating costs; uncertainties of litigation; labour disputes; timing of completion of capital or maintenance projects; currency and interest rate fluctuations; various events which could disrupt operations; and technological changes.

Although InnVest believes that the expectations represented by such forward-looking statements are reasonable, there can be no assurance that such expectations will be consistent with these forward-looking statements. The forward-looking statements contained in this MD&A are made as of the date of this MD&A. Except as required by law, InnVest does not undertake any obligation to publicly update or revise any forward-looking statements whether as a result of new information, future events or otherwise. All forward-looking statements contained in this MD&A are expressly qualified by this cautionary statement.

# BUSINESS OVERVIEW

InnVest holds one of Canada's largest hotel portfolios together with a 50% interest in Choice Hotels Canada Inc., one of the largest franchisors of hotels in Canada. InnVest's portfolio is well diversified across hotel accommodation categories, brands, geography and customers.

InnVest's hotels are typically located near major thoroughfares in urban and suburban areas, business centres, government and manufacturing facilities, universities, airports and tourist attractions. The hotels have a diverse customer base, including business travellers, leisure travellers, tours, associations and corporate groups.

## Hotel Real Estate Owner

As at March 31, 2014, InnVest's portfolio comprised 124 hotel properties (15,586 rooms) operated under internationally recognized franchise brands. The hotel portfolio is evenly divided between full-service and limited-service hotels based on number of rooms. Full-service hotels however, generate higher revenues per room given higher ADRs charged and greater ancillary services sold. As a result, full-service hotels in the portfolio accounted for approximately 67% of hotel revenues generated during the first quarter of 2014 (2013 – 66%). Approximately 78% of hotel revenues (2013 – 78%) were generated from room revenues with the remainder being generated from food and beverage sales and other services including meeting space rental, parking, retail operations and telephone use.

InnVest's hotels are operated by four hotel management companies which earn base and incentive fees related to the revenues and profitability of each hotel. Westmont Hospitality Canada Limited ("Westmont"), a division of one of the largest privately held managers of hotels in the world, manages the majority of InnVest's hotels (111 hotels). InnVest also partners with other third-party managers including Delta Hotels (8 hotels), Fairmont Hotels (3 hotels) and Hilton Hotels (2 hotels), each an experienced hotel manager with recognized brands.

The hotels' primary operating costs include wages, food costs, utilities, management fees and sales and marketing expenses. Other property level expenses include property taxes, ground rent for leasehold interests and property insurance. Many of these other property level expenses are relatively fixed and do not change in accordance with revenue levels.

## Office, Retail and Retirement Home Business

At March 31, 2014, InnVest owns one retail complex as well as one retirement home. These real estate interests are adjacent to an owned hotel and were acquired as part of the hotel's acquisition. During the three months ended March 31, 2014, this business segment contributed $196 in revenues (2013 – $804). In May 2013, InnVest sold one office and retail complex in Sherbrooke, Quebec. Historically, this asset contributed over 60% of this business segment's annual revenues and the vast majority of its gross operating profit.

## Franchise Business

InnVest owns 50% of Choice Hotels Canada Inc. ("CHC"), which has franchise agreements with over 300 locations in Canada. The remaining 50% interest is owned by Choice Hotels International Inc. ("Choice International"), one of the largest hotel franchise companies in the world. In addition to strong international brand recognition, Choice International has a centralized reservation system, sales and marketing programs and proprietary property management systems.

In 1993, CHC was granted a 99-year licence to franchise all Choice hotel brands in Canada, including Comfort Inn, Quality Suites and Quality Hotels. CHC earns franchise revenue by charging hotel owners a monthly royalty fee based on a percentage of the revenue generated by the licenced properties and by selling franchises.

**HOTEL MANAGEMENT DIVERSIFICATION**(1)


**HOTEL SERVICE CATEGORY DIVERSIFICATION**(1)


**HOTEL GEOGRAPHIC DIVERSIFICATION**(1)


(1) Based on portfolio as at March 31, 2014

# BUSINESS STRATEGY

In early 2013, InnVest announced a comprehensive two-year strategic plan based on four key initiatives. This 2013 strategic plan is being reviewed as a consequence of certain changes to InnVest's Board of Trustees (the "Board") following the settlement of a proxy contest launched in January 2014 (the "Settlement").

In conjunction with this review, the Board has appointed an interim Managing Director and commenced a search for a permanent full-time Chief Executive Officer to be employed by InnVest and the Chief Financial Officer role will become fully dedicated to the affairs of the REIT during the year.

The following summary outlines progress achieved against InnVest's 2013 strategic plan:

| Strategic Initiative | Objective | Progress Update |
|---|---|---|
| Portfolio repositioning program | Improve the overall quality and diversification of the portfolio by divesting of low-yielding non-core hotels and selectively growing the portfolio in stable markets with long-term growth potential.<br>Planned sale of 24 non-core assets through the end of 2014 generating gross proceeds of $185 million and net proceeds after debt repayment and selling costs of about $60 million.<br>Additional hotels may be considered for sale based on management's ongoing assessment of its portfolio return expectations. During the first quarter of 2014, three assets were identified as additional sales candidates. | Under the direction of the Board, a review of the entire property portfolio has commenced to help determine the optimal future strategy for InnVest.<br>In 2013, InnVest sold eight non-core assets for gross proceeds of $113.1 million (net proceeds of approximately $28.4 million). In the first quarter of 2014, four non-core assets were sold for gross proceeds of $14.3 million (net proceeds of $7.4 million). Six hotels are currently under purchase and sale agreements for aggregate gross proceeds of approximately $23.9 million. In aggregate, these sales represent over 80% of InnVest's targeted divestiture program through the end of 2014.<br>The sale of these low yielding assets has contributed to improve operating margins by 110 bps during the first quarter of 2014. |
| Capital investment program | Execute a two-year (2013-2014) capital program to invest approximately $130 million in the core hotel portfolio; approximately $80 million above the estimated reserve over this two-year period. This incremental funding is expected through non-core asset sales and incremental debt proceeds.<br>The capital program is aimed at renovating and repositioning approximately 60 Comfort Inn hotels, targeting profit-improving projects to reposition select hotels as well as fortifying hotel competitive positions in key markets.<br>Additional investments that meet internal return on investment expectations may be considered. The ultimate extent and timing of these planned capital investments will be dependent on business levels and capital availability. | Over $60 million was invested in 2013 with approximately $70 million planned for 2014, $18.5 million of which was invested in the first quarter of 2014.<br>Planned investments in 2014 include completing guestroom upgrades at the Delta Winnipeg, Delta Prince Edward and Fairmont Palliser, as well as the continuation of phased renovations at the Sheraton Suites Eau Claire and the repositioning of one unbranded hotel to a Holiday Inn.<br>Through the end of the first quarter of 2014, 35 Comfort Inn hotels have been renovated as part of InnVest's brand revitalization program and an additional 3 were underway. Through the end of the second quarter, 46 core Comfort Inn hotels are expected to be renovated, with the balance expected to be renovated following the busier summer travel season.<br>Renovations, particularly those geared towards repositioning an asset, will typically take time before targeted returns are achieved. Furthermore, the benefit of InnVest's 2013 renovation activity is being offset by ongoing renovation activity underway during the current year. On balance, InnVest's capital program is contributing to improved GOP for the portfolio. |

| Strategic Initiative | Objective | Progress Update |
|---|---|---|
| Strengthen the balance sheet | Maintain a strong balance sheet with appropriate leverage and staggered debt maturities in order to minimize its cost of capital and provide adequate financial flexibility to withstand market cycles.<br>Target leverage reduction below 60%. This is expected to be accomplished through asset sales, regular principal amortization repayments and potential capital market transactions.<br>Following its capital investment program, InnVest anticipates to be building cash reserves, positioning it to further reduce indebtedness or to deploy its capital in select investments to grow the portfolio. | Following changes to InnVest's Board in March 2014, a Capital Task Force subcommittee was established to review InnVest's capital structure and alternatives to better optimize cost of capital, diversity of funding sources and liquidity so as to best enable the future execution of InnVest's business strategy in a manner that creates significant value for unitholders. As a result, InnVest's strategic plan, including future leverage targets are currently under review.<br>In March 2014, KingSett Capital ("KingSett") was introduced as a strategic capital partner of InnVest, providing the REIT with incremental capital sources to support debt and growth initiatives. Furthermore, KingSett may purchase assets from InnVest at fair market value, subject to Board approval.<br>Building on its commitment to limit its use of convertible securities, in April 2014, InnVest completed a $50 million subordinated credit facility with KingSett and InnVest has an option to draw an additional $50 million (refer to *Related Party Transactions*). Subsequently, InnVest called its $70 million Series C Debentures for early redemption in June 2014.<br>In January, InnVest took advantage of favourable interest rates by refinancing a $68 million mortgage, incremental proceeds of which were available to repay mortgage maturities in April 2014.<br>Following these announced transactions, InnVest will not have any significant debt maturities until July 2015.<br>At March 31, 2014, proforma financing transactions completed or announced following the end of the quarter, InnVest's leverage was 65.5% (refer to *Liquidity and Capital Resources*). |
| Improve operations | Leverage a renovated product to shift business to higher rated segments and capture greater market share amidst positive industry trends.<br>Continually strive to improve InnVest's operating efficiency by taking advantage of its size and implementing industry best practices to maximize cash flows margins. | Progress achieved in executing InnVest's strategic plan has contributed to improve operating margins by 110 bps during the first quarter of 2014.<br>In addition, InnVest completed amendments to its hotel management agreement with Westmont to provide the REIT with greater flexibility and incentive compensation (see *Related Party Transactions*). Coupled with the active asset management of the portfolio, these changes are expected to contribute to enhanced business oversight and alignment of interests with key stakeholders and help position the REIT to improve operations. |

# OUTLOOK

The hospitality industry is highly correlated to the economy and as such, uncertain global and domestic economic conditions continue to impact the Canadian lodging industry. InnVest's broad, diversified portfolio remains a key advantage in the current environment. Fundamentals for the Canadian lodging industry remain favourable, with improving demand expectations through the balance of the year and a low supply outlook.

Through the end of 2014, InnVest expects to continue its portfolio repositioning strategy of divesting of low-yielding assets and reinvesting proceeds generated to undertake an extensive capital program to enhance its product offering at a number of select hotels. While impacting near-term operating results caused by displacement, these targeted investments are expected to improve the portfolio's competitive positioning and operating performance through increased occupancies and average daily rates over the longer term.

InnVest is committed to enhancing unitholder alignment and growing unitholder value. InnVest's strategy to reduce debt (including reducing InnVest's reliance on dilutive securities), reposition its portfolio and invest in core assets is expected to enhance the stability and growth of the portfolio's long-term cash flows and valuation.

# FIRST QUARTER HIGHLIGHTS

- Revenue per available room ("RevPAR") on a same-hotel basis improved 0.5% driven by rate gains and stable occupancies. Excluding hotels under renovation during the quarter or recovering from renovations recently undertaken, RevPAR growth would have exceeded 3.5%;
- Same-hotel revenues improved 1.2% over the prior year. Overall revenues declined $9.4 million reflecting asset sales. Notwithstanding the revenue decline, gross operating profit ("GOP") improved 1.7% to $13.5 million;
- Realized an improved net loss of $34.9 million compared to a loss of $41.7 million in the prior period, benefitting from lower non-cash charges in 2014. InnVest typically incurs a loss in the first quarter given the seasonality of the portfolio (refer to *Quarterly Results*).
- Funds from operations ("FFO") and adjusted funds from operations ("AFFO") improved 12.5% and 11.8% respectively;
- Sold four non-core assets for aggregate gross proceeds of $14.3 million and has commitments to sell six additional hotels for aggregate gross proceeds of $23.9 million. In aggregate, management has completed or committed transactions representing over 80% of its divestiture objectives through 2014;
- Refinanced one mortgage for $68.0 million with incremental proceeds available to repay mortgage maturities in April;
- Subsequent to the end of the quarter, InnVest entered into subordinated loan agreements with KingSett for $50.0 million and InnVest has an option for an additional $50.0 million. Subsequently, InnVest called its $70.0 million Series C convertible debentures for early redemption in June 2014; and
- Following the end of the quarter, management also completed amendments to its hotel management agreement with Westmont including the internalization of its asset management function.

# FINANCIAL HIGHLIGHTS

| | Three months ended March 31, | | |
|---|---|---|---|
| | **2014** | 2013 | Variance |
| Revenues | **$ 114,431** | $ 123,822 | $ (7.6%) |
| Gross operating profit[1] | **13,494** | 13,263 | 1.7% |
| Net loss and comprehensive loss | **(34,871)** | (41,666) | 16.3% |
| Funds from operations[1] | **(4,575)** | (5,231) | 12.5% |
| Adjusted funds from operations[1] | **(7,623)** | (8,644) | 11.8% |
| Distribution declared | **9,378** | 9,360 | – |
| Per unit diluted: | | | |
| Net loss and comprehensive loss | **$ (0.372)** | $ (0.445) | $ 0.073 |
| Funds from operations | **$ (0.049)** | $ (0.056) | $ 0.007 |
| Adjusted funds from operations[2] | **$ (0.081)** | $ (0.092) | $ 0.011 |
| Distributions declared | **$ 0.0999** | $ 0.0999 | $ – |

(1) Refer to *Non-IFRS Financial Measures and Additional IFRS Financial Measures* on page 16.
(2) Adjusted funds from operations per unit is calculated on a basis consistent with that used to calculate net income (loss) per unit.

The following discussion summarizes InnVest's performance for the three months ended March 31, 2014 as compared to 2013.

### Revenues

| | Three months ended March 31, | | |
|---|---|---|---|
| | **2014** | 2013 | Variance |
| Hotel | **$ 114,235** | $ 123,018 | (7.1%) |
| Other real estate properties | **196** | 804 | (75.6%) |
| Revenues | **$ 114,431** | $ 123,822 | (7.6%) |

Asset sales completed since 2013 contributed to a decline in hotel revenues during the three months ended March 31, 2014. Generating over 99% of total revenues, InnVest's principal business is the ownership of hotel real estate (see detailed discussion below). Revenues from other real estate properties declined owing to the sale of one office and retail complex in late May 2013.

## Hotel revenues

| | Three months ended March 31, 2014 | 2013 | Variance |
|---|---|---|---|
| Room | **$ 88,982** | $ 95,869 | (7.2%) |
| Non-room | **25,253** | 27,149 | (7.0%) |
| Hotel revenues | **$ 114,235** | $ 123,018 | (7.1%) |

Hotel revenues consist primarily of revenue generated from room occupancy. Non-room revenues include food and beverage services and other miscellaneous revenue streams associated with hotel operations such as meeting space rentals, parking, retail operations and telephone use.

Hotel revenues during the first quarter of 2014 decreased $8.8 million, or 7.1%, with hotel property divestitures (including one early lease surrender) contributing to declines of $10.1 million. Since the beginning of 2013, twelve hotels (2,149 rooms) have been divested (eight in 2013 and four in 2014).

Same-hotel hotel revenues achieved were impacted by disruption caused by renovations at select hotels during the quarter, or recovering from renovations recently undertaken, including the Sheraton Calgary Suites Eau Claire, Fairmont Palliser in Calgary, the Delta Prince Edward Island and a number of Comfort Inn hotels. As a result, same-hotel RevPAR growth during the three months ended March 31, 2014 was limited to 0.5%. Excluding hotels impacted by renovations during the quarter, same-hotel RevPAR growth would have exceeded 3.5%.

| Same-Hotel Portfolio | Occupancy | Variance to 2013 | ADR | Variance to 2013 | RevPAR | Variance to 2013 |
|---|---|---|---|---|---|---|
| Ontario | **56.5%** | 1.8 pts | **$ 105.51** | (1.0%) | **$ 59.60** | 2.3% |
| Quebec | **53.8%** | (1.1 pts) | **$ 109.89** | 2.8% | **$ 59.15** | 0.7% |
| Atlantic | **45.3%** | (0.7 pts) | **$ 108.43** | 0.8% | **$ 49.13** | (0.6%) |
| Western | **59.5%** | (2.8 pts) | **$ 158.97** | 3.1% | **$ 94.60** | (1.5%) |
| Total | **54.7%** | – | **$ 117.88** | 0.7% | **$ 64.42** | 0.5% |

Note: Gross hotel revenues on a same-hotel basis (124 hotels), excluding hotels which were sold.

### Room Revenues

Room revenues during the three months ended March 31, 2014 declined $6.9 million or 7.2%. Reduced revenues following asset sales ($7.2 million) offset growth across InnVest's same-hotel portfolio, notwithstanding notable renovations underway.

Room revenues for the quarter is net of $1.9 million (2013 – $2.1 million) of costs associated with third-party loyalty programs.

| | As at March 31, 2014 # of hotels | # of rooms | Three months ended March 31, 2014 Room revenue $ | Variance $ | Variance % |
|---|---|---|---|---|---|
| Core Portfolio | | | | | |
| Ontario | 54 | 6,448 | **$ 34,734** | $ 538 | 1.6% |
| Quebec | 23 | 2,579 | **13,758** | 211 | 1.6% |
| Atlantic | 18 | 2,282 | **10,156** | (77) | (0.8%) |
| Western | 17 | 2,967 | **24,655** | (457) | (1.8%) |
| Total Core Portfolio | 112 | 14,276 | **$ 83,303** | $ 215 | 0.3% |
| Non-Core Portfolio | 12 | 1,310 | **5,196** | 118 | 2.3% |
| Total Current Portfolio | 124 | 15,586 | **$ 88,499** | $ 333 | 0.4% |
| 2014 Dispositions | 4 | 330 | **483** | (448) | nm |
| 2013 Dispositions and lease surrender | 8 | 1,819 | **–** | (6,772) | nm |
| Total Portfolio | 136 | 17,735 | **$ 88,982** | $ (6,887) | (7.2%) |

"nm" – not meaningful

Total Current Portfolio analysis for the three months ended March 31, 2014

- The Ontario region saw modest growth with strength in the Greater Toronto Area somewhat offset by softness in northern Ontario (slower mining activity and renovation activity).
- The Quebec region saw modest growth with strength in Quebec City somewhat offset by shortfalls in resource-based northern Quebec markets as well as markets impacted by renovation activity.
- Room revenue in the Atlantic region decreased modestly owing to renovation activity underway, including at the Delta Prince Edward.
- Renovation activity at two full-service hotels in Calgary – Fairmont Palliser and Sheraton Eau Claire – contributed to first quarter revenue declines in the Western region. Renovations at both hotels are expected to be completed during the second quarter.

### Non-Room Revenues

The sale of food and beverage represents over 80% of the non-room revenue earned over the periods presented. Non-room revenues decreased $1.9 million (7.0%) owing to the divestiture of hotels over the past year. Same-hotel revenues improved 4.0% or $1.0 million led by group activity in full-service hotels.

## Hotel and other real estate properties expense

| | Three months ended March 31, 2014 | 2013 | Variance |
|---|---|---|---|
| Hotel | **$ 100,628** | $ 109,957 | (8.5%) |
| Other real estate properties | **309** | 602 | (48.7%) |
| Hotel and other real estate properties | **$ 100,937** | $ 110,559 | (8.7%) |

InnVest continually focuses on managing all costs to maximize overall profitability without impacting the service levels offered to its guests. Management's focus is on limiting incremental costs associated with improved occupancy and/or adjusting costs in periods of declining occupancy in order to enable margin expansion. Many property level expenses, including property taxes, rent and insurance are relatively fixed and do not change in accordance with overall demand levels.

Hotel expenses during 2013 decreased $9.3 million (8.5%), reflecting the elimination of costs associated with assets sold totalling $12.5 million. Same-store expenses were negatively impacted by higher energy costs of $1.6 million during the quarter owing to the unusually cold temperatures and higher utility rates.

Consistent with changes in revenues, other real estate properties saw reduced operating expenses reflecting the sale of one office and retail complex during the second quarter of 2013.

## Gross operating profit

| | Three months ended March 31, 2014 | 2013 | Variance |
|---|---|---|---|
| Hotel | **$ 13,607** | $ 13,061 | 4.2% |
| Other real estate properties | **(113)** | 202 | nm |
| Gross operating profit | **$ 13,494** | $ 13,263 | 1.7% |

"nm" – not meaningful

Gross operating profit ("GOP") during the three months ended March 31, 2014 improved 1.7%, reflecting the accretive nature of the sales completed over the period.

**HOTEL GOP**

The hotel industry has a high level of fixed costs with incremental revenue gains requiring marginal increases in costs. As a result, revenue growth achieved beyond inflation can contribute to substantial operating leverage for the portfolio. Notably, while occupancy growth contributes to improved profitability, more profit is achieved through increases in ADR. Conversely, in periods of marginal (below inflation) or declining revenues, decreases to expenses are limited, resulting in reduced profitability.

Notwithstanding the hotel revenue reduction of $8.8 million (7.1%), Hotel GOP in 2013 improved modestly highlighting the low yielding nature of divestitures completed. Assets sold contributed to improving Hotel GOP by approximately $2.4 million during the first quarter of 2014 owing to the seasonal nature of hotels sold. Same-hotel Hotel GOP declined $1.9 million highlighting the impact of higher utility costs during the period as well as limited costs savings achieved during renovations given the high fixed-cost nature of expenses during the seasonally low first quarter. Same-hotel Hotel GOP margins declined to 12.1% from 13.9%.

| | As at March 31, 2014 | | Three months ended March 31, 2014 | | |
|---|---|---|---|---|---|
| | # of hotels | # of rooms | GOP $ | Variance $ | Variance % |
| Core Portfolio | | | | | |
| Ontario | 54 | 6,448 | **$ 5,528** | $ (397) | (6.7%) |
| Quebec | 23 | 2,579 | **1,640** | (182) | (10.0%) |
| Atlantic | 18 | 2,282 | **(203)** | (223) | nm |
| Western | 17 | 2,967 | **7,187** | (970) | (11.9%) |
| Total Core Portfolio | 112 | 14,276 | **$ 14,152** | $ (1,772) | (11.1%) |
| Non-Core Portfolio | 12 | 1,310 | **(392)** | (100) | 34.2% |
| Total Current Portfolio | 124 | 15,586 | **$ 13,760** | $ (1,872) | (12.0%) |
| 2014 Dispositions | 4 | 330 | **(97)** | (87) | nm |
| 2013 Dispositions and lease surrender | 8 | 1,819 | **(56)** | 2,505 | nm |
| Total Portfolio | 136 | 17,735 | **$ 13,607** | $ 546 | 4.2% |

"nm" – not meaningful

### Other Expenses

| | Three months ended March 31, | | |
|---|---|---|---|
| | **2014** | 2013 | Variance |
| Corporate and administrative | **$ 5,196** | $ 1,283 | nm |
| Interest expense: | | | |
| Mortgages and other debt | **11,158** | 11,724 | (4.8%) |
| Convertible debentures | **6,282** | 6,410 | (2.0%) |
| Joint venture income | **(864)** | (833) | 3.7% |
| Other expense, net | **(1,704)** | (1,313) | nm |
| Depreciation and amortization | **20,226** | 20,712 | (2.3%) |
| Unrealized loss on liabilities presented at fair value | **8,071** | 17,228 | nm |
| Other expenses | **$ 48,365** | $ 55,211 | (12.4%) |

"nm" – not meaningful

Other expenses during the three months ended March 31, 2014 decreased $6.8 million or 12.4% with reduced non-cash unrealized losses somewhat offset by higher corporate and administrative expenses.

As part of the Settlement reached in March 2014 (refer to *Business Strategy*), InnVest incurred $3.6 million in non-recurring costs, including the reimbursement of customary transaction costs incurred by the parties involved. These costs contributed to the higher corporate and administrative expenses during the first quarter of 2014.

Mortgage interest expense declined reflecting the net repayment of mortgage debt from asset sales and reduction of InnVest's weighted average interest rate following refinancing activities over the past year. These benefits were somewhat offset by higher incremental mortgage proceeds following a refinancing in early January 2014, proceeds of which were subsequently applied towards the repayment of mortgage debt in April 2014. The increase in interest expense related to InnVest's convertible debentures reflect the issuance of $115.0 million of Series G 5.75% Debentures on February 27, 2013 and the early redemption of its $75.0 million 6.0% Series B Debentures on April 1, 2013.

Joint venture income reflects InnVest's 50% interest in the net profits of CHC. For the three months ended March 31, 2014, InnVest's joint venture income generated $0.9 million (2013 – $0.8 million).

First quarter results include $1.1 million of gains on asset sales as well as a $0.6 million reversal of prior impairments relating to two properties.

InnVest accounts for various unit-based instruments as financial liabilities. These instruments are remeasured at their fair value at each reporting period resulting in non-cash losses or gains based on the volatility of InnVest's unit price over the periods presented and their impact on convertible debenture holders' conversion option feature. For the three months ended March 31, 2014, InnVest recognized a fair value loss of $8.1 million (2013 – $17.2 million).

### Income Taxes

For the three months ended March 31, 2014, InnVest generated a deferred income tax recovery of $nil as compared to a deferred income tax recovery of $0.3 million in the prior period.

### Net Loss

For the three months ended March 31, 2014, InnVest realized a net loss of $34.9 million ($0.372 per unit diluted) compared to a net loss of $41.7 million in the prior period ($0.445 per unit diluted). The improvement largely reflects changes in non-cash items.

### Funds from Operations (FFO)

For the three months ended March 31, 2014, InnVest generated an FFO loss of $4.6 million ($0.049 per unit diluted) compared to a loss of $5.2 million in the prior period ($0.056 per unit diluted) reflecting the improved Hotel GOP coupled with reduced mortgage interest expense following asset sales.

Refer to *Non-IFRS Financial Measures and Additional IFRS Financial Measures* on page 17 for a reconciliation of net loss to FFO.

### Adjusted Funds from Operations (AFFO)

For the three months ended March 31, 2014, InnVest generated an AFFO loss of $7.6 million ($0.081 per unit diluted) compared to a loss of $8.6 million in the prior period ($0.092 per unit diluted). The year-over-year improvement reflects the FFO increase coupled with a lower FF&E Reserve owing to asset sales. Refer to *Non-IFRS Financial Measures and Additional IFRS Financial Measures* on page 18 for a reconciliation of FFO to AFFO.

Distributions declared during the first quarter of 2014 totalled $9.4 million, or $0.0999 per unit (2013 – $9.4 million or $0.0999 per unit).

## CHANGES IN FINANCIAL CONDITION

### Operating Activities

For the three months ended March 31, 2014, cash utilized by operating activities totalled $3.1 million compared to $5.5 million in the prior period.

### Financing Activities

In January 2014, management completed the refinancing of the Sheraton Eau Claire, Calgary for $68.0 million and repaid the outstanding mortgage of $31.6 million. The repayment of long-term debt also reflects mortgage repayments following asset sales during the year ($5.9 million) as well as the regular payment of annual mortgage principal amortization.

Cash distributions during the first quarter of 2014 totalled $9.3 million, relatively unchanged from the prior period.

Financing activities in the prior period reflected net proceeds of $110.0 million from the Series G 5.75% convertible debentures issued in February 2013 (gross proceeds of $115.0 million). Proceeds were used to fund the early redemption of $75.0 million of Series B – 6.0% convertible debentures on April 1, 2013 and to repay the amount drawn on the line of credit.

### Investing Activities

Each year, InnVest allocates between 4% and 5% of total hotel revenues at each hotel to replace furniture, fixtures and equipment and to fund capital improvements (the "FF&E Reserve"). Capital expenditures during the three months ended March 31, 2014 totalled $18.5 million (2013 – $5.8 million) compared to the allocated FF&E Reserve of $4.8 million (2013 – $5.2 million). In February 2013, InnVest announced a strategic plan which included significant capital investments in its core hotel portfolio through the end of 2014 (refer to *Business Strategy*). Capital investments undertaken during the first quarter of 2014 reflect the continuing rollout of InnVest's Comfort Inn revitalization program (guestrooms, bathrooms, corridors, lobby and breakfast room). Other significant projects underway during the quarter included guestroom upgrades at the Delta Prince Edward (all 211 guestrooms completed in early May 2014) and Fairmont Palliser (approximately 130 guestrooms to be completed in May 2014), as well as the continuation of phased renovations at the Sheraton Suites Eau Claire (over 150 guestrooms completed in April 2014). The decrease in restricted cash reflects its use to fund certain capital investments during the quarter.

Investing activities reflect the year-to-date distributions of $0.7 million received from InnVest's investment in CHC (2013 – $0.7 million).

Investing activities also include gross proceeds of $14.3 million ($13.3 million net of costs) from the sale of four properties during the quarter.

## QUARTERLY RESULTS

### Seasonality

InnVest's operations are seasonal and as such its results are not consistent throughout the year. Revenue earned from hotel operations fluctuates throughout the year, with the third quarter being the highest (on a same-hotel basis) due to the increased level of leisure travel in the summer months and the first quarter being the lowest because leisure travel tends to be lower. The results from operations vary materially from quarter to quarter given the seasonal nature of the revenue stream and the fact that certain costs such as property taxes, insurance, interest, and depreciation and amortization are fixed or virtually fixed.

Quarter ended (unaudited) (2012 restated)

| | **Q1 2014** | Q4 2013 | Q3 2013 | Q2 2013 | Q1 2013 | Q4 2012 | Q3 2012 | Q2 2012 |
|---|---|---|---|---|---|---|---|---|
| Revenues | **$ 114,431** | $ 140,667 | $ 161,133 | $ 161,276 | $ 123,822 | $ 148,499 | $ 173,371 | $ 161,149 |
| Gross operating profit | **13,494** | 29,751 | 47,537 | 43,429 | 13,263 | 28,793 | 50,104 | 41,527 |
| Net (loss) income | **(34,871)** | (47,741) | 13,946 | 20,505 | (41,666) | 146,498 | (221,472) | 1,989 |
| FFO | **(4,575)** | 12,472 | 31,504 | 25,097 | (5,231) | 11,762 | 30,911 | 23,170 |
| AFFO | **(7,623)** | 8,173 | 26,482 | 20,174 | (8,644) | 7,226 | 25,287 | 17,981 |
| Distributions declared | **9,378** | 9,373 | 9,368 | 9,364 | 9,360 | 9,349 | 9,345 | 9,345 |
| Per unit – diluted: | | | | | | | | |
| Net (loss) income | **$ (0.372)** | $ (0.509) | $ 0.139 | $ 0.189 | $ (0.445) | $ 1.227 | $ (2.368) | $ 0.021 |
| FFO | **(0.049)** | 0.127 | 0.270 | 0.223 | (0.056) | 0.125 | 0.293 | 0.228 |
| AFFO | **(0.081)** | 0.086 | 0.226 | 0.180 | (0.092) | 0.077 | 0.239 | 0.178 |
| Trust units outstanding | **93,909,613** | 93,830,897 | 93,788,684 | 93,745,281 | 93,702,704 | 93,583,904 | 93,557,172 | 93,538,022 |
| Weighted average trust units outstanding | **93,858,254** | 93,812,648 | 93,770,602 | 93,726,338 | 93,663,167 | 93,572,670 | 93,547,482 | 93,538,022 |
| Total assets | **$ 1,271,608** | $ 1,280,541 | $ 1,339,982 | $ 1,387,235 | $ 1,468,212 | $ 1,412,981 | $ 1,478,062 | $ 1,540,997 |
| Total long-term debt | **688,038** | 674,088 | 680,851 | 690,792 | 714,399 | 730,618 | 777,072 | 806,171 |

## ASSET PROFILE

InnVest's total asset carrying value was $1,271.6 million at March 31, 2014, down $8.9 million, as compared to $1,280.5 million at December 31, 2013.

| | **Mar 31, 2014** | Dec 31, 2013 |
|---|---|---|
| **Current assets** | | |
| Cash | **$ 31,643** | $ 20,261 |
| Accounts receivable | **21,761** | 28,788 |
| Prepaid expenses and other assets | **8,943** | 8,915 |
| Finance lease receivable | **6,168** | 6,413 |
| Assets held for sale | **83,103** | 58,658 |
| | **151,618** | 123,035 |
| **Non-current assets** | | |
| Restricted cash | **3,969** | 6,760 |
| Investment in joint venture | **1,318** | 1,202 |
| Hotel properties | **1,101,105** | 1,135,503 |
| Other real estate properties | **1,936** | 1,964 |
| Intangible assets | **11,662** | 12,077 |
| Total assets | **$ 1,271,608** | $ 1,280,541 |

Hotel properties (inclusive of those held for sale) comprise over 90% of InnVest's total assets. In accordance with its strategic plan, InnVest completed the sale of four hotels in the first quarter of 2014 for aggregate gross proceeds of $14.3 million. These transactions contributed to a reduction in assets held for sale of $12.0 million as compared to December 31, 2013 and resulted in aggregate net gain on sales of $1.1 million and the reversal of previous impairments of $0.6 million. Three additional hotels with a net book value of $33.7 million were classified as held for sale at March 31, 2014 as compared to December 31, 2013. At March 31, 2014, fourteen hotels were classified as held for sale (1,948 rooms). Six hotels are currently under purchase and sale agreements.

Changes in accounts receivable is consistent with the seasonal nature of operations during the first quarter. In April 2014, InnVest received the $6.2 million balance of its finance lease receivable. The finance lease receivable related to a lease and sale arrangement for one Ontario hotel that was entered into in 2012.

# LIQUIDITY AND CAPITAL RESOURCES

InnVest has several sources of liquidity including the following:

**CASH GENERATED FROM HOTEL OPERATIONS**

InnVest's operations are seasonal with the third quarter being the highest earnings period and the first quarter typically being the weakest earnings period given the different levels of business and leisure travel during these quarters. Over the annual period, InnVest anticipates generating GOP sufficient to fund distributions to unitholders, the annual FF&E Reserve and debt service requirements.

**LINE OF CREDIT**

At March 31, 2014, InnVest has a line of credit with a major banking institution up to a maximum of $40.0 million. The line of credit is used to finance temporary shortfalls in cash resulting from business seasonality and working capital fluctuations. The credit facility may also be used to provide short-term financing in the event of the acquisition of a new hotel. At March 31, 2014, no amount was drawn on the line of credit (December 31, 2013 – $nil). Management expects to finalize a bridge line during the second quarter of 2014 to provide additional short-term liquidity.

**ISSUING ADDITIONAL DEBT**

InnVest also has the ability to raise funds by mortgaging its properties or by issuing either unsecured debt or unsecured convertible debt securities. InnVest typically uses long-term debt financing to refinance existing debt or to finance an acquisition. The ability to secure debt financing on reasonable terms is ultimately dependent on market conditions and the lender's determination of InnVest's creditworthiness. During the first quarter of 2014, InnVest refinanced $68.0 million of mortgage debt with an existing lender for a 10-year term.

In April 2014, InnVest completed a $50.0 million four-year subordinated credit agreement with KingSett and InnVest has an option to draw an additional $50.0 million of subordinated non-revolving stand-by liquidity facility. Refer to *Related Party Transactions* for a discussion of the terms of these loans. At March 31, 2014, substantially all of InnVest's hotel assets have been pledged as security under debt agreements.

**ISSUING ADDITIONAL EQUITY SECURITIES**

InnVest's listing on the Toronto Stock Exchange gives it the ability to access, subject to market conditions, additional equity through the issuance of additional units or equity-linked instruments.

At March 31, 2014, InnVest has total liquidity of $92.6 million. This amount does not include the $50.0 million subordinated term loan financing (funded in April 2014) or the $50.0 million subordinated liquidity facility (available at InnVest's option) provided by KingSett in April 2014. On May 1, 2014, InnVest called its $70.0 million Series C 5.85% convertible debentures for early redemption on June 3, 2014.

| | March 31, 2014 |
|---|---|
| Cash | $ 31,643 |
| Restricted cash | 3,969 |
| Operating line availability | 30,286 |
| Capital expenditure loan facility availability | 26,686 |
| Total liquidity | $ 92,584 |

Management believes that InnVest's credit facilities, cash on hand and expected cash flow from operations, when combined with the financing provided by KingSett and the potential to sell assets or access debt and equity markets, will allow InnVest to meet all its financial commitments. If necessary, near-term disruptions to operating earnings and cash flow could be addressed through reductions in discretionary capital allocation decisions such as capital investments above the FF&E Reserve and/or distributions.

## Cash on Hand

At March 31, 2014, InnVest has cash totalling $35.6 million, of which $4.0 million is restricted to undertake capital refurbishments in accordance with certain mortgage and franchise agreements.

Each year, InnVest allocates an FF&E Reserve totalling between 4% and 5% of total hotel revenue. Capital expenditures during the three months ended March 31, 2014 totalled $18.5 million (2013 – $5.8 million) compared to the allocated FF&E Reserve of $4.8 million (2013 – $5.2 million). Incremental capital above the allocated FF&E Reserve was funded with cash on hand. At March 31, 2014, future capital commitments approximate $17.2 million.

The following chart shows the changes in the FF&E Reserve restricted cash balance since December 31, 2013.

| | | |
|---|---|---|
| Opening balance, January 1, 2014 | $ | 6,760 |
| FF&E Reserve | | 4,762 |
| Transferred from operating cash | | 10,943 |
| Capital expenditures | | (18,496) |
| Closing balance, March 31, 2014 | $ | 3,969 |

## Debt Strategy

InnVest's debt strategy involves the use of various forms of debt including conventional property-specific secured mortgages, unsecured convertible debentures, secured floating interest rate bank financing and subordinated term loans. Management's objectives are to access the lowest cost of debt with the most flexible terms and to have a staggered debt maturity schedule to manage interest rate and refinancing risk.

**CREDIT FACILITY AND BRIDGE LOAN**

InnVest's operations are seasonal (see *Quarterly Results*). InnVest's credit facility ensures that the seasonal fluctuation in cash flows will not affect its ability to operate in the normal course of business.

InnVest has an operating line of credit of up to $40.0 million with a major banking institution which matures August 31, 2015. The operating line is secured by 11 properties. The amount of the operating line is subject to a mortgageability test which is based on the operating results of the secured properties. Interest rates are based on the lesser of (i) Canadian prime rate plus 2.0% and (ii) the Canadian Bankers' Acceptance rate plus 3.0%. Based on the operating results of the secured properties for the four quarters ended March 31, 2014, InnVest qualifies for $30.3 million availability under the line of credit. At March 31, 2014, no amount was drawn on the credit facility (December 31, 2013 – $nil). Letters of credit totalling $2.4 million were pledged against the facility (December 31, 2013 – $2.2 million).

At March 31, 2014, InnVest has a $2.8 million (December 31, 2013 – $2.8 million) bridge loan secured by one hotel. During the first quarter of 2014, the bridge loan was extended to mature February 28, 2015 and bears interest at the Canadian Bankers' Acceptance rate plus 4.0%.

**SECURED LONG-TERM DEBT, SUBORDINATED TERM LOANS AND CONVERTIBLE DEBENTURES**

InnVest attempts to stagger the maturity of fixed-term debt to minimize interest and financing risks.

| | **March 31, 2014** | December 31, 2013 |
|---|---|---|
| **Mortgages** | | |
| Mortgages payable | **$ 731.7** | $ 705.7 |
| Weighted average term to maturity | **3.8 years** | 3.3 years |
| Weighted average interest rate | **5.7%** | 5.8% |
| Percentage of secured financing at floating interest rate debt | **2.7%** | 3.6% |
| **Convertible debentures** | | |
| Convertible debentures outstanding | **$ 276.4**(1) | $ 346.4 |
| Weighted average term to maturity | **4.0 years**(1) | 3.5 years |
| Weighted average interest rate | **5.9%** | 5.9% |

(1) Proforma the redemption of the $70.0 million Series C convertible debentures.

Total mortgages payable at March 31, 2014 include $39.4 million presented as current liabilities related to assets held for sale (December 31, 2013 – $27.2 million). In 2014, four hotels were sold contributing to mortgage repayments of approximately $5.9 million of floating interest rate mortgage.

On January 7, 2014, management completed the refinancing of the Sheraton Eau Claire, Calgary for $68.0 million at a fixed interest rate of 5.33% for a 10-year term. Incremental proceeds of $36.4 million from the refinancing were available to partially repay a $45.4 million mortgage maturity in April 2014 (secured by 10 properties). Following this repayment in April, one of the unencumbered assets was pledged to the credit facility (to increase the security to 12 hotels), one asset was sold as part of a previous financing arrangement (eliminates the current finance lease receivable), and the remaining seven hotels are expected to be pledged to replace existing mortgage security (to accommodate assets sales) or toward a new $40.0 million bridge loan to be used pending permanent financing.

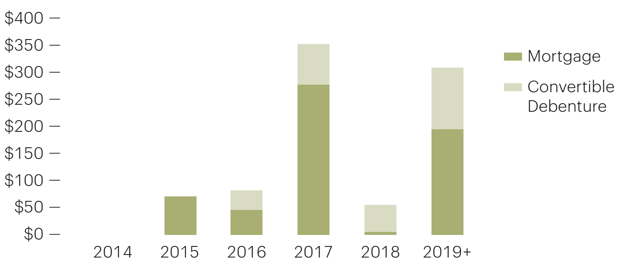
On April 24, 2014, InnVest entered into and closed a credit agreement with KingSett for a four-year $50.0 million subordinated term loan facility. Proceeds are to be used for general corporate purposes and the repayment of convertible debentures. KingSett has also provided InnVest with an option to draw an additional $50.0 million subordinated non-revolving stand-by liquidity facility. Refer to *Related Party Transactions* for a discussion of the terms of these loans. In early May 2014, InnVest called its $70.0 million Series C Debentures for early redemption on June 3, 2014.

As part of certain mortgage agreements, InnVest has access to a loan facility for up to $30.0 million to fund 65% of capital expenditures incurred at certain of its hotels. At March 31, 2014, InnVest has remaining capacity on this facility of $26.7 million (December 31, 2013 – $26.7 million), of which approximately $12.7 million is available to be drawn based on capital expenditures incurred to-date.

At March 31, 2014, InnVest has approximately $119.7 million (December 31, 2013 – $121.0 million) of mortgages secured by conduit financing maturing in 2014 and 2015. Approximately $45.4 million of these mortgages were repaid in April 2014.

InnVest has five series of fixed-rate convertible debentures totalling $346.4 million at March 31, 2014 (December 31, 2013 – $346.4 million), $70.0 million of which was called for early redemption as noted above.

The following chart highlights InnVest's mortgage (excluding those held for sale) and convertible debenture maturity schedule at March 31, 2014, proforma the repayment of mortgage maturities in April 2014 and the announced early redemption of the Series C Debentures. The proforma average term to maturity for the mortgages and convertible debentures is 4.0 years.




Based on recent negotiations with lenders and its knowledge and experience refinancing mortgages and accessing the public markets, management plans to address its debt maturities in the normal course of business. Continued contraction of interest rate spreads, along with decreases in bond yields, albeit modest in nature since the end of 2012, are allowing borrowing rates for the industry to remain attractive.

## Leverage

InnVest is not permitted to exceed certain financial leverage amounts under the terms of its Declaration of Trust. InnVest is permitted to hold indebtedness up to a level of 60% of gross asset value (75% including convertible debentures). The financial ratio is computed as of the last day of each financial year excluding any indebtedness under any operating line, non-interest bearing indebtedness, trade accounts payable and for greater certainty, deferred income tax liability. Management's policy is not to exceed this leverage limit at any time during the year. Separately, InnVest is further limited by its credit facility covenant which limits aggregate indebtedness (including convertible debentures) to a level up to 70% of gross asset value.

At March 31, 2014, InnVest's leverage excluding and including convertible debentures was 45.5% (December 31, 2013 – 44.0%) and 66.9% (December 31, 2013 – 65.5%), respectively. Proforma transactions announced or completed following the end of the quarter ($50.0 million KingSett financing, $45.4 million mortgage maturity repayments and the redemption of InnVest's $70 million Series C convertible debenture), InnVest's leverage would have approximated 65.5% at March 31, 2014 (47.7% excluding convertible debentures).

| | March 31, 2014 | |
|---|---|---|
| Total assets per Consolidated Balance Sheet | $ 1,271,608 | |
| Accumulated depreciation and amortization | 343,686 | |
| Gross Asset Value | $ 1,615,294 | |
| Book value of mortgages and bridge loan[1] | $ 734,453 | 45.5% |
| Convertible debentures[2] | 346,358 | 21.4% |
| Total debt | $ 1,080,811 | 66.9% |

(1) Mortgages payable are gross of financing issuance costs and include $39.4 million in mortgages related to assets held for sale.
(2) Adjusted to face value.

## Contractual Obligations Repayment Summary

Given available liquidity, access to capital and expectations of improving economic and operating trends, management expects to be able to fund all commitments in the normal course of business.

The following table summarizes InnVest's contractual obligations as at March 31, 2014. InnVest has no off-balance sheet items.

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 and Thereafter | Contractual Cash flows[2] |
|---|---|---|---|---|---|---|---|
| Accounts payable and other liabilities | $ 66,922 | $ – | $ – | $ – | $ – | $ – | $ 66,922 |
| Liabilities related to assets held for sale | 46,901 | – | – | – | – | – | 46,901 |
| Mortgage payable | | | | | | | |
| – principal[1] | 52,904 | 84,304 | 58,465 | 285,046 | 9,300 | 202,265 | 692,284 |
| – interest[3] | 25,400 | 35,090 | 32,151 | 17,788 | 11,861 | 19,324 | 141,614 |
| Bridge loan | | | | | | | |
| – principal | 750 | 2,000 | – | – | – | – | 2,750 |
| – interest | 72 | 26 | – | – | – | – | 98 |
| Convertible debentures | | | | | | | |
| – principal | 70,000 | – | 36,358 | 75,000 | 50,000 | 115,000 | 346,358 |
| – interest | 10,268 | 16,442 | 15,215 | 13,988 | 8,050 | 3,306 | 67,269 |
| Long-term land leases | 2,197 | 2,858 | 2,876 | 2,854 | 2,858 | 82,376 | 96,019 |
| Capital commitments | 17,202 | – | – | – | – | – | 17,202 |
| Total | $ 292,616 | $ 140,720 | $ 145,065 | $ 394,676 | $ 82,069 | $ 422,270 | $1,477,417 |

(1) Principal includes regular amortization and repayments.
(2) Contractual cash flows include principal and interest payments and include extension options available to InnVest.
(3) Interest amounts for floating rate debt is based on interest rates prevailing at March 31, 2014.

As at March 31, 2014, InnVest has leasehold interests in 10 of its hotels. The leaseholds require minimum annual average lease payments and expire between 2018 and 2088. At March 31, 2014, the average term of InnVest's leaseholds approximated 35 years.

### Contingent Obligations

InnVest and its operating subsidiaries are contingently liable with respect to litigation and claims that arise from time to time in the normal course of business. In the normal course of business, InnVest receives default notices relating to the maintenance of brand standards at certain hotels. InnVest typically disputes such notices and negotiates a resolution with its franchisors or management companies in cases where the management company provides the hotel brand which may include investments in hotels.

## DISTRIBUTIONS TO UNITHOLDERS

For the three months ended March 31, 2014, distributions totalling $9.4 million were declared ($0.0999 per unit), relatively unchanged from the prior year (2013 – $9.4 million or $0.0999 per unit).

For the twelve months ended March 31, 2014, InnVest's payout ratio was 79.4% of AFFO, improving modestly from the payout ratio for the year ended December 31, 2013.

| | **Twelve months ended March 31,** | Years ended December 31, | | | | |
|---|---|---|---|---|---|---|
| | **2014** | 2013 | 2012 | 2011 | 2010 | 2009 |
| | | | | | | As reported pursuant to Canadian GAAP |
| AFFO | **$ 47,206** | $ 46,185 | $ 44,619 | $ 46,440 | $ 41,776 | $ 51,524 |
| Distributions | **37,483** | 37,465 | 37,383 | 44,896 | 44,384 | 51,297 |
| AFFO in excess of (less than) distributions | **9,723** | 8,720 | 7,236 | 1,544 | (2,608) | 227 |
| Non-cash distributions made through the DRIP | **520** | 500 | 143 | 309 | 1,688 | 2,756 |
| AFFO in excess of (less than) cash distributions | **$ 10,243** | $ 9,220 | $ 7,379 | $ 1,853 | $ (920) | $ 2,983 |
| AFFO payout ratios: | | | | | | |
| Total distributions | **79.4%** | 81.1% | 83.8% | 96.7% | 106.2% | 99.6% |
| Cash distributions (excluding DRIP) | **78.3%** | 80.0% | 83.5% | 96.0% | 102.2% | 94.2% |

Liquidity to fund distributions is generated from cash flow from operations, cash on hand, available bank operating lines and by the ability to finance certain under-leveraged assets. First and fourth quarter distributions are typically partially funded through cash on hand or InnVest's credit facility given the seasonality of revenues in contrast to costs which are fixed throughout the year.

Distributions to unitholders are approved by InnVest's Board of Trustees. Each month, InnVest may distribute such percentage of its estimated adjusted funds from operations as the Trustees determine in their discretion. In exercising their discretion to approve the level of distributions, the Trustees use forecasts prepared by management and other financial information to determine if sufficient cash flow will be available to fund distributions. Such financial information is subject to change due to the nature of the Canadian hotel industry which can be difficult to predict, even in the short-run. Refer to *Risks and Uncertainties* on page 18.

## UNIT INFORMATION

Since January 1, 2014, InnVest issued units as follows:

| | |
|---|---|
| Units outstanding, January 1, 2014 | 93,830,897 |
| Distribution reinvestment plan | 24,111 |
| Executive compensation plan | 44,988 |
| Trustee compensation plan | 9,617 |
| Units outstanding, March 31, 2014 | 93,909,613 |
| *Issued subsequent to the quarter* | |
| Payment in kind related to long-term debt[(1)] | 573,361 |
| Distribution reinvestment plan | 55,534 |
| Trustee compensation plan | 7,244 |
| Units outstanding, May 7, 2014 | 94,545,752 |

Note 1: Related to up-front fee and commitment fee to KingSett. Refer to *Related Party Transactions*.

The following table summarizes the number of units issuable based on the convertible debentures outstanding at March 31, 2014.

| Convertible debentures | Maturity date | Conversion strike price | Balance outstanding | Units to be issued upon conversion |
|---|---|---|---|---|
| Series C – 5.85% | August 1, 2014[(1)] | $ 14.70 | $ 70,000 | 4,761,904 |
| Series D – 6.75% | March 31, 2016 | $ 5.70 | $ 36,358 | 6,378,596 |
| Series E – 6.00% | September 30, 2017 | $ 8.00 | $ 75,000 | 9,375,000 |
| Series F – 5.75% | March 30, 2018 | $ 9.45 | $ 50,000 | 5,291,005 |
| Series G – 5.75% | March 31, 2019 | $ 5.80 | $ 115,000 | 19,827,586 |

(1) Called for early redemption on June 3, 2014.

For each series of debentures, InnVest may elect, from time to time, to satisfy its obligation to pay interest by delivering units. Also, for each of its debentures, InnVest may, at its option, on not more than 60 days' and not less than 30 days' prior notice and subject to applicable regulatory approval, elect to satisfy its obligation to repay all or any portion of the principal amount of the debentures that are to be redeemed or that are to mature by issuing units. The number of units to be issued in respect of each debenture will be determined by dividing the principal amount by 95% of the volume-weighted average trading price of the units on the Toronto Stock Exchange for the 20 consecutive trading days ending on the fifth trading day preceding the date fixed for redemption or maturity, as the case may be.

### Redemptions

On May 1, 2014, InnVest called its $70.0 million Series C 5.85% Debentures (due August 1, 2014) for early redemption on June 3, 2014.

### Distribution reinvestment plan ("DRIP")

InnVest has a DRIP whereby eligible Canadian unitholders may elect to have their distributions of income from InnVest automatically reinvested in additional units of InnVest.

### Executive and Trustee compensation programs

InnVest's executive compensation program typically provides for the grant of restricted units to certain senior employees. Units granted vest equally on the third and fourth anniversary of the effective date of grant. At March 31, 2014, there were 34,225 unvested executive units granted under the plan (December 31, 2013 – 27,210). Given his short-term compensation agreement, InnVest's Chief Executive Officer is issued units which vest immediately upon grant, rather than vesting over the three and four year periods. In March 2014, 40,000 units were granted to the Chief Executive Officer (2013 – 8,000).

InnVest has set aside 350,000 units in reserve for Board compensation. At March 31, 2014, the balance in this reserve account is 159,989 units (December 31, 2013 – 169,606).

## RELATED PARTY TRANSACTIONS

In accordance with InnVest's corporate governance practices, all related party transactions are approved by the independent trustees.

### Westmont Hospitality Canada Limited

InnVest has a management agreement for hotel management and accounting services and an administrative services agreement with Westmont. Also, for certain hotels owned by InnVest and not managed by Westmont, Westmont is entitled to an asset management fee based on a fixed percentage of the purchase price of the hotel or a fixed percentage of Hotel GOP, subject to an annual minimum fee. Westmont is controlled by a minority unitholder of InnVest and is currently entitled to appoint two members to the Board of Trustees.

On April 21, 2014, InnVest finalized changes to certain agreements with Westmont as follows:

- Asset management of InnVest will be internalized effective November 30, 2014 at no cost to InnVest. As a result, InnVest will no longer pay asset management fees to Westmont effective December 1, 2014;
- Amendment and extension of the hotel management agreement on the following terms:
  - The term of the agreement was extended until April 21, 2024 and may be renewed on the mutual consent of both parties.
  - Westmont no longer has the exclusive right to manage InnVest's acquired hotels. InnVest may consider appointing Westmont to manage any additional hotels on a case-by-case basis. Westmont was released from its non-compete arrangements.
  - InnVest has the ability to terminate Westmont's appointment to manage any or all hotels for any reason on 60 days' prior written notice with respect to any or all of the hotels managed by Westmont, subject to a termination payment equal to three times the sum of all management fees earned or payable (as such fees are defined in the management agreement) in respect of the hotels no longer covered by the management agreement due to such termination during the 12-month period immediately preceding the month in which the termination occurs (subject to adjustment in certain circumstances).
  - Westmont's base management fee has been reduced to 2.95% from 3.375% and a new incentive fee structure has been adopted that will allow Westmont to earn up to 3.80% of the gross revenue of managed hotels per year.
    - Effective April 1, 2014, Westmont is entitled to an annual base incentive fee equal to 0.425% of gross revenues, to be adjusted at the end of the year as follows:
      - For each percentage point (1.0%) that the year-over-year net operating cash flow of the managed hotels increases, the base incentive fee will be increased by 2.8333 basis points, to a maximum incentive fee of 0.85%;
      - For each percentage point (1.0%) that the year-over-year net operating cash flow of the managed hotels decreases, the base incentive fee will be reduced by 2.8333 basis points, to a minimum incentive fee of 0%; and
      - Where there is no change in the year-over-year net operating cash flow of the managed hotels, the incentive fee will remain unchanged at 0.425%.

In accordance with the management agreement, in addition to the base management fee and incentive fee, Westmont is entitled to the following fees in respect of hotels that it manages (i) purchasing fees based on 5% of the cost of certain goods and supplies; (ii) construction fees based on 5% of the cost of construction and capital expenditures; and (iii) per guest room fees for accounting services in respect of the hotel businesses. The amended and restated management agreement did not result in any changes to the basis for such additional fees.

The amended and restated management agreement allows InnVest to request Westmont's services in connection with construction work to be performed at hotels that it does not manage and for accounting services in respect of InnVest's business on a case-by-case basis, as may be agreed to by both parties. Westmont is also entitled to be reimbursed for certain reasonable out-of-pocket costs and expenses incurred in the performance of its duties under the management agreement, provided that such costs have been identified in an approved budget or are otherwise approved in writing.

Westmont also provides certain administrative and support services, including the provision of: (i) office space and office equipment; (ii) communications and computer systems; and (iii) such administrative and secretarial support services as reasonably required from time to time to support InnVest's ongoing administration and operation. Such services are provided on a cost recovery basis pursuant to a budget.

Total management and other fees paid to Westmont during the three months ended March 31, 2014 were $4.4 million (2013 – $4.0 million). These fees represent approximately 72% (2013 – 68%) of total hotel management and other fees paid by InnVest to the four hotel management companies with which it partners.

### KingSett Capital

On April 24, 2014, InnVest entered into and closed a credit agreement with KingSett (the "Credit Agreement") for a $50.0 million subordinated term loan facility (the "Term Loan"). KingSett has also provided an option to draw an additional $50.0 million subordinated non-revolving stand-by liquidity facility (the "Liquidity Loan"). The Term Loan and the Liquidity Loan are supported by a general security agreement. A trustee of the REIT has an indirect controlling interest in KingSett.

The Term Loan will be outstanding for four years and be subject to (a) an up-front fee, payable to KingSett within 20 days of the closing of the Term Loan, of $1.5 million (the "Up-Front Fee"), and (b) regular interest payments of 8.75% per annum (the "Term Interest Payments"). In addition, in consideration for KingSett agreeing to provide InnVest with the Liquidity Loan, InnVest has agreed to pay KingSett a commitment fee, payable within 20 days of the closing of the Term Loan, of $1.5 million (the "Commitment Fee"). If drawn, the Liquidity Loan will be subject to regular interest payments of 9.5% per annum (the "Liquidity Interest Payments").

In connection with the Credit Agreement, InnVest issued 573,361 units in satisfaction of the Up-Front Fee and the Commitment Fee in April 2014. In addition, in the first year that the Term Loan is outstanding, a portion of the Term Interest Payments due in that year equal to 3% per annum will be payable in units at the option of KingSett and, if the Liquidty Loan is drawn, a portion of the Liquidity Interest Payments in that year equal to 3.75% per annum will be payable in units at the option of KingSett. During the three subsequent years, the same portions of the Term Interest Payments and the Liquidity Interest Payments will be payable in units if mutually agreed by KingSett and InnVest. InnVest's obligation to issue any units in satisfaction of the Up-Front Fee, the Commitment Fee and a portion of the Interest Payments was subject to the receipt of applicable regulatory approvals and compliance with InnVest's internal policies, including its insider trading policy. Subject to the foregoing, any such units will be issued at a price equal to the five-day volume-weighted average price of the units on the TSX prior to the date of each issuance.

## NON-IFRS FINANCIAL MEASURES AND ADDITIONAL IFRS FINANCIAL MEASURES

InnVest's consolidated financial statements are prepared in accordance with IFRS. Included in this MD&A are certain additional IFRS measures and non-IFRS measures, which are measures of InnVest's historical or future financial performance that are not calculated and presented in accordance with IFRS. These measures are unlikely to be comparable to similar measures presented by other reporting issuers. InnVest uses these measures to better assess its underlying performance and provides these additional measures so that investors may do the same. The following discussion defines the measures used by InnVest and presents why management believes they are useful supplemental measures of InnVest's performance.

### Additional IFRS Financial Measures

#### GROSS OPERATING PROFIT ("GOP")

GOP is defined as revenues less hotel and other real estate properties. GOP reflects results of operations from InnVest's two business segments: hotel ownership and other real estate assets. For the three months ended March 31, 2014 and 2013, InnVest's hotel ownership operations accounted for over 99% of its total GOP.

Measures which reflect the cash flow generating ability of real estate assets are commonly used by real estate owners which, when considered with IFRS measures, give management a more complete understanding of property level results before debt service. It also facilitates comparisons between InnVest and its competitors. Management believes that GOP, specifically Hotel GOP, is one of InnVest's key performance indicators since it helps management, lenders and investors evaluate its core business' ongoing profitability.

GOP is an additional IFRS financial measure derived from the consolidated financial statements but does not have a standardized meaning prescribed by IFRS. Therefore it is unlikely to be comparable to similar measures presented by other issuers. GOP has been calculated as follows:

| | Three months ended March 31, 2014 | 2013 |
|---|---|---|
| Revenues | $ 114,431 | $ 123,822 |
| Hotel and other real estate properties | | |
| Operating expenses | 85,965 | 93,108 |
| Property taxes, rent and insurance | 10,612 | 12,682 |
| Management fees | 4,360 | 4,769 |
| | 100,937 | 110,559 |
| Gross operating profit | $ 13,494 | $ 13,263 |

## Non-IFRS Financial Measures

**FUNDS FROM OPERATIONS ("FFO")**

FFO is a common measure of performance in the real estate investment trust industry. FFO is one measure used by industry analysts and investors in the determination of InnVest's valuation, its ability to fund distributions and investors' investment return requirements. As a result, InnVest believes that FFO is a useful supplemental measure of its operating performance for investors. FFO assumes that the value of real estate investments does not necessarily decrease on a systematic basis over time, an assumption inherent in IFRS, and it adjusts for items included in net income that do not necessarily provide the best indicator of operating performance, such as gains or losses on the sale of assets, provisions for impairment (and impairment reversals) of assets as well as changes in the fair value of certain equity-based financial instruments classified as financial liabilities.

FFO should not be considered a substitute for net income or cash flow from operating activities determined in accordance with IFRS.

InnVest presents FFO in accordance with Real Property Association of Canada's ("REALpac") White Paper on Funds From Operations revised in November 2012 except that InnVest excludes unusual items which are not in the normal course of business and are not expected to reoccur. InnVest's method of calculating FFO may be different from that of other organizations.

InnVest calculates FFO by using net income (loss) and adjusting for:

i) Depreciation, amortization and accretion, excluding amortization of deferred financing costs;
ii) Deferred income tax expense or recovery;
iii) Any gains or losses on the disposition of assets;
iv) Non-cash writedown of assets held for sale as well as the impairment provision (and impairment reversals) on assets;
v) Non-cash effect of certain equity-based financial instruments classified as financial liabilities under IFRS (includes distributions included in corporate and administrative expense and changes to fair value each reporting period); and
vi) Non-recurring costs that may impact cash flow. Items are considered non-recurring when a similar loss or gain is not reasonably likely to occur within the next two years and has not occurred during the prior two years.

A reconciliation of IFRS net loss to FFO is as follows:

| | For the three months ended March 31, 2014 | 2013 |
|---|---|---|
| Net loss | $ (34,871) | $ (41,666) |
| Add/(deduct): | | |
| Depreciation and amortization | 20,226 | 20,712 |
| Deferred income tax (recovery) expense | – | (282) |
| Unrealized changes in the fair value of financial liabilities | 8,071 | 17,228 |
| Distributions included in corporate and administrative expense | 36 | 36 |
| Gain on sale of assets | (1,056) | (1,259) |
| Reversal of prior impairment | (575) | – |
| Non-recurring costs: | | |
| Proxy defense and settlement costs | 3,594 | – |
| FFO | $ (4,575) | $ (5,231) |
| FFO per unit: | | |
| Basic | $ (0.049) | $ (0.056) |
| Diluted | $ (0.049) | $ (0.056) |
| Weighted average units outstanding: | | |
| Basic | 93,858,254 | 93,663,167 |
| Diluted | 94,244,391 | 94,026,036 |

**ADJUSTED FUNDS FROM OPERATIONS ("AFFO")**

InnVest uses AFFO (previously referred to as distributable income), as its measure of normalized cash flow in order to assess its ability to fund distributions for current or potential investors. AFFO is defined as FFO adjusted for:

i) Non-cash deferred financing charges;
ii) The reserve for replacement of furniture, fixtures and equipment and capital improvements; and
iii) Any other adjustment determined by the Board of Trustees in their discretion.

A reconciliation of FFO to AFFO is as follows:

| | Three months ended March 31, | |
|---|---|---|
| | **2014** | 2013 |
| FFO | **$ (4,575)** | $ (5,231) |
| Add/(deduct): | | |
| Non-cash portion of mortgage interest expense | **566** | 524 |
| Non-cash portion of convertible debenture interest and accretion | **1,148** | 1,238 |
| FF&E Reserve | **(4,762)** | (5,175) |
| AFFO | **$ (7,623)** | $ (8,644) |
| AFFO per unit: | | |
| Basic | **$ (0.081)** | $ (0.092) |
| Diluted | **$ (0.081)** | $ (0.092) |
| Weighted average units outstanding: | | |
| Basic | **93,858,254** | 93,663,167 |
| Diluted | **94,244,397** | 94,026,036 |

AFFO is also used by management and the Board of Trustees to determine the level of distributions to unitholders and also serves as an important measure for investors in their evaluation of the performance of management.

In addition, when evaluating acquisition opportunities, the AFFO to be generated by the asset is reviewed by management to determine whether a proposed acquisition is expected to generate an increase in AFFO per unit. Therefore, AFFO is an important measure for management as a guideline through which operating and financial decisions are made and is an integral part of the investment decision for investors and potential investors. There is no standard industry-defined measure of AFFO. InnVest's method of calculating AFFO may be different from that of other organizations.

Reconciliation of cash from operating activities to AFFO:

| | Three months ended March 31, | |
|---|---|---|
| | **2014** | 2013 |
| Cash flow utilized in operating activities | **$ (3,092)** | $ (5,517) |
| Changes in non-cash working capital | **(9,108)** | (195) |
| Other | **9,339** | 2,243 |
| FF&E Reserve | **(4,762)** | (5,175) |
| AFFO | **$ (7,623)** | $ (8,644) |

# RISKS AND UNCERTAINTIES

The achievement of InnVest's objectives is, in part, dependent on the successful mitigation of business risks identified. All real estate investments are subject to a degree of risk including changes in general economic and local market conditions, competition from other hotels, new supply, equity and credit markets conditions, fluctuations in interest costs, compliance with legislative requirements and various other factors.

There have been no changes to InnVest's assessment of its risk factors since December 31, 2013. For a discussion of risk factors that have been identified, readers should refer to InnVest's 2013 Annual Report and InnVest's Annual Information Form dated March 19, 2014, both of which are available on SEDAR.

# CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of InnVest's financial position and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with IFRS. The preparation of financial statements requires management to make judgments, estimates and assumptions concerning the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenue and expenses during the reporting period. Management uses its judgment and knowledge from past experience as a basis for estimates and other assumptions required in the preparation of the financial statements. Management's estimates and assumptions are evaluated and updated on a regular basis taking into account current market conditions. The actual results may materially differ, if management were to use different estimates and assumptions.

Other than as noted below, the significant accounting policies used in the preparation of the Interim Financial Statements for the three months ended March 31, 2014 are consistent with those reported in the audited consolidated financial statements for the year ended December 31, 2013.

Effective January 1, 2014, InnVest implemented accounting policy changes relating to amendments to IAS 32 – *Financial Instruments Presentation* and IFRIC 21 – *Levies*. The adoption of these changes did not have a significant impact on InnVest's Interim Financial Statements.

**IAS 32 – Financial Instruments: Presentation**
Amendments to IAS 32 provide additional guidance on the presentation of offsetting financial assets and financial liabilities. The amendments present application guidance on the legal right to offset financial assets and liabilities and management's intent to settle on a net basis.

**IFRIC 21 – Levies**
IFRIC 21 clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs.

# FUTURE ACCOUNTING CHANGES

InnVest has reviewed new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on its consolidated financial statements and note disclosures.

**Amendments to IAS 36 – Impairment of assets**
Amendments to IAS 36 require the disclosure of the recoverable amount of impaired assets when an impairment loss has been recognized or reversed during the period and additional disclosures about the measurement of the recoverable amount of impaired assets when the recoverable amount is based on fair value less costs of disposal, including the discount rate when a present value technique is used to measure the recoverable amount. The amendments to IAS 36 are effective for annual periods beginning on or after January 1, 2014. The adoption of this standard is not expected to have a significant impact on InnVest's condensed interim consolidated financial statements.

**IFRS 9, Financial instruments**
IFRS 9, *Financial Instruments* will replace IAS 39, *Financial Instruments: Recognition and Measurement* for classification and measurement of financial assets and liabilities.

IFRS 9 as issued reflects the International Accounting Standards Board's ("IASB") work to date on the replacement of IAS 39, and applies to the classification and measurement of financial assets and financial liabilities as defined in IAS 39. In February 2014, the IASB tentatively decided to require IFRS 9 to be adopted for annual periods beginning on or after January 1, 2018. The IASB intends to expand IFRS 9 to all new requirements for impairment of financial assets measured at amortized cost and hedge accounting. The impact of this ongoing project will be assessed by InnVest as remaining phases of the project are completed. Early adoption of IFRS 9 is permitted, subject to certain conditions.

# CONTROLS AND PROCEDURES

Management of InnVest is responsible for establishing and maintaining adequate internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with IFRS. In accordance with National Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings,* the Chief Executive Officer and the Chief Financial Officer have assessed, or caused an assessment to be made under their direct supervision, of the design and operating effectiveness of InnVest's internal controls over financial reporting as at March 31, 2014, and based on that assessment have concluded that InnVest's internal controls over financial reporting were appropriately designed and were operating effectively.

During the three months ended March 31, 2014, there were no changes in InnVest's internal controls over financial reporting which have significantly affected, or are reasonably likely to significantly affect, InnVest's internal controls over financial reporting.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The inherent limitations in all controls systems ensure that no evaluation of controls can provide absolute assurance that all control issues, including instances of fraud, if any, have been detected. These inherent limitations include, amongst other items: (i) that management's assumptions and judgment could ultimately prove to be incorrect under varying conditions and circumstances; and/or (ii) the impact of material errors.

Additionally, controls may be circumvented by the unauthorized acts of individuals, by collusion of two or more people, or by management override. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential (future) conditions.

# CONDENSED INTERIM CONSOLIDATED BALANCE SHEETS

| (in thousands of Canadian dollars) (unaudited) | March 31, 2014 | December 31, 2013 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash | **$ 31,643** | $ 20,261 |
| Accounts receivable | **21,761** | 28,788 |
| Prepaid expenses and other assets | **8,943** | 8,915 |
| Finance lease receivable | **6,168** | 6,413 |
| Assets held for sale (Note 3) | **83,103** | 58,658 |
| | **151,618** | 123,035 |
| Non-current assets | | |
| Restricted cash (Note 4) | **3,969** | 6,760 |
| Investment in joint venture (Note 5) | **1,318** | 1,202 |
| Hotel properties (Note 6) | **1,101,105** | 1,135,503 |
| Other real estate properties (Note 7) | **1,936** | 1,964 |
| Intangible assets (Note 8) | **11,662** | 12,077 |
| Total assets | **$ 1,271,608** | $ 1,280,541 |
| **LIABILITIES** | | |
| Current Liabilities | | |
| Accounts payable and accrued liabilities | **$ 66,922** | $ 71,989 |
| Distributions payable | **3,127** | 3,125 |
| Long-term debt (Note 9) | **58,617** | 91,079 |
| Convertible debentures (Note 10) | **69,638** | 69,369 |
| Other long-term obligations (Note 12) | **177** | 177 |
| Liabilities related to assets held for sale (Note 3) | **46,901** | 30,652 |
| | **245,382** | 266,391 |
| Non-current liabilities | | |
| Long-term debt (Note 9) | **629,421** | 583,009 |
| Convertible debentures (Note 10) | **260,486** | 259,604 |
| Provisions (Note 11) | **7,676** | 7,073 |
| Other long-term obligations (Note 12) | **3,992** | 4,010 |
| Other liabilities (Note 13) | **27,068** | 18,997 |
| | **1,174,025** | 1,139,084 |
| **UNITHOLDERS' EQUITY** | **97,583** | 141,457 |
| | **$ 1,271,608** | $ 1,280,541 |

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

# CONDENSED INTERIM CONSOLIDATED STATEMENTS OF NET LOSS AND COMPREHENSIVE LOSS

| (in thousands of Canadian dollars, except per unit amounts) (unaudited) | **Three Months Ended March 31, 2014** | Three Months Ended March 31, 2013 |
|---|---|---|
| Revenues (Note 22) | **$ 114,431** | $ 123,822 |
| Hotel and other real estate properties | | |
| Operating expenses (Note 19) | **85,965** | 93,108 |
| Property taxes, rent and insurance | **10,612** | 12,682 |
| Management fees (Note 19) | **4,360** | 4,769 |
| | **100,937** | 110,559 |
| Gross operating profit | **13,494** | 13,263 |
| Other expenses | | |
| Corporate and administrative (Note 19) | **5,196** | 1,283 |
| Interest expense | | |
| Mortgages and other debt | **11,158** | 11,724 |
| Convertible debentures | **6,282** | 6,410 |
| Joint venture income (Note 5) | **(864)** | (833) |
| Other income (Note 20) | **(1,704)** | (1,313) |
| Depreciation and amortization | **20,226** | 20,712 |
| Unrealized loss on liabilities presented at fair value (Note 21) | **8,071** | 17,228 |
| Loss before income tax recovery | **(34,871)** | (41,948) |
| Income tax recovery | **–** | 282 |
| Net loss and total comprehensive loss | **$ (34,871)** | $ (41,666) |
| Net loss per unit (Note 17) | | |
| Basic and diluted | **$ (0.372)** | $ (0.445) |

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

# CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN UNITHOLDERS' EQUITY (DEFICIT)

| (in thousands of Canadian dollars) | Deficit | Units in $ | Total |
|---|---|---|---|
| Balance December 31, 2012 | $ (407,630) | $ 643,320 | $ 235,690 |
| **CHANGES DURING THE PERIOD** | | | |
| Net loss and total comprehensive loss | (41,666) | – | (41,666) |
| Distributions to unitholders | (9,360) | – | (9,360) |
| Distribution reinvestment plan units issued | – | 101 | 101 |
| Vested executive compensation | – | 361 | 361 |
| Trustee compensation | – | 38 | 38 |
| Balance March 31, 2013 | $ (458,656) | $ 643,820 | $ 185,164 |
| **Balance December 31, 2013** | **$ (502,923)** | **$ 644,380** | **$ 141,457** |
| **CHANGES DURING THE PERIOD** | | | |
| **Net loss and total comprehensive loss** | **(34,871)** | **–** | **(34,871)** |
| **Distributions to unitholders** | **(9,378)** | **–** | **(9,378)** |
| **Distribution reinvestment plan units issued** | **–** | **121** | **121** |
| **Vested executive compensation** | **–** | **210** | **210** |
| **Trustee compensation** | **–** | **44** | **44** |
| **Balance March 31, 2014** | **$ (547,172)** | **$ 644,755** | **$ 97,583** |

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

# CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS

| (in thousands of Canadian dollars) (unaudited) | **Three Months Ended March 31, 2014** | Three Months Ended March 31, 2013 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net loss | **$ (34,871)** | $ (41,666) |
| Add (deduct) items not affecting cash | | |
| Depreciation and amortization | **20,226** | 20,712 |
| Gain on sale of assets (Note 20) | **(1,056)** | (1,259) |
| Reversal of previous impairment (Note 20) | **(575)** | – |
| Unrealized loss on liabilities presented at fair value (Note 21) | **8,071** | 17,228 |
| Interest on mortgages and other debt | **11,158** | 11,724 |
| Convertible debentures interest and accretion | **6,282** | 6,410 |
| Interest expense paid | **(20,825)** | (18,145) |
| Deferred income tax recovery | **–** | (282) |
| Non-cash executive and trustee compensation | **254** | 399 |
| Share of net earnings from joint venture income (Note 5) | **(864)** | (833) |
| Changes in non-cash working capital (Note 18) | **9,108** | 195 |
| Cash utilized in operating activities | **(3,092)** | (5,517) |
| **FINANCING ACTIVITIES** | | |
| Repayment of long-term debt | **(42,170)** | (8,936) |
| Proceeds from long-term debt, net of issuance costs | **67,584** | 1,568 |
| Issue of convertible debentures, net of issuance costs | **–** | 110,037 |
| Distributions to unitholders | **(9,255)** | (9,255) |
| Operating loan repayments | **–** | (13,900) |
| Cash generated from financing activities | **16,159** | 79,514 |
| **INVESTING ACTIVITIES** | | |
| Capital expenditures (Note 22) | **(18,496)** | (5,798) |
| Dividends received from investment in joint venture (Note 5) | **748** | 678 |
| Proceeds from sale of assets | **14,325** | 10,000 |
| Payment of costs associated with sale of assets | **(1,053)** | (801) |
| Decrease (increase) in restricted cash | **2,791** | (53) |
| Cash (utilized in) generated from investing activities | **(1,685)** | 4,026 |
| Increase in cash during the period | **11,382** | 78,023 |
| Cash, beginning of the period | **20,261** | 6,466 |
| Cash, end of the period | **$ 31,643** | $ 84,489 |

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

# NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2014 (all Canadian dollar amounts are in thousands, except unit and per unit amounts) (unaudited)

## 1. BASIS OF PRESENTATION

InnVest Real Estate Investment Trust ("InnVest" or the "REIT") is an unincorporated open-ended real estate investment trust governed by the laws of Ontario. The REIT began operations on July 26, 2002. As at March 31, 2014, the REIT owned 124 Canadian hotels operated under international brands.

The REIT leases its hotels to InnVest Hotels Trust ("IHT"), an indirectly-owned unit trust. IHT indirectly holds all of the hotel operating assets, earns revenues from hotel customers and pays rent to the REIT. IHT also indirectly holds a 50% interest in Choice Hotels Canada Inc. ("CHC"). At March 31, 2014, InnVest wholly-owns an indirect interest in the entities that carry on the business of operating hotels.

Revenues earned from hotel operations fluctuate throughout the year, with the third quarter being the highest due to the increased level of leisure travel in the summer months and the first quarter being the lowest as leisure travel tends to be lower at that time of year.

Units of InnVest trade on the Toronto Stock Exchange (the "TSX") under the symbol INN.UN.

InnVest's registered office is at 5090 Explorer Drive, Suite 700, Mississauga, Ontario L4W 4T9.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### a) Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting* as issued by the International Accounting Standards Board ("IASB"). Accordingly, certain information and disclosure normally included in annual financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the IASB, have been omitted or condensed. The interim financial statements have been prepared using the same accounting policies and methods as those used in the consolidated financial statements for the year ended December 31, 2013, except as described below. These financial statements should be read in conjunction with InnVest's consolidated financial statements for the year ended December 31, 2013.

### b) Estimates

The preparation of financial statements in accordance with IAS 34 requires the use of certain critical accounting estimates. It also requires management to exercise judgment in applying the REIT's accounting policies. The critical accounting estimates and judgments have been set out in Note 2 of InnVest's consolidated financial statements for the year ended December 31, 2013.

### c) Application of New and Revised Accounting Standards

Effective January 1, 2014, InnVest has applied the following new and revised IFRSs in these unaudited condensed interim consolidated financial statements.

**AMENDMENTS TO IAS 32 – FINANCIAL INSTRUMENTS PRESENTATION**

The amendments provide additional guidance on the presentation of offsetting financial assets and financial liabilities. The amendments present application guidance on the legal right to offset financial assets and liabilities and management's intent to settle on a net basis. Retrospective application is required. The adoption of the amendments to IAS 32 did not have an impact on InnVest's condensed consolidated interim financial statements.

**IFRIC 21 – LEVIES**

IFRIC 21 clarifies that an entity recognizes a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. The adoption of IFRIC 21 did not have a significant impact on InnVest's condensed interim consolidated financial statements.

### d) Future accounting changes

**IFRS 9 – FINANCIAL INSTRUMENTS**

IFRS 9 (2013), *Financial Instruments* will replace IAS 39, *Financial Instruments: Recognition and Measurement* for classification and measurement of financial assets and liabilities. IFRS 9, as issued, reflects the International Accounting Standards Board's ("IASB") work to date on the replacement of IAS 39, and applies to the classification and measurement of financial assets and financial liabilities as defined in IAS 39. In February 2014, the IASB tentatively decided to require IFRS 9 to be adopted for annual periods beginning on or after January 1, 2018. The IASB intends to expand IFRS 9 to all new requirements for impairment of financial assets measured at amortized cost and hedge accounting. The impact of this ongoing project will be assessed by InnVest as remaining phases of the project are completed.

**AMENDMENTS TO IAS 36 – IMPAIRMENT OF ASSETS**

The amendments require the disclosure of the recoverable amount of impaired assets when an impairment loss has been recognized or reversed during the period and additional disclosures about the measurement of the recoverable amount of impaired assets when the recoverable amount is based on fair value less costs of disposal, including the discount rate when a present value technique is used to measure the recoverable amount. The amendments to IAS 36 are effective for annual periods beginning on or after January 1, 2014. The adoption of this standard is not expected to have a significant impact on InnVest's condensed interim consolidated financial statements.

# 3. ASSETS HELD FOR SALE

Assets held for sale at March 31, 2014 include fourteen hotels. All assets and liabilities relating to these assets have been classified to current assets and current liabilities and are outlined in the table below:

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| **Assets** | | |
| Accounts receivable | **$ 3,140** | $ 1,522 |
| Prepaid expenses and other assets | **1,136** | 416 |
| Hotel properties (net of accumulated depreciation of $32,243; 2013 – $17,649) (Note 6) | **78,763** | 56,656 |
| Intangible assets (net of accumulated amortization of $190; 2013 – $190) (Note 8) | **64** | 64 |
| Total assets | **$ 83,103** | $ 58,658 |
| **Liabilities** | | |
| Accounts payable and accrued liabilities | **$ 7,255** | $ 3,310 |
| Long-term debt (Note 9) | **39,419** | 27,165 |
| Provision (Note 11) | **50** | – |
| Employee retiring allowance (Note 12) | **177** | 177 |
| Total liabilities | **$ 46,901** | $ 30,652 |

Assets held for sale are measured at the lower of their carrying amount and fair value less costs to sell. Once they are classified as held for sale, depreciation ceases. The sales of these properties, which have been approved by the Board of Trustees, are highly probable and are expected to close within a year of their classification as held for sale.

The land amount at March 31, 2014 included in hotel properties is $7,658 (December 31, 2013 – $9,854). The operations of these hotels are not presented as discontinued operations on the condensed interim consolidated statement of net loss and comprehensive loss as they do not represent a separate geographical area of operations or a separate major line of business.

## Sale of assets

During the period ended March 31, 2014, InnVest sold four hotels in 'Assets held for sale' for aggregate net proceeds after closing costs of $13,272. InnVest repaid $5,855 of mortgages relating to these assets resulting in net cash proceeds of $7,417. InnVest recorded a corresponding net gain on sale of $1,056 which was included in 'Other income' (Note 20) in the condensed interim consolidated statements of net loss and comprehensive loss. InnVest also recorded a reversal of a previous impairment of $205 relating to one of these assets sold and $370 relating to an asset held for sale for a total of $575 which have been included in 'Other income' (Note 20), in the condensed interim consolidated statements of net loss and comprehensive loss.

# 4. RESTRICTED CASH

The restricted cash of $3,969 (December 31, 2013 – $6,760) is being held by InnVest to undertake capital refurbishments in accordance with certain mortgage and franchise agreements.

# 5. INVESTMENT IN JOINT VENTURE

InnVest holds a 50% interest in the ownership of CHC, a separate legal entity. CHC's registered office is at 5090 Explorer Drive, Suite 500, Mississauga, Ontario L4W 4T9. InnVest's investment in CHC is classified as a joint venture. InnVest accounts for its investment in CHC using the equity method. The transfer of unrestricted funds from CHC is approved by the joint venture partners. The following table summarizes the movement of InnVest's joint venture investment:

| | Investment in Joint Venture |
|---|---|
| Opening balance, January 1, 2013 | $ 1,265 |
| Add: | |
| InnVest's 50% share of CHC's net income for the year ended December 31, 2013 | 4,433 |
| Less: | |
| Dividends received | (4,496) |
| **Closing balance, December 31, 2013** | **$ 1,202** |
| Add: | |
| InnVest's 50% share of CHC's net income for the three months ended March 31, 2013 | 864 |
| Less: | |
| Dividends received | (748) |
| **Closing balance, March 31, 2014** | **$ 1,318** |

# 6. HOTEL PROPERTIES

| | Land, Building and Leaseholds | Building Finishes | Electrical and Mechanical | Furniture, Fixtures and Equipment | Total |
|---|---|---|---|---|---|
| **Cost** | | | | | |
| Opening balance at January 1, 2014 | $ 831,647 | $ 295,421 | $ 202,140 | $ 99,940 | $ 1,429,148 |
| Derecognition of assets | – | – | – | (1,468) | (1,468) |
| Additions | 761 | 11,387 | 878 | 5,446 | 18,472 |
| Fair value of decommissioning and restoration provision (Note 11) | 630 | – | – | – | 630 |
| Reclass to assets held for sale (Note 3) | (27,691) | (11,469) | (7,573) | (5,331) | (52,064) |
| Balance at March 31, 2014 | 805,347 | 295,339 | 195,445 | 98,587 | 1,394,718 |
| **Accumulated depreciation** | | | | | |
| Opening balance at January 1, 2014 | 74,256 | 140,824 | 26,863 | 51,702 | 293,645 |
| Derecognition of assets | – | – | – | (1,468) | (1,468) |
| Depreciation | 4,736 | 9,756 | 1,738 | 3,529 | 19,759 |
| Reclass to assets held for sale (Note 3) | (7,084) | (6,140) | (1,991) | (3,108) | (18,323) |
| Balance at March 31, 2014 | 71,908 | 144,440 | 26,610 | 50,655 | 293,613 |
| **Carrying value, March 31, 2014** | **$ 733,439** | **$ 150,899** | **$ 168,835** | **$ 47,932** | **$ 1,101,105** |

| | Land, Building and Leaseholds | Building Finishes | Electrical and Mechanical | Furniture, Fixtures and Equipment | Total |
|---|---|---|---|---|---|
| **Cost** | | | | | |
| Opening balance at January 1, 2013 | $ 894,454 | $ 289,163 | $ 223,410 | $ 103,299 | $ 1,510,326 |
| Derecognition of assets | – | – | – | (12,302) | (12,302) |
| Additions | 4,147 | 34,311 | 4,301 | 17,437 | 60,196 |
| Fair value of decommissioning and restoration provision (Note 11) | (2,276) | – | – | – | (2,276) |
| Writedown of assets to recoverable amount | (16,634) | (3,223) | (3,537) | (1,406) | (24,800) |
| Reclass to assets held for sale (Note 3) | (48,044) | (24,830) | (22,034) | (7,088) | (101,996) |
| Balance at December 31, 2013 | 831,647 | 295,421 | 202,140 | 99,940 | 1,429,148 |
| **Accumulated depreciation** | | | | | |
| Opening balance at January 1, 2013 | 58,801 | 113,860 | 22,068 | 53,278 | 248,007 |
| Derecognition of assets | – | – | – | (12,302) | (12,302) |
| Depreciation | 19,406 | 39,119 | 7,404 | 14,670 | 80,599 |
| Reclass to assets held for sale (Note 3) | (3,951) | (12,155) | (2,609) | (3,944) | (22,659) |
| Balance at December 31, 2013 | 74,256 | 140,824 | 26,863 | 51,702 | 293,645 |
| **Carrying value, December 31, 2013** | **$ 757,391** | **$ 154,597** | **$ 175,277** | **$ 48,238** | **$ 1,135,503** |

The depreciation expense has been included in the line item 'Depreciation and amortization' in the condensed interim consolidated statements of net loss and comprehensive loss.

The land amount included in land, building and leaseholds is $138,613 at March 31, 2014 (December 31, 2013 – $138,613). This amount is not depreciated. Hotel properties at March 31, 2014 include $3,427 relating to leased assets (December 31, 2013 – $7,343).

### Impairment review during the period

Each reporting period, InnVest performs a review for indicators of impairment in respect of its hotel properties. If an impairment indicator is identified, InnVest determines the recoverable amount of the individual hotel property as the higher of value-in-use and fair value less costs to sell. Value-in-use is based on a discounted cash flow approach whereas fair value less costs to sell is determined giving consideration to comparable sales transactions and price per room metrics. The discount rate used in measuring value-in-use is based on market conditions per individual hotel property and ranged from 9.75% to 10.5% at March 31, 2014. (December 31, 2013 – ranged from 9.75% to 10.5%). No impairment was recognized for the three months ended March 31, 2014 (2013 – $nil).

## 7. OTHER REAL ESTATE PROPERTIES

Other real estate properties include a retail property and a retirement residence. The land amount included in land and building is $121 at March 31, 2014 (December 31, 2013 – $121). This amount is not depreciated.

As described under Note 6, a similar impairment review was performed on other real estate properties. No impairment was recognized for the three months ended March 31, 2014 (2013 – $nil).

| | Land and Building | Furniture, Fixtures and Equipment | Total |
|---|---|---|---|
| **Cost** | | | |
| Opening balance at January 1, 2014 | $ 2,497 | $ 77 | $ 2,574 |
| Additions | 24 | – | 24 |
| Balance at March 31, 2014 | 2,521 | 77 | 2,598 |
| **Accumulated depreciation** | | | |
| Opening balance at January 1, 2014 | 573 | 37 | 610 |
| Depreciation | 49 | 3 | 52 |
| Balance at March 31, 2014 | 622 | 40 | 662 |
| **Carrying value, March 31, 2014** | **$ 1,899** | **$ 37** | **$ 1,936** |

| | Land and Building | Furniture, Fixtures and Equipment | Total |
|---|---|---|---|
| **Cost** | | | |
| Opening balance at January 1, 2013 | $ 6,981 | $ 76 | $ 7,057 |
| Writedown of assets to recoverable amount | (4,500) | – | (4,500) |
| Additions | 16 | 1 | 17 |
| Balance at December 31, 2013 | 2,497 | 77 | 2,574 |
| **Accumulated depreciation** | | | |
| Opening balance at January 1, 2013 | 376 | 26 | 402 |
| Depreciation | 197 | 11 | 208 |
| Balance at December 31, 2013 | 573 | 37 | 610 |
| **Carrying value, December 31, 2013** | **$ 1,924** | **$ 40** | **$ 1,964** |

The depreciation expense has been included in the line item 'Depreciation and amortization' in the condensed interim consolidated statements of net loss and comprehensive loss.

# 8. INTANGIBLE ASSETS

| | Licence Contracts | Franchise Rights | Total |
|---|---|---|---|
| **Cost** | | | |
| Opening balance at January 1, 2014 | $ 26,320 | $ 2,320 | $ 28,640 |
| Additions | – | – | – |
| Balance at March 31, 2014 | 26,320 | 2,320 | 28,640 |
| **Accumulated amortization** | | | |
| Opening balance at January 1, 2014 | 15,047 | 1,516 | 16,563 |
| Amortization | 329 | 86 | 415 |
| Balance at March 31, 2014 | 15,376 | 1,602 | 16,978 |
| **Carrying value, March 31, 2014** | **$ 10,944** | **$ 718** | **$ 11,662** |

| | Licence Contracts | Franchise Rights | Total |
|---|---|---|---|
| **Cost** | | | |
| Opening balance at January 1, 2013 | $ 26,320 | $ 2,498 | $ 28,818 |
| Derecognition of assets | – | (95) | (95) |
| Additions | – | 171 | 171 |
| Reclass to assets held for sale (Note 3) | – | (254) | (254) |
| Balance at December 31, 2013 | 26,320 | 2,320 | 28,640 |
| **Accumulated amortization** | | | |
| Opening balance at January 1, 2013 | 13,731 | 1,392 | 15,123 |
| Derecognition of assets | – | (95) | (95) |
| Amortization | 1,316 | 409 | 1,725 |
| Reclass to assets held for sale (Note 3) | – | (190) | (190) |
| Balance at December 31, 2013 | 15,047 | 1,516 | 16,563 |
| **Carrying value, December 31, 2013** | **$ 11,273** | **$ 804** | **$ 12,077** |

The amortization expense has been included in the line item 'Depreciation and amortization' in the condensed interim consolidated statements of net loss and comprehensive loss.

# 9. LONG-TERM DEBT

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Mortgages payable | **$ 731,703** | $ 705,666 |
| Bank indebtedness | **2,750** | 2,750 |
| | **734,453** | 708,416 |
| Reclass to liabilities related to assets held for sale (Note 3) | **(39,419)** | (27,165) |
| | **695,034** | 681,251 |
| Less debt issuance costs | **(6,996)** | (7,163) |
| Total long-term debt | **688,038** | 674,088 |
| Less current portion | **(58,617)** | (91,079) |
| Net long-term debt | **$ 629,421** | $ 583,009 |

### Mortgages payable

Substantially all of InnVest's assets have been pledged as security under debt agreements. At March 31, 2014, long-term debt had a weighted average interest rate of 5.7% (December 31, 2013 – 5.8%) and a weighted average effective interest rate of 6.1% (December 31, 2013 – 6.2%). The long-term debt is repayable in average monthly payments of principal and interest totalling $5,034 (December 31, 2013 – $4,955) and matures at various dates from April 30, 2014 to January 1, 2024.

On January 7, 2014, InnVest completed the refinancing of the Sheraton Eau Claire, Calgary for $68,000 at a fixed interest rate of 5.33% for a 10-year term. Incremental proceeds of $36,378 from the refinancing will be available to partially repay a $45,398 mortgage maturing in April 2014 of which $3,591 related to "Assets held for sale."

In addition, InnVest has access to a loan facility for up to $30,000 to fund 65% of capital expenditures incurred at certain of its hotels. At March 31, 2014, InnVest has remaining capacity on the facility of $26,686 (December 31, 2013 – $26,686) of which $12,658 could have been drawn upon.

### Operating line

At March 31, 2014, InnVest has an operating line of credit of up to $40,000 with a major banking institution which expires August 31, 2015. The operating line is secured by 11 properties. The amount of the operating line is subject to a mortgageability test which is based on the operating results of the secured properties, calculated quarterly on a trailing four quarters basis. Based on the operating results of the secured properties for the four quarters ended March 31, 2014, InnVest had the ability to draw up to $30,286. The amount drawn on the operating line as at March 31, 2014 was $nil (December 31, 2013 – $nil). The operating line bears interest at either the Canadian bank prime rate plus 2.0% or the Canadian Bankers' Acceptance rate plus 3.0%.

### Bank indebtedness

InnVest has a bridge loan secured by one property. As at March 31, 2014, the bridge loan amount was $2,750 (December 31, 2013 – $2,750). During the quarter, InnVest extended the bridge loan to February 28, 2015. The bridge loan requires quarterly principal payments of $250 starting June 30, 2014 and bears interest at the Canadian Bankers' Acceptance rate plus 4.0%.

Scheduled repayment of long-term debt is as follows:

| | Regular Amortization | Due on Maturity | Total |
|---|---|---|---|
| Remainder of 2014 | $ 11,847 | $ 41,807 | $ 53,654 |
| 2015 | 14,216 | 72,088 | 86,304 |
| 2016 | 12,971 | 45,494 | 58,465 |
| 2017 | 7,352 | 277,694 | 285,046 |
| 2018 | 4,035 | 5,265 | 9,300 |
| 2019 and thereafter | 8,125 | 194,140 | 202,265 |
| | **$ 58,546** | **$ 636,488** | **$ 695,034** |

The estimated fair value of InnVest's mortgages payable at March 31, 2014 was approximately $744,056 (December 31, 2013 – $716,050). This estimate was determined by discounting expected cash flows at interest rates that reflect current market conditions for debt with similar terms, maturities and credit risk.

Long-term debt includes $28,489 (December 31, 2013 – $28,489) which is subject to floating interest rates. Annual interest expense will increase by $285 for every 1% increase in the base Bankers' Acceptance rate.

Interest expense on mortgages and other debt and convertible debentures interest are considered operating items in the condensed interim consolidated statements of cash flows.

# 10. CONVERTIBLE DEBENTURES

The convertible debentures outstanding as at March 31, 2014 are as follows:

| Debenture | Original Face Amount | Maturity Date | Coupon Interest Rate | Interest Rate Including Issuance Costs | Effective Interest Rate[(1)] | Conversion Strike Price | **Outstanding Principal March 31, 2014** | Outstanding Principal December 31, 2013 |
|---|---|---|---|---|---|---|---|---|
| Series C | 70,000[(2)] | August 1, 2014 | 5.85% | 6.66% | 7.42% | $ 14.70 | **70,000** | 70,000 |
| Series D | 50,000 | March 31,2016 | 6.75% | 7.64% | 9.41% | $ 5.70 | **36,358** | 36,358 |
| Series E | 75,000 | September 30, 2017 | 6.00% | 6.79% | 7.75% | $ 8.00 | **75,000** | 75,000 |
| Series F | 50,000 | March 30, 2018 | 5.75% | 6.57% | 7.40% | $ 9.45 | **50,000** | 50,000 |
| Series G | 115,000 | March 31, 2019 | 5.75% | 6.60% | 7.33% | $ 5.80 | **115,000** | 115,000 |
| Total convertible debentures | | | | | | | **$ 346,358** | $ 346,358 |

(1) Includes issuance costs and conversion option allocation.
(2) See Note 23.

The net proceeds received from the issuance of each convertible debenture have been split between a financial liability element and the conversion option component, representing the value attributable to the option to convert the financial liability into units of InnVest. InnVest has separated the conversion option component for each of its series of convertible debentures and measures such component at fair value at each reporting date. The conversion option feature of the convertible debentures is recorded as a liability under 'Other liabilities' in the condensed interim consolidated balance sheets and is measured at fair value (see Note 13).

| | **March 31, 2014** | December 31, 2013 |
|---|---|---|
| Convertible debentures | **$ 346,358** | $ 346,358 |
| Financing costs and accretion, net | **(429)** | (1,580) |
| Less allocation of conversion option value | **(15,805)** | (15,805) |
| | **330,124** | 328,973 |
| Less current portion | **(69,638)** | (69,369) |
| Convertible debentures – non-current | **$ 260,486** | $ 259,604 |

The fair value of InnVest's convertible debentures, estimated based on the market price for each series of convertible debentures as at March 31, 2014, is $353,042 (December 31, 2013 – $332,474).

The scheduled convertible debentures maturities are as follows:

| | **Due on Maturity** |
|---|---|
| Remainder of 2014 (see Note 23) | **$ 70,000** |
| 2015 | **–** |
| 2016 | **36,358** |
| 2017 | **75,000** |
| 2018 | **50,000** |
| 2019 | **115,000** |
| | **$ 346,358** |
| Financing costs and allocation of conversion option value | **(16,234)** |
| | **$ 330,124** |

# 11. PROVISIONS

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Opening balance, beginning of year | **$ 7,073** | $ 9,349 |
| Increase (decrease) to 'Hotel properties': | | |
| Reclass to assets held for sale (Note 3) | **(50)** | – |
| Other | **23** | – |
| Effect of changes in the discount rate (Note 6) | **630** | (2,276) |
| **Ending balance, end of year** | **$ 7,676** | $ 7,073 |

The entire provision of $7,676 relates to InnVest's decommissioning and restoration obligation.

The provision for decommissioning and restoration relates to the estimated future cost of environmental obligations for certain properties. InnVest intends to settle the obligations at the end of the expected useful life of the hotel properties. At March 31, 2014, the liability has been discounted at a rate of 2.96% based on the Bank of Canada long-term bond yields (December 31, 2013 – 3.2%). Upon the initial recognition of the liability, the decommissioning and restoration obligation was capitalized to buildings and is being amortized over the remaining useful life. The effects of the change of the discount rate are capitalized to buildings and amortized over the remaining useful life.

# 12. OTHER LONG-TERM OBLIGATIONS

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Finance lease | **$ 979** | $ 992 |
| Other lease obligations | **276** | 281 |
| Employee retiring allowance | **1,187** | 1,187 |
| Employee benefit plans | **1,904** | 1,904 |
| Total other long-term obligations | **$ 4,346** | $ 4,364 |
| Reclass to assets held for sale (employee retiring allowance) (Note 3) | **(177)** | (177) |
| Less current portion | **(177)** | (177) |
| Other long-term obligations – non-current | **$ 3,992** | $ 4,010 |

InnVest has one finance lease relating to one Ontario hotel with a lease term through 2018. InnVest has the option to purchase the hotel at a discounted amount at the conclusion of the lease. The fair value of the lease liability is approximately equal to its carrying amount.

### Defined benefit pension plans and other employment benefits

InnVest is responsible to provide employee retirement allowances to certain unionized employees at a limited number of its hotels. Liabilities are recorded for employee retirement allowance benefits using actuarial valuations. InnVest has defined benefit pension plans which are for specific employees of four hotels and are closed plans.

# 13. OTHER LIABILITIES

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Exchangeable units | **$ 1,919** | $ 1,695 |
| Convertible debentures holders' conversion option (Note 15) | **25,074** | 17,227 |
| Unvested executive compensation | **75** | 75 |
| Other liabilities | **$ 27,068** | $ 18,997 |

### Exchangeable units

As part of an acquisition made in 2005, InnVest granted 362,869 exchangeable units ("Exchangeable units") to a third party. The Exchangeable units receive a monthly cash payment equal to the value of the cash distributions that would have been paid on the InnVest units if they had been issued on the date of grant. The Exchangeable units are exchangeable into InnVest units with three business days of prior written notice to InnVest or on August 2, 2015. The Exchangeable units are presented as liabilities at their fair value based on the market price of InnVest units. During the three months ended March 31, 2014, distributions totaling $36 (2013 – $36) were paid on the Exchangeable units and are included in 'Corporate and administrative' expenses in the condensed interim consolidated statements of net loss and comprehensive loss.

### Convertible debenture holders' conversion option

InnVest has separated the conversion option component for each of its series of convertible debentures which are presented as liabilities. InnVest measures the conversion option component at fair value at each reporting date which is derived based on the volatility of InnVest units' market price, market interest rates as well as management's judgment relating to interest rate spreads for instruments of similar terms and risks.

### Executive compensation plan

The senior executives participate in an incentive plan that involves the grant of InnVest units which vest over time. Upon vesting, the payments are be satisfied through the issuance of units. Unvested units are presented as liabilities at their fair value. Upon issuance of units (following the satisfaction of all vesting conditions), the liability is reclassified to 'Unitholders' equity' at the then-current fair value based on the market price of the units.

## 14. CAPITAL MANAGEMENT

InnVest manages its capital, which is defined as the aggregate of unitholders' equity and debt, under the terms of the Declarations of Trust (the "DOT"). InnVest's capital management objectives are (i) to ensure compliance with debt and investment restrictions outlined in its DOT as well as external existing debt covenants, (ii) to allow for the implementation of its disposition strategy and hotel property refurbishment program, and (iii) to build long-term unitholder value. Issuances of equity and debt are approved by the Board of Trustees through their review and approval of InnVest's annual business plan, along with periodic changes to the approved plans throughout each year.

At March 31, 2014, InnVest's primary contractual obligations consisted of long-term mortgage obligations and convertible debentures. InnVest is not permitted to exceed certain financial leverage amounts under the terms of the DOT. InnVest is permitted to hold indebtedness excluding convertible debentures up to a level of 60% of gross asset value. Further, InnVest is permitted to have indebtedness and convertible debentures up to a level of 75% of gross asset value. Indebtedness is computed as of the last day of each financial period excluding any indebtedness under any operating line, non-interest bearing indebtedness, trade accounts payable and, for greater certainty, deferred income tax liability. InnVest is further limited by an operating line covenant to only have total indebtedness including convertible debentures up to 70% of gross asset value. Under the terms of the DOT individual property mortgages, or mortgages on a pool of properties, cannot exceed 75% of the fair value of the underlying property.

At March 31, 2014, InnVest's leverage excluding and including convertible debentures was 45.5% and 21.5%, respectively, calculated as follows:

| | | **March 31, 2014** | | December 31, 2013 |
|---|---|---|---|---|
| Total assets per consolidated balance sheet | | **$ 1,271,608** | | $ 1,280,541 |
| Accumulated depreciation and amortization | | **343,686** | | 328,657 |
| Gross asset value | | **$ 1,615,294** | | $ 1,609,198 |
| Book value of mortgages and bridge loan (Note 9)(1) | **$ 734,453** | **45.5%** | $ 708,416 | 44.0% |
| Convertible debentures (Note 10)(2) | **346,358** | **21.4%** | 346,358 | 21.5% |
| Total indebtedness | **$ 1,080,811** | **66.9%** | $ 1,054,774 | 65.5% |

(1) Adjusted to eliminate financing issuance costs.
(2) Adjusted to face value.

The DOT also includes guidelines that limit capital expended to, among other items, the following:

(a) Direct and indirect investments in real property on which hotels are situated and the hotel business conducted thereon, primarily in Canada, and in entities whose activities consist primarily of franchising hotels;
(b) Temporary investments held in cash, deposits with a Canadian chartered bank or trust company, short-term government debt securities or in money market instruments of, or guaranteed by, a Schedule 1 Canadian bank, short-term commercial paper, notes, bonds of other debt securities of a Canadian entity having a rating of at least R-1 (Mid) by Dominion Bond Rating Service or A-1 (Mid) by Standard & Poor's Corporation maturing prior to one year from the date of issue; and
(c) Investments in mortgages or mortgage bonds, where the related security is a first mortgage on income producing real property which otherwise complies with (a) above and is subject to certain leverage limits and debt service coverage. The aggregate value of such investments shall not exceed 20% of the unitholders' equity.
(d) Investments other than those summarized in (a) through (c) are limited to 15% of InnVest's Unitholder's equity plus accumulated depreciation.

InnVest is in compliance with these guidelines.

InnVest maintains an operating line with a Canadian chartered bank with the following covenants:

| | Threshold | March 31, 2014 | Capacity(1) | December 31, 2013 |
|---|---|---|---|---|
| (i) Total indebtedness (including convertible debentures) as a percentage of gross assets | < 70.0% | **66.9%** | **$ 49,895** | 65.5% |
| (ii) Trailing 12 months consolidated earnings before interest, taxes, depreciation and amortization ("EBITDA") to consolidated interest expense(2) | > 1.8 x | **2.1 x** | **$ 20,783** | 2.1 x |
| (iii) Trailing 12 months consolidated EBITDA to consolidated debt service(3) | > 1.5 x | **1.6 x** | **$ 11,411** | 1.6 x |
| (iv) Unitholders' equity plus accumulated depreciation less 'Intangible assets' | > $ 300,000 | **$ 429,417** | **$ 129,417** | $ 457,973 |

(1) Reflects additional capacity (for debt, EBITDA or unitholders' equity, as applicable) before exceeding the covenant threshold, at March 31, 2014.
(2) Consolidated interest expense excludes non-cash portion of mortgage interest expense and non-cash portion of convertible debenture interest and accretion.
(3) Consolidated debt service includes consolidated interest expense plus regular principal payments of $4,721.

# 15. FINANCIAL INSTRUMENTS

## Risk management

In the normal course of business, InnVest is exposed to a number of risks that can affect its operating performance. These risks, and the actions taken to manage them, include the following:

### INTEREST RATE RISK

The average term to maturity of InnVest's long-term debt and convertible debentures combined exceeds three years. This strategy reduces InnVest's exposure to re-pricing risk resulting from short-term interest rate fluctuations in any one year. Management is of the view that such a strategy will provide the most effective interest rate risk management for debt.

InnVest's floating rate debt balance is monitored by management to minimize InnVest's exposure to interest rate fluctuations. As at March 31, 2014, InnVest's floating rate debt balance of $28,489 (December 31, 2013 – $28,489) is approximately 4.1% (December 31, 2013 – 4.0%) of total long-term debt, excluding convertible debentures.

### CREDIT RISK

Credit risk relates to the possibility that hotel guests, either individual or corporate, do not pay the amounts owed to InnVest. InnVest mitigates this risk by limiting its exposure to customers allowed to pay by invoice after check out ("direct bill"). InnVest reviews accounts receivable regularly and the allowance for doubtful accounts is adjusted for any balances which are determined by management to be uncollectable. This provision adjustment is expensed in operating expenses. The following summarizes accounts receivable related balances:

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Accounts receivable | **$ 21,761** | $ 28,788 |
| Allowance for doubtful accounts | **$ 424** | $ 462 |
| Accounts receivable greater than 90 days not provided for | **$ 238** | $ 267 |
| Bad debt expense | **$ 28** | $ 123 |
| Allowance for doubtful accounts to total receivables | **1.9%** | 1.6% |

**LIQUIDITY RISK**

Liquidity risk arises from the possibility of not having sufficient cash available to InnVest to fund its growth and capital maintenance programs and refinance its obligations as they arise. There is a risk that lenders will not refinance maturing debt on terms and conditions acceptable to InnVest or on any terms at all. There is also a risk that bank lenders will not refinance the operating and bridge loan facilities on terms and conditions acceptable to InnVest or on any terms at all (see Note 23).

Estimated maturities of InnVest's financial liabilities, excluding, 'Other long-term obligations' and 'Other liabilities', are:

| | Remainder of 2014 | 2015 | 2016 | 2017 | 2018 | 2019 and Thereafter | Contractual Cash flows(1) |
|---|---|---|---|---|---|---|---|
| Accounts payable and accrued liabilities | $ 66,922 | $ – | $ – | $ – | $ – | $ – | $ 66,922 |
| Liabilities related to assets held for sale | 46,901 | – | – | – | – | – | 46,901 |
| Mortgage payable – principal(2) | 52,904 | 84,304 | 58,465 | 285,046 | 9,300 | 202,265 | 692,284 |
| Mortgage payable – interest(3) | 25,400 | 35,090 | 32,151 | 17,788 | 11,861 | 19,324 | 141,614 |
| Bridge loan – principal | 750 | 2,000 | – | – | – | – | 2,750 |
| Bridge loan – interest | 72 | 26 | – | – | – | – | 98 |
| Convertible debentures – principal | 70,000 | – | 36,358 | 75,000 | 50,000 | 115,000 | 346,358 |
| Convertible debentures – interest | 10,268 | 16,442 | 15,215 | 13,988 | 8,050 | 3,306 | 67,269 |
| Long-term land leases | 2,197 | 2,858 | 2,876 | 2,854 | 2,858 | 82,376 | 96,019 |
| Total | $ 275,414 | $ 140,720 | $ 145,065 | $ 394,676 | $ 82,069 | $ 422,271 | $1,460,215 |

(1) Contractual cash flows include principal and interest payments and include extension options available to InnVest.
(2) Mortgage principal includes regular amortization and repayments at maturity.
(3) Interest for floating rate debt is based on interest rates prevailing at March 31, 2014.

**CONTINGENT OBLIGATIONS**

InnVest and its operating subsidiaries are contingently liable with respect to litigation and claims that arise from time to time in the normal course of business.

## Fair values

The fair values of InnVest's current financial assets and current financial liabilities approximate their recorded values at March 31, 2014 and December 31, 2013 due to their short-term nature.

The fair value of InnVest's long-term debt is greater than the carrying value by approximately $9,603 at March 31, 2014 (December 31, 2013 – $7,634) due to changes in interest rates since the dates on which the individual mortgages were arranged. The fair value of long-term debt has been estimated based on the current market rates for mortgages with similar terms, credit risks and conditions.

The fair value of InnVest's convertible debentures is greater than the carrying value by approximately $6,684 at March 31, 2014 (December 31 2013 – was less than by $13,728). The fair value of convertible debentures is based on the market price for each series of convertible debentures as at each reporting date.

The fair value hierarchy of financial liabilities measured at fair value on the balance sheet is as follows:

| | **March 31, 2014** | | | December 31, 2013 | | |
|---|---|---|---|---|---|---|
| | **Level 1** | **Level 3** | **Total** | Level 1 | Level 3 | Total |
| Financial Liabilities: | | | | | | |
| Exchangeable units | **1,919** | **–** | **1,919** | 1,695 | – | 1,695 |
| Convertible debenture holders' conversion option | **–** | **25,074** | **25,074** | – | 17,227 | 17,227 |
| Unvested executive compensation | **75** | **–** | **75** | 75 | – | 75 |
| Total financial liabilities | **$ 1,994** | **$ 25,074** | **$ 27,068** | $ 1,770 | $ 17,227 | $ 18,997 |

There were no transfers between Level 1 and Level 2 fair value measurements during the periods presented and no transfer into and out of Level 3. There were no financial instruments measured at Level 2 at any of the dates presented.

The fair market value of convertible debenture holders' conversion option is estimated using a Black-Scholes valuation model and InnVest uses the following methods to determine its underlying assumptions: expected volatilities are based on the historical volatilities of the monthly closing price of InnVest's unit prices; the expected term of the conversion option is based on the remaining term of each series of debentures; the risk-free interest rate is based on the Government of Canada Bond yield with similar life terms to the expected life of the option; and the expected dividend yield is based on the current annual dividend amount divided by InnVest's unit price on the issuance date of the convertible debenture.

The following key assumptions were used in the valuation model:

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Expected volatility | **27.0%** | 27.0% |
| Expected dividend yield | **7.6%** | 8.6% |

The fair market value of convertible debenture holder's conversion option might result in a significantly higher or lower fair value due to a change in the unobservable inputs used.

The following table reconciles movements in convertible debentures holders' conversion option, which are financial instruments classified as Level 3 during the three months ended March 31, 2014 and the year ended December 31, 2013.

| | March 31, 2014 | December 31, 2013 |
|---|---|---|
| Opening balance at January 1 | **$ 17,227** | $ 662 |
| Fair value loss included in net loss (Note 21) | **7,847** | 12,572 |
| Issuance | **–** | 3,993 |
| Balance at end of the period | **$ 25,074** | $ 17,227 |

Fair value losses are included in 'Unrealized loss on liabilities presented at fair value' (see Note 21).

### Letters of credit

As at March 31, 2014, InnVest has letters of credit totalling $2,354 (December 31, 2013 – $2,179) outstanding for security deposits related to various utility companies and liquor licences, and additional security for the pension liabilities.

## 16. UNITS OUTSTANDING

InnVest is authorized to issue an unlimited number of units, each of which represents an equal undivided beneficial interest in any distributions from InnVest. Per the DOT, units cannot be issued from treasury unless the Trustees consider it not to be dilutive to ensuing annual distributions of distributable income to existing unitholders.

Units issued and outstanding:

| | Units |
|---|---|
| Opening balance at January 1, 2013 | 93,583,904 |
| Units issued under distribution reinvestment plan | 115,550 |
| Units issued under trustee and executive plans | 131,443 |
| Balance at December 31, 2013 | 93,830,897 |
| Units issued under distribution reinvestment plan | 24,111 |
| Units issued under trustee and executive plans | 54,605 |
| Balance at March 31, 2014 | **93,909,613** |

### Trustee compensation plan

InnVest has set aside 350,000 units in reserve for the Board of Trustees compensation. The balance in this reserve account at March 31, 2014 is 159,989 units (December 31, 2013 – 169,606 units). Under the Trustee compensation plan, 9,617 units were issued from the reserve for the three months ended March 31, 2014 (December 31, 2013 – 36,943 units).

### Executive Compensation Plan

The senior executives participate in the executive compensation plan under which InnVest units are granted by the Board of Trustees from time to time. All granted units vest equally on the third and fourth anniversaries of the effective date of grant. InnVest has reserved a maximum of 1,000,000 units for issuance under the plan. The balance in this reserve account at March 31, 2014 is 609,343 units (December 31, 2013 – 621,345 units). A unit granted through the plan entitles the holder to receive, on the vesting date, the then-current fair market value of the unit plus the value of the cash distributions that would have been paid on the unit if it had been issued on the date of grant assuming the reinvestment of the distribution into InnVest units. The payment will be satisfied through the issuance of units.

The benefit resulting from the issuance of units under this plan and any fair value adjustments on the liability are recorded as compensation expense and included in 'Corporate and administrative' expense in the condensed interim consolidated statements of net loss and comprehensive loss.

At March 31, 2014 there were 34,225 (December 31, 2013 – 27,210) unvested executive units granted under the plan. The unvested units are presented as liabilities over the vesting periods.

The following table summarizes the status of the executive compensation plan at March 31, 2014, excluding granted units which have fully vested and/or were cancelled:

| | Unvested (Vested) Executive Units, Net | Unvested (Vested) Units Accumulated from Distributions, Net | Unvested (Vested) Total Units, Net | Fair Value Per Unit at Grant Date |
|---|---|---|---|---|
| 2010 – granted | 3,500 | 1,148 | 4,648 | $ 5.30 |
| 2011 – granted | 4,000 | 1,112 | 5,112 | $ 6.80 |
| 2012 – granted | 7,000 | 1,124 | 8,124 | $ 4.50 |
| 2013 – granted | 11,000 | 543 | 11,543 | $ 4.78 |
| Units vested 2013 | (1,750) | (467) | (2,217) | |
| 2014 – granted | 11,563 | 439 | 12,002 | $ 5.28 |
| Units vested 2014 | (3,750) | (1,237) | (4,987) | |
| | 31,563 | 2,662 | 34,225 | $ 5.11 |

### Distribution reinvestment plan ("DRIP")

InnVest has a DRIP whereby eligible Canadian unitholders may elect to have their monthly distributions automatically reinvested in additional InnVest units.

## 17. PER UNIT INFORMATION

The net loss and weighted average number of units for the purposes of diluted earnings per unit are as follows:

| | **Three Months Ended March 31, 2014** | | Three Months Ended March 31, 2013 | |
|---|---|---|---|---|
| | **Net Loss** | **Weighted Average Units** | Net Loss | Weighted Average Units |
| Basic and diluted | **$ (34,871)** | **93,858,254** | $ (41,666) | 93,663,167 |

The following potential units are anti-dilutive and are therefore excluded from the weighted average number of units for the purposes of diluted earnings per unit.

| | **Three Months Ended March 31, 2014** | Three Months Ended March 31, 2013 |
|---|---|---|
| Convertible debentures | **45,634,091** | 50,666,305 |

For the three months ended March 31, 2014, InnVest declared $9,378 distributions to unitholders (2013 – $9,360) at $0.0333 distributions per unit monthly (2013 – $0.0333 per unit monthly). Declared distributions include cash distributions and distributions arising from the DRIP (Note 16). Subsequent to the end of the quarter, InnVest declared $3,127 distributions to unitholders at $0.40 per unit annually or $0.0333 per month to May 7, 2014.

# 18. CHANGES IN NON-CASH WORKING CAPITAL

| Cash generated from (utilized in) | **Three Months Ended March 31, 2014** | Three Months Ended March 31, 2013 |
|---|---|---|
| Accounts receivable | **$ 4,682** | $ 1,666 |
| Prepaid expenses and other assets | **217** | (2,078) |
| Accounts payable and other liabilities | **4,209** | 607 |
| Changes in non-cash working capital | **$ 9,108** | $ 195 |

# 19. RELATED PARTY DISCLOSURES

### Westmont Hospitality Canada Limited

InnVest has a Management Agreement for hotel management and accounting services and an Administrative Services Agreement (the "Agreements") with Westmont Hospitality Canada Limited ("Westmont") pursuant to which Westmont is responsible for the management of the majority of the hotel businesses in InnVest (see Note 23).

Two trustees of InnVest have a direct or indirect controlling interest in Westmont and as such have a material interest in the Agreements. Westmont is considered a related party to InnVest as a result of its ability to exercise significant influence through the Agreements. At March 31, 2014, Westmont managed all but 13 of InnVest's hotels. The Agreements are on terms equivalent to those that prevail in arm's length transactions.

Westmont manages the hotel businesses and provides customary hotel management services, including preparation of annual operating and capital budgets and marketing plans, accounting and financial reporting, supervision of sales and marketing, human resource management, purchasing, management and supervision of construction and technical services, information technology, franchise relations and evaluations, supervision of property repairs and maintenance, supervision of compliance with material contracts relating to the hotel properties, leasing, yield management and quality control. For assets sold which are managed by Westmont, InnVest pays a termination fee equal to the management fees paid based on the trailing 12 months revenues.

For certain hotels owned by InnVest and not managed by Westmont, Westmont is entitled to an asset management fee based on a fixed percentage of the purchase price of the hotel or a fixed percentage of gross operating profit, after the reserve for replacement of furniture, fixtures and equipment and capital improvements, subject to an annual minimum fee (see Note 23)

In accordance with the management agreement, in addition to the base management fee and incentive fee, Westmont is entitled to the following fees in respect of hotels that it manages (i) purchasing fees based on 5% of the cost of certain goods and supplies; (ii) construction fees based on 5% of the cost of construction and capital expenditures; and (iii) per guest room fees for accounting services in respect of the hotel businesses. The amended and restated management agreement did not result in any changes to the basis for such additional fees.

During the three months ended March 31, 2014 and 2013, the fees charged to InnVest pursuant to the Agreements were as follows:

| | **Three Months Ended March 31, 2014** | Three Months Ended March 31, 2013 |
|---|---|---|
| Management fees | **$ 2,275** | $ 2,447 |
| Asset management fees (included in 'Management fees') | **398** | 465 |
| Accounting services (included in 'Operating expenses') | **571** | 592 |
| Administrative services (included in 'Corporate and administrative') | **85** | 85 |
| Purchasing fee and project management and general contractor services (capitalized to 'Hotel properties') | **859** | 275 |
| Termination fees (included in 'Gain on sale of assets') | **190** | 144 |
| | **$ 4,378** | $ 4,008 |

In addition, InnVest reimburses Westmont for costs of certain employees which are paid by Westmont on account of InnVest. Prior to 2013, many of these costs were incurred directly by InnVest. For the three months ended March 31, 2014 InnVest reimbursed $605 of related costs (2013 – $80). Included in 'Accounts payable and accrued liabilities' are amounts owed to Westmont at March 31, 2014 totalling $3,300 (December 31, 2013 – $3,175).

## 20. OTHER INCOME

| | Three Months Ended March 31, 2014 | Three Months Ended March 31, 2013 |
|---|---|---|
| Gain on sale of assets, net (Note 3) | $ 1,056 | $ 1,259 |
| Reversal of previous impairment (Note 3) | 575 | $ – |
| Interest income | 73 | 54 |
| | $ 1,704 | $ 1,313 |

During the three months ended March 31, 2014, InnVest recorded a net gain of $1,056 on the sale of four hotels included in 'Assets held for sale' (2013 – $1,259 on the sale of one hotel included in 'Assets held for sale').

## 21. UNREALIZED LOSS ON LIABILITIES PRESENTED AT FAIR VALUE

Fair value losses recorded are as follows:

| | Three Months Ended March 31, 2014 | Three Months Ended March 31, 2013 |
|---|---|---|
| Exchangeable units | $ 224 | $ 301 |
| Convertible debentures holders' conversion option | 7,847 | 16,927 |
| | $ 8,071 | $ 17,228 |

## 22. SEGMENT INFORMATION

The management of InnVest's operations is organized within four Canadian geographical regions: Western, Ontario, Quebec and Atlantic. Unallocated functions include the revenues and costs associated with InnVest's other real estate properties, and costs of central corporate services provided. All key financing, investing and capital allocation decisions are centrally managed.

### Revenues

| Three Months Ended March 31, 2014 | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| **Hotel properties** | **$ 35,328** | **$ 42,839** | **$ 20,523** | **$ 15,545** | **$ 114,235** |
| **Other real estate properties** | | | | | **196** |
| **Revenues** | | | | | **$ 114,431** |

| Three Months Ended March 31, 2013 | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| Hotel properties | $ 35,875 | $ 45,671 | $ 25,839 | $ 15,633 | $ 123,018 |
| Other real estate properties | | | | | 804 |
| Revenues | | | | | $ 123,822 |

### Net Loss

| Three Months Ended March 31, 2014 | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| **Hotel properties** | **$ 7,190** | **$ 5,467** | **$ 1,490** | **$ (540)** | **$ 13,607** |
| **Other real estate properties** | | | | | **(113)** |
| **Gross operating profit** | | | | | **13,494** |
| **Other expense, net** | | | | | **(48,365)** |
| **Net loss** | | | | | **$ (34,871)** |

| Three Months Ended March 31, 2013 | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| Hotel properties | $ 8,162 | $ 4,739 | $ 126 | $ 34 | $ 13,061 |
| Other real estate properties | | | | | 202 |
| Gross operating profit | | | | | 13,263 |
| Other expense, net | | | | | (55,211) |
| Income tax recovery | | | | | 282 |
| Net loss | | | | | $ (41,666) |

| **Hotel properties** | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| **March 31, 2014** | **$ 365,407** | **$ 435,943** | **$ 169,978** | **$ 129,777** | **$ 1,101,105** |
| December 31, 2013 | $ 377,719 | $ 438,537 | $ 169,331 | $ 149,916 | $ 1,135,503 |

| **Capital expenditures** | Western | Ontario | Quebec | Atlantic | Total |
|---|---|---|---|---|---|
| **Three months ended March 31, 2014** | **$ 6,353** | **$ 4,854** | **$ 3,585** | **$ 3,704** | **$ 18,496** |
| Three months ended March 31, 2013 | $ 1,322 | $ 3,153 | $ 399 | $ 924 | $ 5,798 |

## 23. SUBSEQUENT EVENTS

### Westmont Hospitality Canada Limited

On April 24, 2014, InnVest finalized changes to certain agreements with Westmont including the internalization of the asset management function effective November 30, 2014 and the amendment and extension of the hotel management agreement to reflect a reduction of base management fees from 3.375% to 2.95% along with a new incentive fee structure that will allow Westmont to earn up to 3.80% of gross hotel revenue each year. The new amended hotel management agreement will expire in April 2024.

### KingSett Capital

On April 24, 2014, InnVest entered into and closed a credit agreement with KingSett Capital ("KingSett") (the "Credit Agreement") pursuant to which KingSett has agreed to provide InnVest with a $50,000 subordinated loan facility (the "Term Loan"). KingSett has also provided an option to draw an additional $50,000 subordinated non-revolving stand-by liquidity facility (the "Liquidity Loan"). The Term Loan will be outstanding for four years and be subject to an up-front fee of $1,500 (the "Up-Front Fee") and interest payments of 8.75% per annum (the "Term Interest Payments"). In addition, in consideration for KingSett agreeing to provide InnVest with the Liquidity Loan, a $1,500 commitment fee is payable upon the closing of the Term Loan (the "Commitment Fee"). If drawn, the Liquidity Loan will be subject to interest payments of 9.5% per annum (the "Liquidity Interest Payments"). The Term Loan and Liquidity Loan are supported by a general security agreement.

In connection with the Credit Agreement, InnVest issued 573,361 units in satisfaction of the Up-Front Fee and the Commitment Fee. In addition, in the first year that the Term Loan is outstanding, a portion of the Term Interest Payments due in that year equal to 3% per annum will be payable in units at the option of KingSett and, if the Liquidity Loan is drawn, a portion of the Liquidity Interest Payments in that year equal to 3.75% per annum will be payable in units at the option of KingSett. During the three subsequent years, the same portions of the Term Interest Payments and the Liquidity Interest Payments will be payable in units if mutually agreed by KingSett and InnVest. InnVest's obligation to issue any units in satisfaction of the Up-Front Fee, the Commitment Fee and a portion of the Interest Payments will be subject to the receipt of applicable regulatory approvals and compliance with InnVest's internal policies, including its insider trading policy.

### Finance Lease Receivable and Financing Activity

On April 30, 2014, InnVest received the remaining balance of its finance lease receivable. The finance lease receivable related to a lease and sale arrangement for one Ontario hotel that was entered into in 2012. On April 30, 2014, InnVest repaid $45,398 relating to 2 pools of mortgages secured by 10 properties. The weighted average debt on these mortgages was 6.56%. One of these properties was included as assets held for sale.

### Convertible Debenture Redemption

On May 1, 2014, InnVest called its $70,000 Series C 5.85% Debentures (due August 1, 2014) for early redemption on June 3, 2014.

## 24. APPROVAL OF THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

These condensed interim consolidated financial statements were authorized for issue by the Board of Trustees of InnVest on May 7, 2014.

# Corporate and Unitholder Information

## Corporate Office

5090 Explorer Drive, Suite 700
Mississauga, Ontario L4W 4T9
Toll-free: 1-877-209-3429
Phone: 905-206-7100
Fax: 905-206-7114
Email: investor@innvestreit.com
Website: www.innvestreit.com

## Stock Exchange Listing

The Toronto Stock Exchange
Trading Symbol: INN.UN
Convertible Debentures:
INN.DB.C, INN.DB.D, INN.DB.E, INN.DB.F, INN.DB.G

## Registrar and Transfer Agent

Inquiries regarding change of address, registered holdings, transfers and duplicate mailings should be directed to the following:

Computershare Trust Company of Canada
100 University Avenue, 11th floor
Toronto, Ontario
Phone: 1-800-564-6253
Fax: 1-866-249-777

## Auditors

Deloitte LLP
Toronto, Ontario

## Distribution Reinvestment Plan

Unit holders may acquire units by reinvesting cash distributions without paying brokerage commissions or administrative charges. For general information concerning the Distribution Reinvestment Plan or for a change of address, please contact the transfer agent and registrar.

| | Ontario | | Quebec | | Atlantic | | Western | | Total | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| As of March 31, 2014 | No. of Hotels | No. of Guest Rooms | No. of Hotels | No. of Guest Rooms | No. of Hotels | No. of Guest Rooms | No. of Hotels | No. of Guest Rooms | No. of Hotels | % of No. of Guest Rooms | Total Guest Rooms |
| Comfort Inn | 28 | 2,249 | 20 | 1,556 | 14 | 1,029 | 8 | 652 | 70 | 5,486 | 35.2% |
| Delta Hotel | 1 | 220 | 2 | 337 | 4 | 1,017 | 2 | 689 | 9 | 2,263 | 14.5% |
| Holiday Inn | 9 | 1,565 | 1 | 176 | 1 | 196 | 1 | 151 | 12 | 2,088 | 13.4% |
| Quality Hotel, Quality Suites | 4 | 687 | 4 | 551 | 1 | 159 | 1 | 126 | 10 | 1,523 | 9.8% |
| Travelodge | 3 | 368 | – | – | – | – | 2 | 422 | 5 | 790 | 5.1% |
| Hilton Hotel | – | – | 1 | 571 | 1 | 197 | – | – | 2 | 768 | 4.9% |
| Fairmont Hotels & Resorts | – | – | – | – | – | – | 2 | 604 | 2 | 604 | 3.9% |
| Holiday Inn Express | 3 | 452 | – | – | – | – | – | – | 3 | 452 | 2.9% |
| Radisson Hotel/Suites | 2 | 388 | – | – | – | – | – | – | 2 | 388 | 2.5% |
| Staybridge Suites | 3 | 342 | – | – | – | – | – | – | 3 | 342 | 2.2% |
| Sheraton Suites | – | – | – | – | – | – | 1 | 323 | 1 | 323 | 2.1% |
| Best Western | 1 | 130 | – | – | – | – | – | – | 1 | 130 | 0.8% |
| Hilton Garden Inn | 1 | 120 | – | – | – | – | – | – | 1 | 120 | 0.8% |
| Hilton Homewood Suites | 1 | 83 | – | – | – | – | – | – | 1 | 83 | 0.5% |
| Independent | 2 | 226 | – | – | – | – | – | – | 2 | 226 | 1.4% |
| Total | 58 | 6,830 | 28 | 3,191 | 21 | 2,598 | 17 | 2,967 | 124 | 15,586 | 100.0% |

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InnVest REIT holds one of Canada's largest hotel portfolios together with an interest in Choice Hotels Canada Inc., one of the largest franchisors of hotels in Canada. Our portfolio comprises 124 hotel properties with approximately 15,500 guest rooms, operated under 14 internationally recognized brands.
www.innvestreit.com