

# Management Report of Fund Performance



## COVINGTON FUND II INC.

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This annual management report of fund performance contains financial highlights but does not contain the complete annual financial statements of Covington Fund II Inc. (the "Fund"). You can obtain a copy of the annual financial statements at your request, and at no cost, by calling 1-866-244-4714, by writing to us at Covington Capital Corporation, 36 Distillery Lane, Suite 440, Toronto, Ontario M5A 3C4, by visiting our website at [www.covingtonfunds.com](http://www.covingtonfunds.com) or on SEDAR at [www.sedar.com](http://www.sedar.com).

Shareholders may also contact us using one of these methods to request a copy of the Fund's proxy voting policies and procedures or proxy voting disclosure record.

**FORWARD LOOKING STATEMENTS**

This report may contain forward-looking statements about the Fund, its future performance, strategies or prospects, and possible future Fund actions. The words "anticipate", "could", "should", "may", "expect", "believe", "plan", "intends", "estimate", "forecast", "objective", "would"; and similar expressions are intended to identify forward-looking statements.

Forward-looking statements involve inherent risks and uncertainties, both about the Fund and general economic factors. It is not possible to guarantee that future performance, liquidity, predictions, forecasts, projections or other forward-looking statements will be achieved. Factors such as economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings or catastrophic events could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made by the Fund. Please consider these and other pertinent factors before making any investment decisions and do not place undue reliance on forward-looking statements. All opinions contained in forward-looking statements are subject to change without notice.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### INVESTMENT OBJECTIVES AND STRATEGIES

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The investment objective of the Fund is to realize long-term capital appreciation on part of the investment portfolio, and current yield and early return of capital on the remainder of the investment portfolio. The strategy to accomplish this is by investing in two different types of situations. The first is in companies which the Fund anticipates will have significant growth potential in early stage or expanding markets. The second is in more established steady growth companies which the Fund anticipates will provide current yield and early return of capital to the Fund. The Fund combines the tax benefits of a Labour Sponsored Venture Capital Corporation ("LSVCC") and a Labour Sponsored Investment Fund ("LSIF") while giving investors access to the venture capital market.

The Fund is now in its twentieth year of operations. The Fund has neither sold new subscriptions nor undertaken new investments in the past several years. In May 2018, the Manager announced that the primary focus is on optimizing the value of the investment holdings as it seeks out opportunities to exit the remaining portfolio investments over the next approximately 24-month period and return capital to unitholders.

Since the merger with the VenGrowth Funds in 2011, approximately 63% of the outstanding shares of the Fund have been redeemed for cash.

### RISKS AND UNCERTAINTIES

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The Fund is and always has been suitable for investors with a long-term investment focus and higher risk tolerance than conventional investment funds as discussed in the Fund's Annual Information Form.

**Liquidity risk** – Liquidity remains the largest risk factor facing the Fund. As at August 31, 2019, the Fund's investment portfolio consisted of 16 companies of which 1 is publicly traded and 15 are privately held. The majority of the Fund's total assets are held within private companies. The private illiquid nature and the follow-on funding required to support these companies continues to place liquidity pressures on the Fund. Exit opportunities for private companies within the portfolio are not certain and these investments cannot be readily converted to cash on an as needed basis. The exit strategy for venture backed companies is typically through mergers and acquisitions ("M&A") whereby strategic buyers may seek to augment their portfolios by purchasing smaller, private companies or, private companies may seek to grow themselves by accessing the public equity markets through an initial public offering ("IPO"). Uncertain M&A and IPO activity contributes to additional liquidity strain on the Fund.

The tax credit program for purchases of LSIFs has been phased out by the Ontario government. Additionally, the Federal government announced the phase-out of the LSVCC program after 2016 but reversed this stance in March 2016. The elimination of the program provincially along with market pressures has, in recent years, restricted the ability of all investment funds operating in this sector to raise significant amounts of capital. The Fund is closed to new subscriptions; as such, the Fund is dependent upon internal growth and portfolio exits in order to meet its investment objectives and provide liquidity to its shareholders via redemptions.

These on-going liquidity pressures in conjunction with significant and increasing redemption requests received immediately upon the Fund re-opening for redemptions have caused the Fund to close for redemptions.

**Valuation risk** – The process of valuing venture investments for which no published market exists is subject to inherent uncertainties and the resulting values may differ from values which would have been ascribed had a ready market existed for those investments. This is valuation risk as described in the Fund's financial statements.

**Portfolio risk** – Virtually all of the Fund's venture holdings are in private companies. As the portfolio matures and exits occur, the portfolio concentration may change. For example, investments in the biotechnology sector are typically longer-term holds with varying levels of economic outcomes; as such, the weighting of biotech holdings within the portfolio as a whole may fluctuate over time. This is a concentration risk which may impact portfolio performance as different sectors experience market and economic fluctuations differently from one another. For example, at its peak, the biotechnology/health science sector has accounted for as much as 56% of the Fund's overall venture portfolio value but was represented by 25% of the companies within the portfolio. At year end, this sector represented 37% of the portfolio value held in 24% of the holdings. Volatility within the public markets could also place additional market risk within the venture portfolio.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### RESULTS OF OPERATIONS

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The total net assets attributable to holders of redeemable shares of the Fund (the "NAV") were \$55,624 compared to \$65,957 as of August 31, 2018. The decrease in NAV is mainly due to operating expenses of \$3,135 and overall net losses related to portfolio activity of \$6,922. The Fund's cash position at year-end was \$16,822 to provide the Fund with liquidity to not only fund operations and to support existing companies within the portfolio but also for future distributions to the unitholders. The Fund's venture portfolio value as of August 31, 2019 was \$39,450 compared to \$70,874 on August 31, 2018.

Fund expenses for the fiscal year ended August 31, 2019 totalled \$3,135 which is down from \$4,483 in 2018. While NAV based expenses have fallen relative to the decrease in assets under management, expenses have decreased overall as they relate to non-recurring items namely: loan fees and interest, contingent incentive participation amounts and other investee specific fee income/expense.

The MER for Class A Shares, Series I was 5.01% and 4.99% for Class A Shares, Series II, down from 5.43% and 5.37% respectively in 2018.

### RECENT DEVELOPMENTS

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Covington is moving toward a windup of the Fund in the next 12-18 months while managing exits of the remaining portfolio holdings with a goal to optimize and distribute proceeds to the unitholders.

On May 7, 2018, the Fund was re-opened for redemptions totalling approximately \$10,000. Upon completion of this redemption, the Manager announced that the primary focus is on optimizing the value of the investment holdings as it seeks out opportunities to exit the remaining portfolio investments over the next approximately 18 to 24-month period and return capital to unitholders.

On September 8, 2015, the Fund announced a temporary hold on redemptions given the magnitude of redemption requests had the potential to eliminate the liquidity required to operate the Fund in an efficient manner. The Fund was re-opened again January 18, 2016, October 24, 2016, and May 7, 2018; and subsequently halted each time as available cash limits were reached.

The fair value of the Fund's portfolio will continue to be determined every week and there are currently no changes to the valuation approach to its private investments as a result of the recent suspension of redemptions event. The challenge remains to optimize exit values for the private investments while trying to meet redemption requests from shareholders. It is not in the best interest of the Fund nor the portfolio companies to accelerate exits to the detriment of obtaining a fair value on those exits in the current marketplace.

### RELATED PARTY TRANSACTIONS

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The Manager and Sponsor are deemed to be related parties to the Fund. Please refer to the section entitled "Fees and Expenses" which outlines the fees paid to these related parties or Note 7 in the Fund's 2019 financial statements.

CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

FINANCIAL HIGHLIGHTS

The following tables show selected key financial information about the Fund and are intended to help you understand the Fund's financial performance.

FUND'S NET ASSETS ATTRIBUTABLE TO HOLDERS OF REDEEMABLE UNITS

	Year ended August 31, 2019	Year ended August 31, 2018	Year ended August 31, 2017	Year ended August 31, 2016	Year ended August 31, 2015
<b>SERIES I</b>					
Net assets attributable to holders of redeemable units, beginning of year <sup>(1)</sup> <sup>(2)</sup>	\$ 4.58	\$ 5.58	\$ 6.83	\$ 8.16	\$ 8.98
Increase (decrease) from operations:					
Total revenue	1.31	0.01	0.07	1.22	0.08
Total expenses	(0.22)	(0.28)	(0.44)	(0.39)	(0.46)
Realized gain (loss) on investments	(3.04)	(0.06)	0.27	(1.46)	0.89
Unrealized gain (loss) on investments	1.25	(0.67)	(1.11)	(0.77)	(1.35)
Total increase (decrease) from operations <sup>(2)</sup>	(0.70)	(1.00)	(1.21)	(1.40)	(0.84)
Net assets attributable to holders of redeemable units, end of year <sup>(1)</sup> <sup>(2)</sup>	\$ 3.88	\$ 4.58	\$ 5.58	\$ 6.83	\$ 8.16
<b>SERIES II</b>					
Net assets attributable to holders of redeemable units, beginning of year <sup>(1)</sup> <sup>(2)</sup>	\$ 4.36	\$ 5.31	\$ 6.50	\$ 7.78	\$ 8.59
Increase (decrease) from operations:					
Total revenue	1.25	0.01	0.07	1.19	0.07
Total expenses	(0.21)	(0.27)	(0.43)	(0.39)	(0.48)
Realized gain (loss) on investments	(2.90)	(0.06)	0.25	(1.44)	0.85
Unrealized gain (loss) on investments	1.19	(0.64)	(1.04)	(0.69)	(1.21)
Total increase (decrease) from operations <sup>(2)</sup>	(0.67)	(0.95)	(1.15)	(1.33)	(0.77)
Net assets attributable to holders of redeemable units, end of year <sup>(1)</sup> <sup>(2)</sup>	\$ 3.69	\$ 4.36	\$ 5.31	\$ 6.50	\$ 7.78

(1) This information is derived from the Fund's audited annual financial statements. The net assets attributable to holders of redeemable units per unit presented in the financial statements may differ from the net asset value per unit calculated for fund pricing purposes.

(2) Net assets attributable to holders of redeemable units are based on the actual number of shares outstanding as at the stated dates. The increase/(decrease) from operations is based on the weighted average number of shares outstanding over the fiscal period.

# COVINGTON FUND II INC.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### RATIOS AND SUPPLEMENTAL DATA

<b>SERIES I</b>	<b>Year ended August 31, 2019</b>	Year ended August 31, 2018	Year ended August 31, 2017	Year ended August 31, 2016	Year ended August 31, 2015
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ 34,467	\$ 40,847	\$ 56,758	\$ 84,636	\$ 127,748
Number of shares outstanding	8,881,037	8,914,877	10,165,503	12,385,692	15,655,888
Management expense ratio <sup>(2)</sup>	5.01%	5.43%	6.87%	5.35%	5.33%
Management expense ratio before IPA <sup>(2)</sup>	5.01%	5.53%	6.41%	4.28%	4.69%
Portfolio turnover rate <sup>(3)</sup>	4.87%	7.38%	3.94%	39.54%	20.42%
Trading expense ratio <sup>(4)</sup>	0.02%	-	-	0.07%	0.08%
Net assets attributable to holders of redeemable units per unit	\$ 3.88	\$ 4.58	\$ 5.58	\$ 6.83	\$ 8.16
<b>SERIES II</b>					
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ 21,157	\$ 25,110	\$ 35,552	\$ 56,194	\$ 86,840
Number of shares outstanding	5,729,460	5,760,376	6,699,307	8,645,176	11,166,508
Management expense ratio <sup>(2)</sup>	4.99%	5.37%	6.95%	5.56%	5.81%
Management expense ratio before IPA <sup>(2)</sup>	4.99%	5.47%	6.49%	4.49%	5.17%
Portfolio turnover rate <sup>(3)</sup>	4.87%	7.38%	3.94%	39.54%	20.42%
Trading expense ratio <sup>(4)</sup>	0.02%	-	-	0.08%	0.08%
Net assets attributable to holders of redeemable units per unit	\$ 3.69	\$ 4.36	\$ 5.31	\$ 6.50	\$ 7.78

(1) This information is provided as at August 31 of the years shown.

(2) Management expense ratio includes all fees, expenses, capital taxes, HST and the Manager's conditional IPA and is expressed as an annualized percentage of the average net assets administered during the period. Conditional IPA is the determination of the bonus that would be payable to the Manager if the Fund were to dispose of its venture investment at its carrying value as at the dates shown. The Manager is entitled to this bonus only upon realization of certain conditions as outlined in the Fund's prospectus and/or annual information form.

(3) The Fund's portfolio turnover rate indicates how active the Fund's portfolio advisor manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund buying and selling all of the securities in its portfolio once in the course of the period. The higher a fund's portfolio turnover rate in a period, the greater the trading costs payable by the fund in the period, and the greater the chance of an investor receiving taxable capital gains in the period. There is not necessarily a relationship between a high turnover rate and the performance of a fund.

(4) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net assets during the period.

### MANAGEMENT FEES

Covington, as the Manager, is responsible for directing the business, operations and affairs of the Fund and for implementing the investment strategy, monitoring the Fund's investments and providing management assistance to portfolio companies. Because the portfolio companies of the Fund are generally small in size and at an earlier stage of development relative to conventional mutual funds, the Fund requires a greater level of management involvement in the analysis, monitoring support and development activities.

Covington uses its management fees to finance its operations as follows: approximately 98% for general administration over the affairs of the Fund including implementation of the Fund's investment strategy, portfolio management and financial monitoring, retaining and supervising service providers and managing its overall business affairs and 2% for the implementation of communications, sales, marketing, and distribution strategies.

CLASS A SHARES

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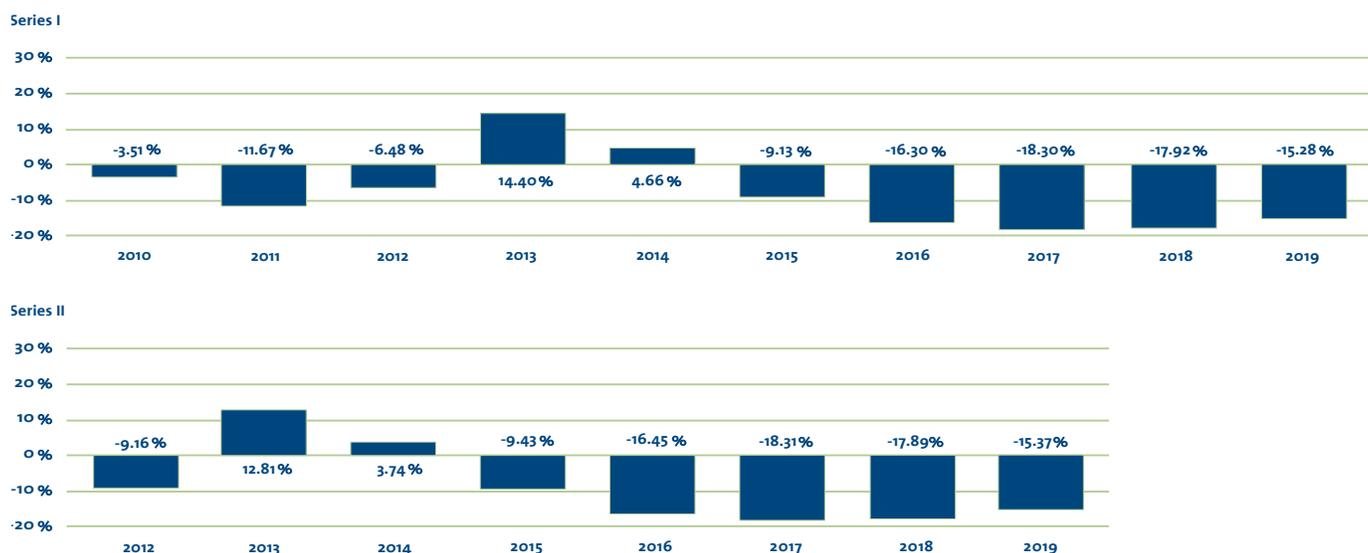
MANAGEMENT FEES - Continued

The Fund pays annual fees of 1.35% of the net asset value of the Fund for management services. The Fund's management expense ratio ("MER") consists of all of its operating expenses, including sales commissions, certain ongoing marketing costs of the Fund, audit and legal expenses, fees paid to any independent valuator, IPA (if any), and certain consultancy costs. The largest component of the MER are fees that are calculated as a percentage of the NAV of the Fund and these fees are the management fees, Vengrowth contract amount, the capital maintenance fees, the Co-Sponsor's fees and the Transfer Agent's fees. For a summary of these fees, please see Note 7 to the Fund's audited financial statements.

PAST PERFORMANCE

Year by Year Non-Cumulative Returns

The graph below indicates the Fund's annual performance for each of the years shown and how the Fund's performance has changed from year to year. It also shows, in percentage terms, how an investment made on the first day of each financial year should have increased or decreased by the last day of each financial year. The Fund's past performance is no guarantee of how it will perform in the future.



Annual Compound Returns

The table below summarizes the Fund's past performance for the past ten, five, three and one year periods from August 31, 2019. As a basis of comparison, we have provided the Retail Venture Capital Index as posted on www.globefund.com as of August 31, 2019.

The Retail Venture Capital Average is the most representative broad-based securities market index as it accumulates all the Ontario based LSIFs. The S&P/TSX Venture Composite Index is included as an indicator for the TSX Venture Exchange, which lists Canadian companies that do not meet the criteria to be listed on the Toronto Stock Exchange. These companies tend to be earlier stage and may be technology focused thereby providing a benchmark for a maturing venture capital portfolio.

Compound Returns	Series I	Series II	Retail Venture Capital Average*	S&P/TSX Venture Composite Index
1 Year	-15.28%	-15.37%	-5.57%	-18.41%
3 Years	-17.18%	-17.20%	-3.20%	-9.78%
5 Years	-15.45%	-15.55%	-3.82%	-9.61%
10 Years	-8.48%	N/A	-5.61%	-7.45%
Since Inception	-4.86%	-9.33%	**	**

\* Source: globefund.com

\*\* No comparable index available for the same period.

**CLASS A SHARES**

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

**SUMMARY OF INVESTMENT PORTFOLIO**

Below is a summary of the Fund's portfolio as at August 31, 2019. This is a summary only and may change due to ongoing portfolio activity in the Fund. See the Statement of Investment Portfolio in the financial statements for a complete listing. An update is available quarterly on Covington's website at [www.covingtonfunds.com](http://www.covingtonfunds.com).

**HOLDINGS <sup>(1)</sup>**

	<b>Debt at cost</b>	<b>Equity at cost</b>	<b>Total at cost</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>
Axela Inc.	24,149	-	24,149
Mist Mobility Integrated Systems Technology Inc.	16,775	2,250	19,025
Interface Biologics Inc.	-	17,473	17,473
PowerBand Global Inc.	2,488	8,446	10,934
OTYC Holdings Inc.	-	6,820	6,820
Clek Inc.*	674	5,458	6,132
Embotics Corporation	-	6,079	6,079
Ivey CSBIF I Inc.	-	1,814	1,814
Ivey CSBIF II Inc.	-	1,814	1,814
Fusebill Inc.	-	1,615	1,615
Fidelity PAC Metals Ltd.	892	-	892
Spartan Bioscience Inc.	-	231	231
bitHeads Inc.	98	-	98
Black Bull Resources Inc.†	-	6	6

\* Investment made and tracked in US\$.

† Indicates a publicly traded security.

(1) Excluding cash and short-term investments.

CLASS A SHARES

[in \$000's of Canadian dollars except for number of companies and percentages]

SUMMARY OF INVESTMENT PORTFOLIO - *Continued*

Stage of development	Number of companies	Cost of investments \$	% Total venture investments at cost %	Fair value of investments \$	% Total venture investments at fair value %
Start-Up/Early	5	25,398	26.2	16,856	42.7
Expansion	9	60,750	62.6	22,484	57.0
Later	2	10,934	11.2	110	0.3
	16	97,082	100.0	39,450	100.0
<b>Industry class</b>					
Biotechnology/Health Sciences	4	48,673	50.1	14,462	36.6
Financial Services	2	3,628	3.7	2,306	5.9
Technology	6	18,726	19.3	2,725	6.9
Manufacturing/Distribution	4	26,055	26.9	19,957	50.6
	16	97,082	100.0	39,450	100.0
				Fair value of investments \$	% of Net asset value %
<b>Composition of net assets</b>					
Venture investments, at fair value				39,450	70.9
Other assets, net of liabilities				16,174	29.1
<b>Net assets attributable to holders of redeemable units</b>				55,624	100.0

**Fund Symbols**

**Covington Fund II Inc.**

CIG912 - Closed

CIG 961 - Closed

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